



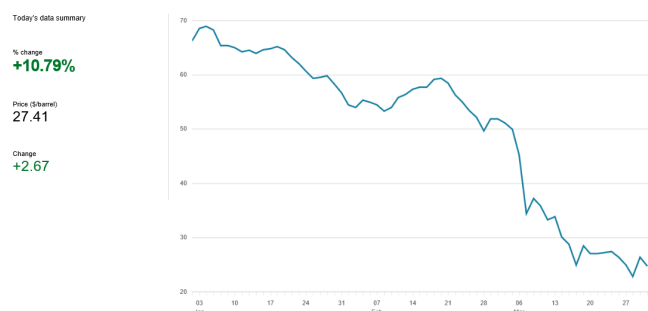
Peter Stewart (partner), Rob Broom (associate) and Natasha Ahmed (trainee), from our Energy & Natural Resources Practice, consider the impact of the coronavirus disease 2019 (COVID-19) pandemic on the oil and gas industry.

1. The Current Low Oil Price Climate

The price of crude oil, which was already hammered by market conditions, took a further hit in the wake of the COVID-19 outbreak, dropping to 18-year lows (with WTI and Brent Crude oil on 2 April 2020 priced at around US\$20.31 and US\$22.76, respectively),¹ piling pressure on energy companies to lower production or “shut-in” projects as they battle to survive. As the epidemic enters its third month, the impacts to the oil markets have provided enough evidence for analysts to make an initial downward estimate for growth, with many cautioning that the potential for additional peak infections, as seen with the SARS infection in 2003, could test markets further throughout the year.²

The market has had to contend with the twin shocks of the demand crash caused by the COVID-19 pandemic and the unexpected oil price war that erupted between leading producers (Russia and Saudi Arabia) earlier this month, which has undermined the production cutback expected to have helped stabilise this month. The breakup of the Russian-Saudi oil deal over production cuts, known as “OPEC-plus” (which will run until the end of this month), has helped cause oil prices to plummet to new lows (see Figure 1) and created associated geopolitical risks.³

Figure 1: Brent Crude oil futures (three-month spread (29 December 2019 – 2 April 2020))



Source: WebFG as at 11:57 a.m. 2 Apr 2020⁴

Both Saudi Arabia and Russia have increased their production and reduced prices in order to capture more of the market from each other. This sudden increase in oil production, coupled with the declined demand for oil due to the COVID-19 pandemic, has pushed prices to new lows on both the supply and demand sides, and brought about the oil price crash the industry has seen in the last few weeks.

(a.) 10% of Oil Production Could Become Uneconomic

According to the Middle East North Africa Financial Network, Saudi Arabia is able to undertake this aggressive push because production costs are low in the kingdom; the cost of producing and transporting a barrel of oil in Saudi Arabia (and other Arab Gulf states) is less than US\$10. In Russia, it is less than US\$18 (see Figure 2). By boosting supply and forcing prices lower, Riyadh is putting pressure on those higher-cost producers, particularly the US, where production has increased to 12.8mbpd⁵ from 5.5mbpd in 2009, overtaking Saudi Arabia and Russia to become the world’s largest producer (see Figure 3).

1 Crude Oil and Commodity Prices as at 2 April 2020, available at <https://www.oil-price.net/>, accessed 2 April 2020.

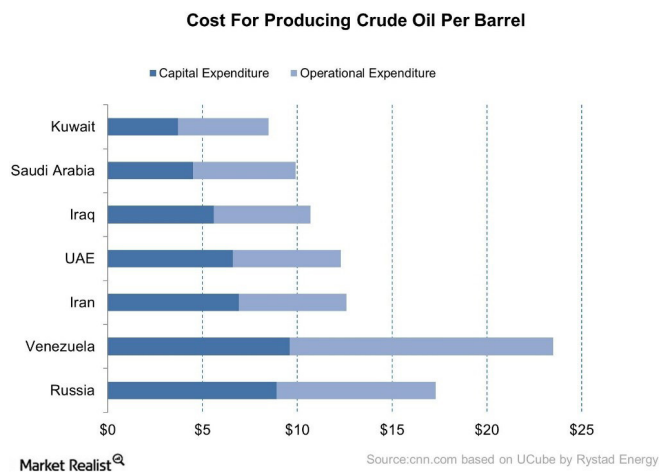
2 Fitch Solutions, “Weekly Commodities Strategy: Oil Markets Stabilise as impacts from COVID-19 take shape”.

3 Maxim A. Suckhov, “Russia hoping to outdo Saudis over time in coronavirus-hit oil market,” Al-Monitor, 23 March 2020, available at <https://www.al-monitor.com/pulse/originals/2020/03/russia-saudi-oil-war-coronavirus.html>, accessed 25 March 2020.

4 BBC News Oil Data, available at <https://www.bbc.co.uk/news/topics/cmj223708t/oil>, accessed 2 April 2020.

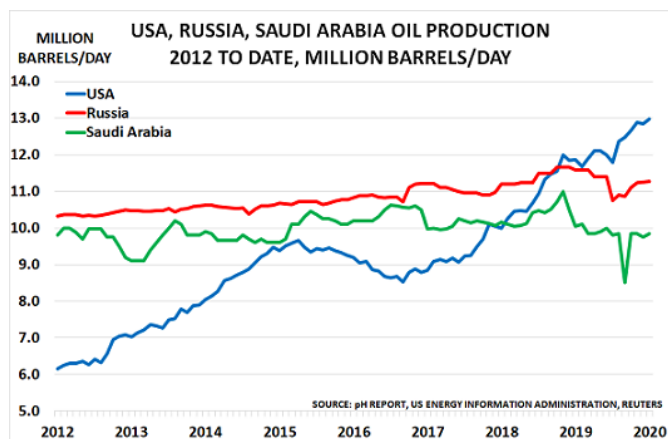
5 1,000 barrels per day (MBPD) is a unit of measurement of crude oil and petroleum products produced, processed or consumed on a daily basis. MBPD is the acronym of 1,000 barrels per day and it is the same as MBOPD, which stands for 1,000 barrels of oil per day.

Figure 2: Cost for producing crude oil per barrel for Russia and some prominent Organization of the Petroleum Exporting Countries (OPEC) members



Source: CNN.com⁶

Figure 3: US, Russia and Saudi Arabia oil production (2012 – to date, million barrels/day)

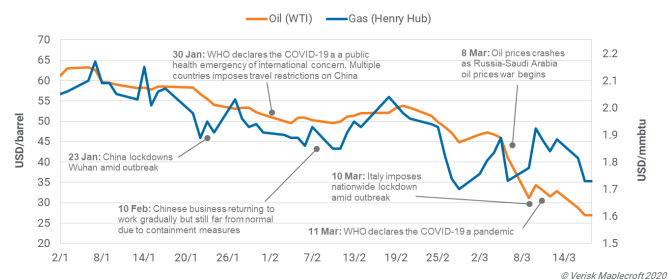


Source: Reuters⁷

The last time Saudi Arabia pursued this strategy was in 2014-15, when 1 million barrels of US production were removed, as it became unprofitable to operate some wells.⁸ Saudi Arabia requires an oil price of around US\$80 to balance its budget, but has cash reserves and the ability to borrow to deal with a price plunge for now. Russia requires around US\$42 to balance its books and has hefty cash reserves it can draw on.

Ratings agency Fitch has said that a sustained sharp drop in oil prices would hit the sovereign ratings of those exporting countries with weaker finances, particularly those with exchange rates pegged to the dollar.⁹ With airlines grounding their fleets, authorities imposing lockdowns and factory closures hammering demand, crude prices have slumped to 17-year lows. The *Financial Times* reported that at least 10% of global oil production could become uneconomic if oil prices hold at this level, and according to a report from WoodMackenzie, should Brent Crude oil remain around US\$25 a barrel level, revenue from 10 million barrels a day of global supply would not cover the cost of production and payments to governments.¹⁰

Figure 4: Oil and gas price collapse weighing on Russia-Saudi supply connection and COVID-19's impact on demand



Source: Verisk Maplecroft 2020¹¹

(b.) Project Commerciality – Potential Derailment of Oil and Gas Project Sanctioning in 2020

The factors outlined above, taken together, are poised to wreak havoc on new project development plans for 2020, according to an impact analysis from Rystad Energy, which estimates that exploration and production (E&P) companies are likely to reduce project sanctioning by up to £131 billion, or about 68% year-on-year, as they batten down the hatches to weather the storm. According to Platts, with oil prices at current levels and reducing funding levels, E&P operators are more likely to seek to focus on projects with shorter-term paybacks, such as tiebacks.¹² Apart from reducing activity (which would likely be reactivated when the peak of COVID-19 infections are reached and travel restrictions are lifted), energy companies are likely to seek to extract more efficiencies by producing as much as they can for lower levels of investment, and they are also likely to defer the sanctioning of new projects.

6 [Rabindra Samanta, "Why Can Russia Compete with Saudi Arabia?" Market Realist, 9 December 2015, available at https://marketrealist.com/2015/12/russia-can-compete-saudi-arabia/](https://marketrealist.com/2015/12/russia-can-compete-saudi-arabia/), accessed 2 April 2020.

7 USA, Russia, Saudi Arabia Oil Production eight-year spread, available at <http://www.new-normal.com/category/saudi-arabia/>, accessed 2 April 2020.

8 "Oil price collapse beyond any government's control," Middle East and North Africa Financial Network, 10 March 2020.

9 "Saudi Arabia, Russia raise stakes in oil production standoff," Reuters, 11 March 2020, available at <https://economictimes.indiatimes.com/news/international/business/saudi-arabia-increase-oil-output-to-record-high/articleshow/74565313.cms>, accessed 30 March 2020.

10 Anjali Raval, "a tenth of oil production may become uneconomic," Financial Times, 22 March 2020.

11 Kaho Yu, "Multiple COVID-19 shocks mean no respite for oil and gas sector in near future," 20 March 2020, available at <https://www.maplecroft.com/insights/analysis/multiple-covid-19-shocks-mean-no-respite-for-oil-and-gas-sector-in-near-future/>, accessed 30 March 2020.

12 Starr Spencer and Brian Scheid, "Oil demand, price uncertainty make upcoming US Gulf sale hard to predict," S&P Global Platts, accessed 16 March 2020. Tiebacks are a connection between a new oil and gas discovery and an existing production facility.

If prices of Brent Crude are to average US\$30 per barrel this year (which is seen as an increasingly likely scenario), total project sanctioning could be reduced to just US\$61 billion (with US\$30 billion of the overall expenditure being tied to onshore projects and US\$31 billion to offshore projects).¹³ Project sanctioning schedules are expected to face delays of several months, even for those with breakeven requirements of less than US\$40 a barrel, as most oil companies will prefer to wait for the spread of COVID-19 to slow down and for prices to start an upward recovery. The current price climate has come at the worst possible time for the upstream market, already oversupplied following a warm winter and the new Ukraine transit deal with Russia.¹⁴ Given the costs associated with restarting more mature fields, it is also likely that a sizable chunk of this supply may never return to the market.¹⁵

(c.) Impact on Production and Delivery Activities in the Wake of COVID-19

The market's short-term future, as with the wider global economy, will largely depend on how the COVID-19 pandemic evolves and its impact on demand; sharp demand drops in Asia, particularly in China, are unlikely to return to normal at least until mid-April. As a result, exporters have been eyeing alternative storage and refining destinations, such as Europe's large wholesale market. However, this will likely change over the coming weeks, as COVID-19 in Europe continues to escalate.¹⁶

The oil and gas industry is currently noting a disrupting impact on production and delivery activities:

- Producers are curbing oil drilling to adjust to lower levels.
- A lack of on-site personnel due to quarantine measures is leading to delays and interruptions to supply and service delivery, and platform operations.
- Some importers have threatened to cancel seaborne imports due to demand collapse.
- Off-takers are struggling to staff ports, with unmanned terminals/ports (in general, facilities such as refineries, platforms, ports and LNG terminals that are highly labour-intensive will likely face workforce shortages due to containment protocols). Total imports are at risk of cancellation, as buyers have sent out notices that they will struggle to take them. LNG import cargoes have had diversions or have been instructed to anchor offshore as floating storage – the prospect of a flotilla of diverted LNG carriers sailing around the world looking for a home only adds to the bearish sentiment.
- Buyers are seeking to resell or lift fewer cargoes from loading programmes.
- Large-scale *force majeure* declarations are being used to cut or delay contracts or to renegotiate pricing during the COVID-19 outbreak (see Section 2 (a)).

- Refiners are also expected to curb output and decline offers from producers – this is true, in particular, with jet fuel – whose use has been limited because of a slowdown of industrial activity and due to its shorter shelf life (compared with other refined projects), it normally cannot be stored for long periods.

(d.) COVID-19 and Cheap Oil Impact on African Projects

Africa's oil-dependent countries are all vulnerable to prolonged periods of low oil prices and most of the continent's top planned oil and gas projects were expecting sanctioning under an oil price assumption of between US\$55 and US\$60 per barrel (see Figure 5). Decreases in oil demand have been contributed to by various factors, including port closures, travel restrictions and manufacturing shutdowns, and have caused oil importers in China to cancel purchases of African oil, forcing sellers to divert cargoes as they seek new buyers, often at discounted prices.¹⁷ With oil prices falling to below their breakeven costs, many projects could be delayed, causing the continent's expected liquids production to decline for most of this decade and energy-reliant state budgets to take significant hits.



¹³ "Covid-19 & Oil Price War could Derail 2/3 of the World's Oil & Gas Project Sanctioning in 2020", Gulf Oil & Gas, 23 March 2020.

¹⁴ Ibid 9.

¹⁵ Ibid 5.

¹⁶ Ibid 9.

¹⁷ [Morné van der Merwe, Wildu du Plessis, Virusha Subban, Janet MacKenzie, Kieran Whyte, Marc Yudaken, John Bell](https://globalcompliancencnews.com/south-africa-the-impact-of-covid-19-on-key-african-sectors/) and [Michael van Rensburg](https://globalcompliancencnews.com/south-africa-the-impact-of-covid-19-on-key-african-sectors/), "South Africa: The Impact of COVID-19 on Key African Sectors", Global Compliance News, 26 March 2020, available at <https://globalcompliancencnews.com/south-africa-the-impact-of-covid-19-on-key-african-sectors/>, accessed 2 April 2020.

Figure 5: Top 2020-2022 crude and gas financial investment decisions (FIDs) in Africa facing the risk of being delayed

Project	Country	Operator	Breakeven oil price USD per barrel	Resources Million barrels of oil equivalent	Liquids	Gas
Tilenga	Uganda	Total/Tullow Oil	40.35	825	825	0
Bonga South-west – Aparo	Nigeria	Shell	58.75	630	630	0
Etan – Zabazaba	Nigeria	Eni	41.95	510	510	0
Pecan	Ghana	Aker Energy	49.00	300	300	0
South Lokichar Phase 1	Kenya	Tullow Oil	60.65	215	215	0
Kingfisher South	Uganda	CNOOC	48.00	195	195	0
Agogo FFD	Angola	Eni	44.80	180	180	0
PAJ (Block 31)	Angola	BP	47.80	150	150	0
Preowei (Egina FPSO)	Nigeria	Total	43.30	145	145	0

Project	Country	Operator	Breakeven gas price USD per thousand cubic feet	Resources Million barrels of oil equivalent	Liquids	Gas
Area 4 LNG Train 1 & 2	Mozambique	ExxonMobil	7.05	2325	0	2325
GTA LNG Hub	Mauritania	BP	7.30	1420	0	1420
Yakaar (domestic)	Senegal	BP	5.32	220	0	220
HA	Nigeria	Shell	6.00	210	0	210

Source: Rystad Energy research and analysis¹⁸

It is likely that investments for major planned oil and gas projects will see a timeline shift, or even a spending cut altogether, which will ultimately impact production levels in this region.¹⁹ Cuts in exploration spending and cancellation of drilling plans today could potentially mean years of delay in new discoveries, reserves replacement and new fields being brought on stream. Where discoveries have been made and appraisals and development plans have been approved, contractors are likely to seek to postpone final investment decisions (FIDs) for the time being.

For net oil-exporting countries, this will result in increased liquidity issues, lost tax revenues and currency pressure. The biggest international oil companies (IOCs) operating in the continent that were expected to take major FIDs this year, or in the near future, on multibillion-dollar projects in Africa are all cutting spending by an average of 20% globally (cutting capital spending, selling assets and controlling everyday cash as much as possible to preserve cash), which will inevitably impact exploration and projects in Africa.²⁰

Declining global oil prices and softer demand reflecting lower global growth prospects increase the risk of higher budget deficits in oil-dependent countries of sub-Saharan Africa, where the impact will be felt even stronger because of the reliance of state budgets on oil exports, high workforce, production and transportation costs (with markets being further away). Apart from South Africa, the continent's biggest economies rely heavily on oil revenue to fuel state budget and public spending and ensure macro-economic stability. All sub-Saharan Africa's producers had budgeted 2020 with an oil benchmark well above US\$50, from around US\$51 in Equatorial Guinea up to around US\$57 in Nigeria. With predictions that oil prices will not go anywhere above US\$30 for the rest of the year, most budgets inevitably need to be re-adjusted and public spending needs to be drastically cut.²¹

18 Rystad Energy research and analysis, available at <https://www.oilandgasvisionjobs.com/news-item/it-was-time-for-africa-now-covid-19-and-cheap-oil-are-set-to-hit-new-projects-and-slash-state-budgets>, accessed 2 April 2020.

19 "It was time for Africa: Now Covid-19 and cheap oil are set to hit new projects and slash state budgets"; OGV energy, 26 March 2020, available at <https://www.oilandgasvisionjobs.com/news-item/it-was-time-for-africa-now-covid-19-and-cheap-oil-are-set-to-hit-new-projects-and-slash-state-budgets>, accessed 30 March 2020.

20 APO Group, "When Coronavirus and OPEC price war strikes Africa's oil & gas sector", 28 March 2020, available at <https://www.ghanaweb.com/GhanaHomePage/business/When-Coronavirus-and-OPEC-price-war-strikes-Africa-s-oil-gas-sector-906973>, accessed 2 April 2020.

21 Ibid 17.

22 Ibid 12.

23 Rolake Akinkugbe-Filani, "How coronavirus and the global oil price war can impact Nigeria"; The Africa Report, 11 March 2020.



Potential resulting currency devaluation could also hail challenges. The Central Bank of Nigeria is employing different strategies to uphold the currency value, but if this fails and Nigeria (which based its 2020 capital budget on plans to produce 2.1 million barrels per day of oil this year at a crude price of US\$57 per barrel²²) runs extremely low on reserves, the naira could depreciate, forcing investors to exit Nigerian equities and bonds. In addition, with demand dwindling, cargos of West African crude blends from Nigeria and other African countries are heavily discounted to buyers, mostly in Europe, or remaining unsold.²³

2. Legal Considerations for the Industry

Amidst the uncertainty around how the COVID-19 pandemic will unfold, one thing is certain – the oil and gas sector must prepare for the looming wave of oncoming legal issues, which will affect all upstream, midstream and downstream activities.

(a.) Force Majeure

As a reminder, a *force majeure* clause is a key provision contained within typical international commercial agreements, which aims to provide relief to contracting parties from the performance of a contract following the occurrence of certain events. A *force majeure* clause will typically set out what is to be and not to be considered an event of *force majeure*. An obscure "act of God" event of *force majeure* that means contracts can be broken in the face of insurable obstacles has to be carefully considered if it can apply to the COVID-19 outbreak, and different legal systems tend to come up with different answers. Claims for *force majeure* are often rebutted with arguments that low prices do not constitute a *force majeure* event – potentially, a quarantine in a loading or unloading port could be, but legal advice should be sought before proceeding.

Above all, governments must consider the effects and associated risks of suspending or terminating contracts, the changing commercial priorities of operators, contractors and exploration/production companies (e.g. stacking rigs and reducing production schedules may cause operators to default on such contracts, not complying with drilling commitments and supply volume requirements), and whether or not different measures (e.g. deferring deliveries or seeking an extension of an exploration licence limited to actual delays when and as felt) could be an alternative. It is worth noting that it is impossible to predict what the end of the pandemic will bring, or if a true end to COVID-19 issues is realistic. In addition, price decreases will inevitably make contract performance uneconomical for many parties and, therefore, there is a strong incentive to find a mutually beneficial solution.

For governments, cancelling contracts in the space of very little competition, especially in the context of operators that would remain committed to drilling wells (having typically spent sizable amounts of money on exploration programmes) but for the current climate, may not be the favoured approach. Even if cancellation is motivated by clearing the decks to re-bid licences in the short term, there may not be any willing operators to bid for them, especially considering that if a low oil price (below US\$30) is the state of play at least for the medium term, projects could become permanently uncommercial. Governments should also be aware that they should not rely on a *force majeure* clause to allow them to automatically exit a difficult situation, and may seek instead to rely on different tools at their disposal to allow for contractor delays through, for example, granting extensions of time, keeping the contractors engaged on the projects. Governments could also consider working with contractors to deal with funding issues to enhance and maintain production (particularly in a tight CAPEX environment).

(b.) Production Sharing Agreements

Production sharing agreements (PSAs) are among the most common types of contractual arrangements for petroleum exploration and development. Governments, as the owner of the mineral resources, appoint a contractor to provide the expertise, capital investment, through exploration, drilling and the construction of the infrastructure, thereby assuming the entire cost risk of the project. As an incentive, the contractor acquires an entitlement to a stipulated share of the oil produced as a reward for the risk taken and services rendered. Due to the Russia-Saudi Arabia price war, COVID-19 pandemic and the consequential low oil price climate, drilling commitments (and, for that matter, exploration licences) are proving either impossible to comply with or economically unviable. Due to the current climate, various contractors are seeking temporary suspension of activities or are requesting extensions under PSAs.



Governments will understandably be concerned of the potential of the non-performance of the contractor, particularly not finishing the project or trying to renegotiate its work and/or other obligations due to COVID-19 (i.e. requesting for an extension of the initial exploration period or requesting to shut wells to decrease production rates). Typically, governments will have an obligation, under the PSA, to monitor that the contractor complies with the work obligations specified in the contract (i.e. number of wells drilled, depth and technology). Any amendments to the details of the agreed work programme or budget will usually require formal governmental approval. It should also be noted that the contractor is only able to recoup its exploration expenditure if oil is found – so there are financial reasons that make prolonging the exploration phase disadvantageous. On the other hand, if the contractor cannot raise funds (now), and relief is not forthcoming from the government, their exploration limits may expire and they will lose all of their investment – so prolonging the period until funding becomes available (higher price environment) could be key and/or permitting a further investor to enter and inject capital into the project.

PSAs are usually only terminated following an unsuccessful exploration phase of the contract. However, PSAs do give the government the right to terminate following material breach of the agreement after appropriate notice and failure to remediate. Another concern is whether contractors declare a *force majeure* under the PSA. Governments should assess *force majeure* clauses and determine whether the clause is drafted broadly in nature, or lists specific events. Parties should meet to discuss the consequences of any *force majeure* and whether the term of the agreement may (or must) be extended.

(c.) Health, Safety and Environment

The impact on the world's production potential of crude oil and gas will inevitably decrease as more workers are infected by COVID-19. While office-based employees are generally able to work from home with moderate to little impact on functionality, employees involved in planning and executing work (e.g. the spudding of wells or on-site field logistics) are likely to require to cease work, as companies would argue that safe and responsible operations would be compromised. The obvious consequence of a lack of on-site personnel are delays and interruptions to supply and service delivery, and platform operations, including inspection, repair and replacement of equipment and drilling activities. This presents the energy industry with significant challenges, particularly in respect of health and safety and developing COVID-19 policies. If there is a shortage of available personnel both onshore and offshore, exploration and production could be forced to a total stop. Governments should be monitoring their contractors' supply chains and the real effect of any disruption to it.

Authors



Peter Stewart

Partner, London
T +44 20 7655 1483
E peter.stewart@squirepb.com



Rob Broom, GMC

Associate, London
T +44 20 7655 1263
E robert.broom@squirepb.com



Natasha Ahmed

Trainee Solicitor, London
T +44 20 7655 1031
E natasha.ahmed@squirepb.com

