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LOW COSTS OF OIL PRICES IMPACT ENERGY DECISIONS: GEOPOLITICS AND INVESTMENTS

The world has faced declining and low oil prices since late 2014.\(^1\) As oil prices continue to drop and remain low, energy-dependent companies are struggling to meet short-term goals.\(^2\) However, due to the near certain long-term increase in global energy costs, these struggles and low prices should be viewed as temporary.\(^3\) As companies face the current low prices of oil, they should be careful not to be too shortsighted. Reducing or delaying production of expensive to extract resources may be wise for now but offloading oil assets and infrastructure altogether would be an unwise long-term decision.

Oil prices began to fall significantly in late 2014.\(^4\) In a matter of months, the price fell by more than 40%, resulting in the lowest prices for crude since 2004.\(^5\) This drop came on the heels of five years of relatively stable oil prices.\(^6\) The price slump for crude oil and natural gas has lasted longer than expected, encompassing the first part of 2016.\(^7\) Anticipated oil prices for 2016 are $34 per barrel on average, which is over a 70% drop from the prices in June of 2014.\(^8\)

Several dynamics have continued to contribute to the downturn in price. Despite a host of “peak oil” naysayers in the past decade, current supply is far outpacing demand.\(^9\) This excess supply is partially driven by Saudi Arabia’s,

\(^3\) Martin Pelletier, Why the Price of Oil Will Recover Faster Than You Think, FIN. POST BUS. (Jan. 18, 2016), http://business.financialpost.com/investing/investing-pro/why-the-price-of-oil-will-recover-faster-than-many-think__lsa=eac8-646a (Discussing both the production patterns of oil producers and the cyclical nature of oil prices).
\(^4\) Why the Oil Price Is Falling, supra note 1.
\(^5\) Berthelsen, supra note 2.
\(^6\) Id.
\(^7\) Berthelsen, supra note 2.
\(^8\) Id.; see also Why the Oil Price Is Falling, supra note 1 (the price per barrel in June of 2014 was $115 per barrel).
and subsequently OPEC’s, unwillingness to cut production. The OPEC motive for keeping production high appears to be two fold. First, OPEC has animosity towards the nations that the low prices hurt the most, including Russia. Second, OPEC hopes to put some of their greatest competition out of business, namely American frackers and other high expense producers. The idea being that fracking and tar sands, which have break-even points between $50 and $80 per barrel respectively, would not be able to survive a $34 per barrel market. The results of this low price market have been as expected for high expense producers: they have suffered terribly.

There are three questions for OPEC and the world. First, can this price war last long enough to put enough companies out of business that it will make a long-term impact? Second, if it can last long enough to put companies out of business, what does that mean? Third, where will OPEC be sitting at the end of it all?

The answer to the first question is simply that it depends on the individual company. For companies that require constant production revenue to stay afloat, especially in cases of debt, the Saudi tactic combined with Saudi Arabia’s $900 billion dollar reserve will pose a significant problem. However, for companies who can sit out the slump without active production, this tactic will only delay their profit but will not permanently harm them. This ties into the second question, what happens long-term even if the Saudi tactic is successful. The answer, from most people’s perspective, is absolutely nothing. Some companies may go out of business but that does not change the reality of oil presence in the ground. Therein lies the beauty of mineral resources like oil and natural gas: they do not spoil just sitting in the ground. Oil and natural gas reserves are a passive asset and require no maintenance. Whether it is the companies currently in legal possession or another business altogether, the oil will remain ready to produce as long as needed. In either case, production can resume when prices rebound. Which brings up the final question: what does OPEC achieve by overproducing? The answer is relatively

10 Id.
11 Why the Oil Price Is Falling, supra note 1.
12 Klare, supra note 9.
13 Id.
14 Id.
15 Why the Oil Price Is Falling, supra note 1.
little economically. Currently OPEC is motivated by preserving its market share.\textsuperscript{17} OPEC may be able to crush production dependent companies out of business for a time but this does not destroy the oil assets in the ground. Wherever one company fails, it will be possible for another company to take over their oil assets. There is no reason why one company is preferable to another from OPEC’s perspective. Long-term OPEC would benefit as much as anybody from high prices. The motivation in this case appears to be more political than economic: a smaller market share means less of a voice in the international community. Economically there is no significant impact from a smaller market share, so long as the oil goes to market.

Long-term, oil prices are likely to recover. Despite Saudi efforts, low prices “are forcing all producers to freeze their production.”\textsuperscript{18} The result of the forced reduction in production may be a market “correction” according to some.\textsuperscript{19} It is clear that many companies still producing oil are losing money, due to low prices.\textsuperscript{20} Additionally, while there is an oversupply, there has not been a reduction in demand for oil.\textsuperscript{21} Indeed, demand for oil has grown, but not as quickly as the supply did when certain fracking and tar sands reserves came into production.\textsuperscript{22} These factors, taken together with the historical cyclical nature of oil markets, indicate that a recovery will occur in the future: it’s simply a question of time.\textsuperscript{23}

Saudi decision to flood the market with oil has the potential to skew the investing picture. Low oil prices discourage investment. The problem is that Saudi Arabia ramping up production has resulted in an artificially weak oil market.\textsuperscript{24} The weak market has been reflected both in terms of crude prices and the investment market more broadly.\textsuperscript{25} Companies are already responding to this weak market in how they are investing in infrastructure around the oil

\textsuperscript{17} Klare, supra note 9.
\textsuperscript{19} Id.
\textsuperscript{20} Parasie & Said, supra note 18.
\textsuperscript{21} Klare, supra note 9.
\textsuperscript{22} Id.
\textsuperscript{23} Pelletier, supra note 3.
\textsuperscript{24} Id.
\textsuperscript{25} See Evelyn Cheng, S&P, Dow snap 5-day win streak as energy drops 4%, CNBC (Mar. 8, 2016), http://www.cnbc.com/2016/03/08/us-markets.html.
industry. Specifically, there has been a drop in investing in difficult to extract resources. The question then is exactly how should companies handle this artificial market. There are two things that investors should probably do. First, it is likely prudent to delay producing difficult to extract oil because those projects are currently going to lose money. In oil this means reducing drilling and delaying wildcat operations. Second, investors should recognize that difficult to extract oil projects will become profitable again when the current oil market rebalances itself. Thus, it would be unwise to jump ship on hard to extract resources altogether. One method that could be quite lucrative is acquiring mineral resources but not developing new fields, with the large expense that entails, until a market correction occurs. Companies may want to even reduce well unit production on producing wells to pick up the profit of higher prices down the road. The challenge with this is that a company must be able to wait until the market corrects before they will see their investments return. For some companies that proposition simply requires too much cash. For those who can afford to wait it out, this is likely a winning strategy. A prime example is Chevron, which is opting to keep their debt low, making modest investments and waiting out the storm on the premise that oil will rebound.

In conclusion, it’s a buyers’ market when it comes to unproduced oil reserves. Those with the capital to invest in oil without the necessity of immediate oil profits should potentially consider investing in mineral reserves, as these are likely to gain value in the future. Similarly, this is not a good time for energy companies to bring new large-scale production on line or to start exploration projects for new fields. Production is currently not where companies should be looking. However, if companies check out of infrastructure investment too far, they may not be able to act fast enough to

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27 Klare, supra note 9.

28 Id.

29 Pelletier, supra note 3.

30 Id.

31 Persinos, supra note 16.


33 Paton, supra note 32 (discussing the need for companies to reduce the size of projects and the rate at which they bring resources in to production).
react to the uptick in price when the market turns around. In the meantime, individuals can enjoy significantly discounted prices at the pump.

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