Is Oil Becoming Stranded?

By Paul Spedding, Former Global Co-Head of Oil And Gas Research at HSBC and Advisor to Carbon Tracker.

First appeared on Project Syndicate in February 2016.

For a quick summary watch this 'Bloomberg Markets' video interview:

Paul Spedding discusses why this oil price drop is different.

The conventional wisdom regarding the recent plunge in the price of oil is that we are seeing a repeat of the 1985-1986 collapse, when Saudi Arabia ramped up production as part of a dispute with other members of the OPEC cartel. This time, the thinking goes, Saudi Arabia is doing the same in response to its loss of market share to shale-oil
production in the United States.

But there is another parallel that is even more relevant – with important implications for the long-term price of oil. The recent collapse is reminiscent of a similar dive in the price of coal – which crashed from a brief high of $140 a ton in 2008 to about $40 a ton today – which led some deposits to become “financially stranded,” meaning that the cost of developing them outweighs potential returns.

The drop was the result of long-term environmental policies, including programs aimed at mitigating climate change, which undercut demand for coal. Efforts to improve air quality in China, US carbon and mercury emissions standards, cheaper natural gas, and growing investments in renewable energy have all eroded coal’s share of the energy market.

A similar mechanism may be at work in the oil market. As pressure grows on governments to take action to combat climate change, demand for fossil fuels is likely to drop, which could result in prices remaining depressed for longer than the industry anticipates – perhaps forever.

To be sure, some critics – including the British economist Dieter Helm – dismiss the possibility that assets can become stranded. They contend that the absence of serious international efforts to reduce emissions, the cyclical nature of petroleum markets, investors’ short time horizons, and the fact that most oil assets are state-owned make it unlikely that policies to mitigate climate change will have an impact on oil prices.

These arguments are easily rebutted. For starters, while the international community is unlikely to agree any time soon on a global mechanism for putting a price on carbon emissions, other types of environmental policies have already had an effect on demand for oil.

That is a crucial development, because even small shifts in supply or demand can cause large swings in the price of oil. The drop from $120 per barrel in 2014 to under $35 today is the result of a 2% change (roughly two million barrels a day) in the supply-demand balance. That reflects Saudi Arabia’s output increase of more than a million barrels a day, as well as mandated efficiency measures in the European Union, partly motivated by efforts to cut carbon dioxide emissions, which have contributed to a comparable drop in demand – by about 1.5% a year. Similar measures can be expected elsewhere as governments strive to meet the targets pledged under the Paris climate
agreement.

Second, though oil prices may be cyclical, structural changes in energy markets are likely to undermine price increases. Alternative transport technologies, including electric cars, static batteries, and hybrid solutions, are already threatening to make oil less necessary.

Third, while many investors do have short time horizons, development of resources in the oil industry can easily extend to more than a decade. That means that the “safe” cash flow from today’s assets can end up invested in the next generation of high-cost assets that are at a far greater risk of stranding.

Finally, the fact that many oil properties are state-owned does not protect investors who have put their money into publicly traded assets. Governments may have strategic reasons to hold onto unprofitable assets, but investors who own shares in partly privatized state firms do not. Furthermore, the first victims of any long-term price decrease will be high-cost producers, many of which are publicly traded, leaving investors more – not less – exposed.

Commodity markets have repeatedly proved vulnerable to expectations that prices will fall. Given the political pressure to mitigate the impact of climate change, smart investors will be watching closely for indications of policies that will lead to a drop in demand and the possibility that their assets will become financially stranded.

It is dangerous to assume that stranding can occur only over the long term. Doing so risks putting investors in the same position as the last shareholders in Peabody Energy, the world’s largest private coal company, which is teetering on the edge of bankruptcy. The fact that Peabody Energy is still operating, and thus technically not stranded, is probably of little comfort to its owners.

Full Disclosure:

Why Chevron Needs to Stress-Test the
Business at Two-Degrees

This paper examines Chevron’s current disclosures in the context of Carbon Tracker’s April 2015 Blueprint, where we identified the key company information needed by investors to understand whether and how fossil fuel companies are managing energy transition risk.

Chevron’s disclosures (considered as a whole) lag behind its peers in terms of planning information and how its planning decisions incorporate climate risk. What ‘decision-relevant’ information should investors ask for? Read the report here.

---

**Relevant news of the month:**

**The Climate Summit of Money**  
*By Katy Lederer, 24th February 2016*  
The often dramatic projections of market dislocation from, on the one hand, sudden shifts in the energy markets to, on the other, the shocks of climate change itself are based on the concept of “the carbon bubble,” which was formulated in 2011 by the nonprofit climate-finance think tank Carbon Tracker and popularized in a 2012 *Rolling Stone* article by Bill McKibben.

**Low carbon economy makes sense for investors, says think tank director**  
*By On The Coast, CBC News, 5th March 2016*  
Mark Campanale says fossil fuels, not green energy, will be risky investments going forward: “If we look at the performance of the fossil fuel sector as a whole, including oil and gas, it's hugely underperformed the mainstream stock market. […] "We're seeing the rise of the electric vehicle, we've got these new factories being built by Tesla and other companies, this is going to be the place to go. This is where investors are beginning to look".

Listen to the interview podcast.

**Exxon’s Never Ending Big Dig: Flooding The Earth With Fossil Fuels**  
*By Bill McKibben, 18th February 2016*  
Over the last five years, Exxon has lagged behind many of its competitors as well as the broader market, and a big reason, according to the Carbon Tracker Initiative (CTI), is its heavy investment in particularly expensive, hard-to-recover oil and gas.
The puzzle of oil prices - Has the race to beat the carbon bubble already started?
By James K. Rowe, 29th February 2016

Even the Saudis are betting on a post-carbon future and initiating the carbon bubble’s deflation, strengthening the economic argument against unconventional oil and gas.

Upcoming events:

**MSCI Webinar: Post-COP21 – Implications for Investors**
*17th March 2016 - register here*
Are the fossil fuel industry’s projections adaptable to a clean energy future? Join Mark Fulton, Senior Research Advisor to Carbon Tracker, for a webinar organised by MSCI, to learn about the latest investment trends associated with climate change and a low carbon future.

**Stranded Assets: Risks for High Carbon Investments in a Low Carbon World**
*22nd March 2016, Chatham House, London*
Anthony Hobley, Carbon Tracker’s CEO, will join a Chatham House panel to explore how investors can use long-term targets and planning approaches to manage stranding risk and contribute towards meeting the global 2°C target.

Copyright © Carbon Tracker Initiative 2014, All rights reserved.

Go to our website:
www.carbontracker.org

You can update your preferences or unsubscribe from this list