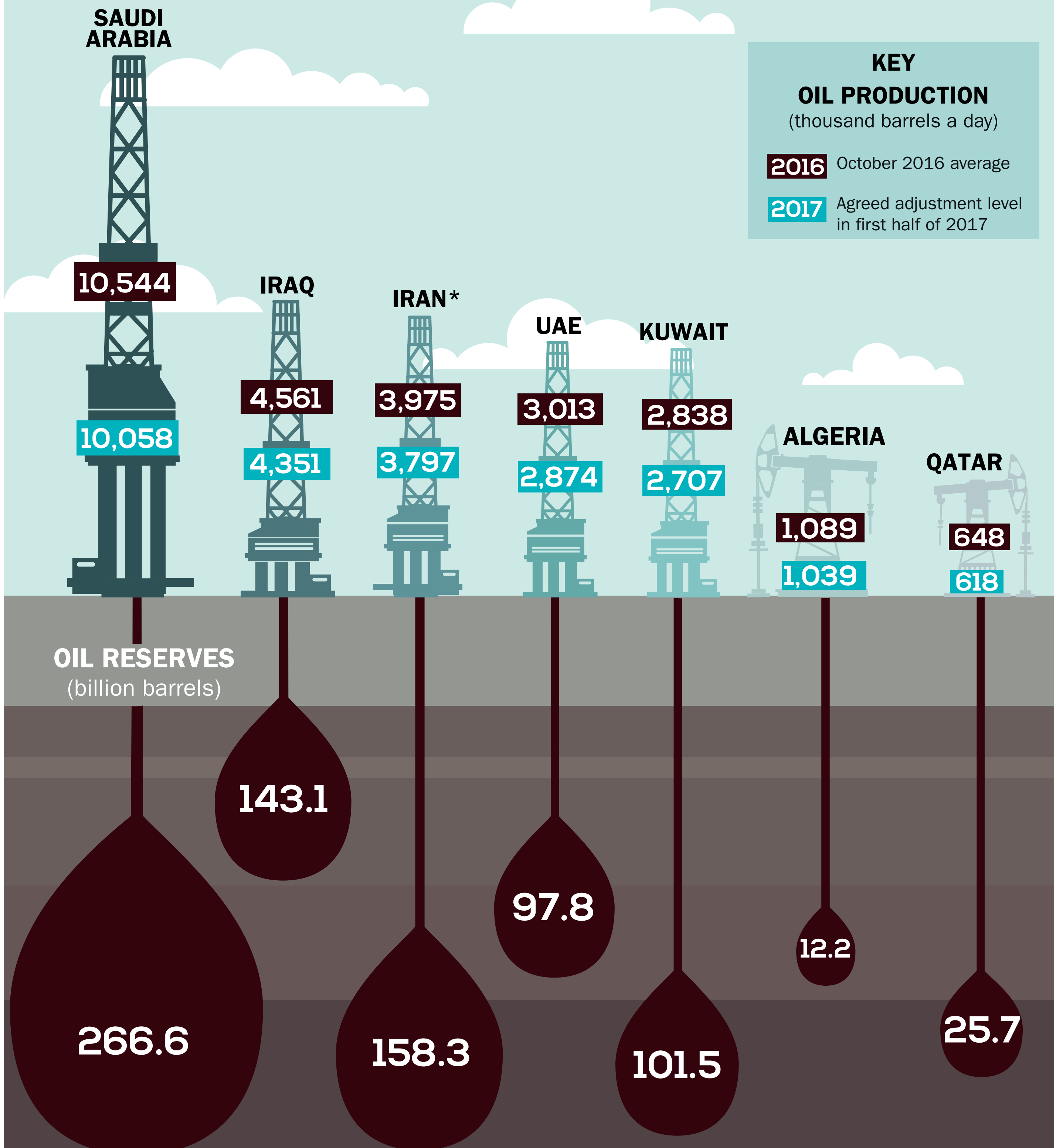
BALANCING THE MARKET

Opec members in the Middle East and North Africa have agreed to set aside their differences and cut oil production to shore up prices



*=Opec data for Iran showed a +90 adjustment, but is calculated as a cut of 178. Sources: Opec (production); BP (reserves)

ADAPTING TO THE NEW NORMAL

With crude prices unlikely to recover to previous peaks, the region's oil companies must adapt their strategies

By Mark Watts

Few in the region in 2014 were prepared for the shock of the longest sustained crash in oil prices in history. After four years of staying consistently above $100 a barrel, oil prices lost more than half their value in just four months and the revenues of the region's national oil companies (NOCs) were slashed in half.

With the majority of forecasts for the next two years predicting prices will average below $60 a barrel, NOCs must now adapt to a 'new normal' for the market, with no guarantees that prices will ever rise back toward previous highs.

Despite being tight-lipped about their plans, some NOCs have been quick to react to the new reality of lower revenues with measures including consolidations, job cuts, spending reductions and – in the case of Saudi Aramco – a plan to open up the books for a public stock market listing.

At the same time, the global oil industry has been facing a period of sharp consolidation, with international oil companies (IOCs) in particular being hit hard by the drop in crude prices over the past 30 months.

UK/Dutch Shell has announced more than 10,000 job cuts since the oil price fell, and the UK's BP revealed plans to lay off 7,000 workers at the start of last year .All oil giants have reported tumbling profits and even losses in recent quarterly and annual results.

Double-edged sword

The effect of low prices on Middle East NOCs has been double-edged. On the positive side, low production costs mean NOCs are still highly profitable on a per-barrel basis at $40-$60, although their higher-cost, non-Opec competitors have suffered as capacity

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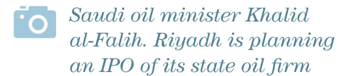


Saudi oil minister Khalid al-Falih. Riyadh is planning an IPO of its state oil firm

is shut in and investment falls out of the market.

At the same time, NOCs bear a larger burden than IOCs as they are responsible for funding the spending programmes of their respective governments. With state budgets reduced by lower oil revenues, NOCs are potential targets for cost-cutting and consolidation.

"For NOCs in the region, the reality is that $50-$60 a barrel prices are the new norm," says Mustafa Ansari, analyst at Saudi-headquartered Arab Petroleum Investments Corporation. "It is very unlikely we will see prices go back up toward $100, so governments will have to adjust to lower revenues.

"Therefore, NOCs won't have the luxury of investing as they have done in the past, particularly in upstream projects. They will need to open up … and attract foreign investors and international oil companies to come and invest."

Ansari says the reduced ability to invest could lead to a trend of more partnerships between NOCs and IOCs as state-owned firms look to share risk and attract more funding.

Cutting costs

NOCs have already reacted to lower oil prices with cost-cutting measures. In May 2015, Abu Dhabi National Oil Company (Adnoc) said it asked its operating companies to cut operating expenditure (opex) by 10-15 per cent. This was followed by reports of significant job cuts at Qatari and Abu Dhabi national oil and gas companies.

Adnoc made a raft of changes, including replacing its CEO, the heads of its gas and petrochemicals businesses, and the CEOs of six operating companies, and later announced the merger of its two large offshore oil producers as well as combining three logistics arms.

The biggest reaction to the pressure of lower crude prices in the Middle East oil sector is perhaps the planned initial public offering (IPO) of the world's largest oil company Saudi Aramco.

Valuing Saudi Arabia's oil giant at an estimated $2 trillion, the flotation would be unprecedented as Aramco would be obligated to reveal details such as the size of the kingdom's oil and gas reserves.

Estimates vary over the impact of lower crude prices on investment in the Middle East oil and gas sector.

According to data from regional projects tracker MEED Projects, investment in the Middle East and North Africa (Mena) hydrocarbons sector hit an eight-year low in 2016. The value of engineering, procurement and construction contract awards in the region dropped 34 per cent to $32.4bn.

However, the higher spending in 2014 and 2015 was largely down to Kuwait's huge refinery expansion programme, while investment in 2016 was broadly in line with the 2011-13 period of peak oil prices.

UK-based oil and gas consultancy Wood MacKenzie forecasts 6 per cent growth in upstream investment to $76bn in the Mena region in 2017. This would take investment just 9 per cent below the level before the collapse in crude prices.

"The region as a whole has remained – even under the low oil prices – relatively robust," Jessica Brewer, principal analyst for Middle East

State oil firms are expected to continue investing in oil

upstream oil and gas at Wood MacKenzie, tells MEED. “And if you look at North Africa, we have actually seen an increase in spending, driven by gas developments.”

“The NOCs will continue investing in oil to sustain capacity. I would imagine even with the Opec cuts they will want to keep capacity at similar levels,” she says, adding that the majority of investment decisions in new upstream schemes in the region in 2017 are expected to be in the gas sector.

The impact of crude prices on investment has varied widely from country to country. Iraq has suffered a significant slowdown since the majority of its oil assets are tied to IOCs through cost-recoverable contracts. This has led to spending being deferred and potentially significant delays to Baghdad’s goals of boosting oil production.

Unpredictable market

As ever, the crude market is unpredictable and forecasters disagree about the extent to which prices will recover in 2017. Following the agreement between Opec and some non-Opec producers, including Russia, to cut output for the first half of 2017, the consensus is an improvement in average prices following a 13-year low of $43.33 a barrel last year.

The US-based Energy Information Administration in its January short-term outlook forecast an improvement to just $52.5 a barrel for Brent this year, followed by $55.18 in 2018 – hardly a great boon to oil-export-reliant countries in the Mena region.

In a December 2016 forecast, UK bank Barclays predicted Brent would rise to an average of $62 a barrel in the second quarter of 2017, but fall back to $53 in the fourth quarter.

Others are more optimistic. Richard Mallinson, analyst at UK-based consultancy Energy Aspects, thinks the Opec/non-Opec deal will send prices upwards by the second half of 2017.

“The deal has sustainably rebalanced the market,” he says. “Our view is the prices are not going to get stuck below $60.

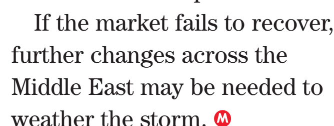
“We think it will take some time for the effects of the deal to work their way through and draw down the inventory overhang, but as we progress into the second half of 2017, we think oil prices are going to head comfortably past $60 and toward $70 … even with a substantial ramp up in US shale production.”

The performance of oil prices in the aftermath of the production cut deal is key. If little recovery is felt in 2017, then Middle East NOCs will have to shift their strategies to prepare for an indefinitely long period of Brent hovering at half the level they had become used to in the 2011-14 boom period.

The planned IPO of Aramco will be a good litmus test for how far governments feel they have to take the reforms at NOCs. There are already reports the flotation could be pushed back from its proposed 2018 date due to the recent rise in oil prices.

If the market fails to recover, further changes across the Middle East may be needed to weather the storm.

PHOTOGRAPH: REUTERS



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