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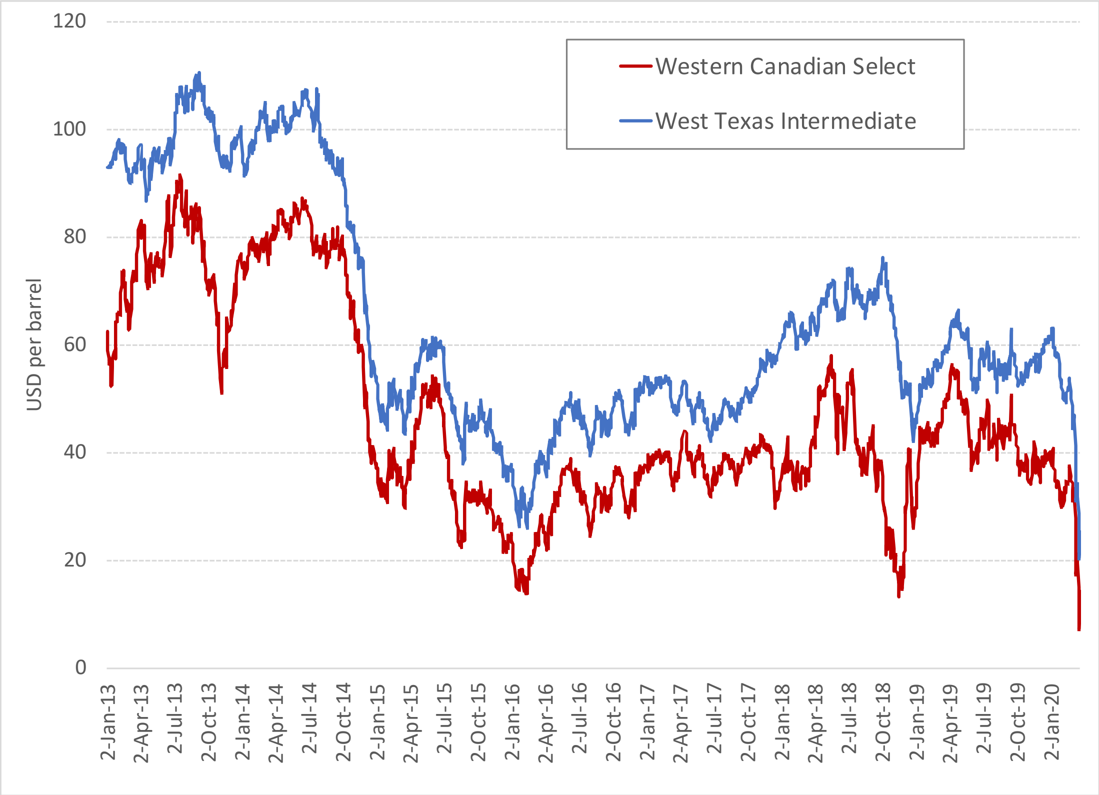
ADDRESSING THE THREAT OF COVID-19 AND THE OIL PRICE WAR IN THE PETROLEUM SECTOR

Canada's petroleum sector faces the dual challenges of the COVID-19 epidemic and an oil price war between two of the world's largest producers. Helping this sector to stay solvent will mean it is ready to contribute to Canada's and Alberta's economic recovery when conditions improve, and avoids adding to Alberta's already-concerning backlog of orphaned wells.

Canada's petroleum sector has never faced a greater threat to its existence than it does right now. It is Canada's largest export sector (Government of Canada n.d.), and represents a very large (27% in 2018) share of Alberta's economy (Government of Alberta n.d.). What happens to this sector is important for all Albertans and Canadians. The week of March 16th, West Texas Intermediate (WTI), the benchmark for oil in North America, traded at less than US$23 per barrel (bbl). Worse still, Western Canadian Select (WCS), the benchmark for Canada's heavy oil, traded for less than US$10 per bbl, an all-time low price.

On Friday, March 13th, Russia and Saudi Arabia failed to reach an agreement to reduce global oil supplies in the face of weakening demand for crude oil from the COVID-19 response. Both vowed to increase supplies to gain market share no matter what that would do to global oil prices. Saudi Arabia is increasing its production by about 2.5 million barrels per day (bpd) (about 2% of global oil supply (IEA 2020)), while Russia is increasing supplies by up to 0.5 million bpd. Goldman Sachs has estimated that global demand for crude oil could decline by 8 million bpd by the end of March due to the COVID-19 response, resulting in an imbalance of over 10 million bpd (10% of global supply), rapidly filling all available global storage, disrupting physical distribution networks, and placing continued pressures on prices (Business Today 2020, Stevens 2020). Figure 1 shows how dramatic the drop in prices has been over the past few days.

Figure 1: Daily West Texas Intermediate (WTI) and Western Canada Select (WCS) Prices, USD per barrel (Jan. 2, 2013 to Mar. 20, 2020)



Data Sources: WTI: Bloomberg, WTI Price in Cushing, WSCRWTIC (Jan. 3, 2013 to Feb. 12, 2020); Daily Oil Bulletin, NYMEX WTI (Feb. 13, 2020 to Mar. 20, 2020). WCS: Bloomberg, WCS Price Index, WSCRWCAS (Jan. 3, 2013 to Feb. 12, 2020); Daily Oil Bulletin, NE2 WCS Closing Price (Feb. 13, 2020 to Mar. 20, 2020).

Canada had already suffered a massive decline in capital spending by the petroleum sector. In 2014 annual capital spending in the industry totalled CAD $80 billion, made up of $47 billion in the conventional sector and $34 billion in the oil sands (ARC Energy Research Institute 2020). By 2019, investment was just $35 billion ($23 billion in the conventional sector and $12 billion in the oil sands),

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a decline of 56%. The Canadian industry adapted to previous price falls, and the companies who survived are leaner and more efficient.

Early in the year, 2020 was expected to see a similar level of investment to 2019 (ARC Energy Research Institute 2020), but over the past two weeks a number of exploration and production (E&P) companies have lowered their spending plans as they face much-lower oil and gas prices and deal with COVID-19 (Varcoe 2020). Announced capital reductions already total more than $4.5 billion for 2020 (BMO Capital Markets 2020).

There are hundreds of companies in the service sector to supply the E&P companies with services like engineering, drilling, well completions, camps, fabrication and assembly and other services. These companies' health is directly tied to the health and capital spending plans of the E&P sector. With the weak economic conditions over the past few years, some of these service sector companies had moved a portion of their operations to the US, where there was more active spending and production was growing. Today that option is no longer viable — the Russia/Saudi Arabia price war and COVID-19 response have essentially closed that option.

Canada needs to very quickly implement a strategy to allow the majority of companies in its petroleum sector, which faces the dual challenges of the COVID-19 pandemic and an oil price war between two of the world's largest producers, to stay solvent through this crisis, so that they are ready to contribute to Canada's and Alberta's economic recovery when conditions improve. Moreover, helping the petroleum sector stay solvent in the current crisis avoids adding to Alberta's already-concerning backlog of orphaned wells.

Most of these companies have little ability to take on additional debt due to restrictions in their existing loan covenants (e.g., debt to cash flow ratio, with much lower cash flow amounts being available for this calculation in these crisis conditions), and it would be virtually impossible to issue new equity in the current market environment. This speaks to the need for governments to become involved in providing more flexible financing. This could take the form of sub-ordinated debt with payments structured to reflect a company's ability to pay, or perhaps cumulative preferred shares. Cumulative preferred shares would be counted as equity on a company's balance sheet, and would provide a pre-determined dividend when the company has the ability to pay it. This structure could be put in place quickly and would provide flexibility in getting through this crisis period of unknown length. It could more effective than governments purchasing common shares of the companies at current extremely depressed prices.

The total enterprise value of 20 publicly traded companies in the energy service sector as of early March was about $14 billion, and debt made up about $8 billion of that value, or nearly 60% (Peters & Co. Limited 2020). If government investment of $2 billion was offered in preferred shares for this group, it could substantially improve balance sheet ratios, and provide cash to help prevent insolvency. Such a model could be applied on a wider basis for private companies and those in related sectors of the industry.

Canada and Alberta have to act quickly and innovatively to preserve the firms who make up the petroleum sector so they can return to delivering energy resources, economic activity, jobs and royalties and taxes once the Russia/Saudi Arabia price war and COVID-19 abate.

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