COVID -19: IMPACT ON OIL AND GAS SECTOR IN INDIA

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ABSTRACT

The Covid-19 pandemic impact has shattered the crude oil demand as the majority of the oil and gas services end-user industries are witnessing a slowdown amid lockdowns. This market environment coupled with crude oversupply concerns are creating an imbalance resulting in a crude price crash. At a time when the global crude oil price is heading south, India's crude oil and natural gas production in 2019-20 dropped 6.1 per cent and 5.2 per cent, respectively, over 2018-19. Affected also by the Covid-19 lockdown, crude oil production dropped 5.5 per cent and natural gas 14.38 per cent in March over the equivalent period in 2019.According to the data released by the Petroleum Planning and Analysis Cell (PPAC), crude oil production in 2019-20 was 32.1 million tonnes (mt), 6.1 per cent lower than the 34.2 mt in 2018-19. On the other hand, cumulative natural gas production in 2019-20 was 31,179.96 million metric standard cubic metres (MMSCM), 5.2 per cent lower than the 32,873.4 MMSCM during 2018-19. Companies across the oil and gas value chain are re-evaluating their Capex guidance, as well as re-aligning their operations to offset the demand slowdown. This is leading to delays and deferrals in project execution and having a negative impact on the services industry. Pulling off all onerous feats since its inception, the Covid-19 crisis just added another victim to its list - oil. In an unprecedented event, oil for the first time in history breached the $0 mark, forcing the mankind to readjust the axes – another impossibility coming true! The WTI (West Texas Intermediate) futures contract of May expiry fell by over 300% to trade at below 'minus US$39 per barrel' on the NYMEX on Monday, April 20th. The Indian counterpart, MCX, accordingly had to settle the price at just INR 1 per barrel showing that it was unprepared for such an unusual volatility in the international markets. However, cheaper fuel may appeal to consumers in the shorter run, but this would also mean lower or no dividend payments by the financially burdened oil companies to the pension funds in the longer run; indirectly affecting millions who are reliant solely on their pension incomes. What does this mean for India? The government earns a large chunk of its income from excise duties with roughly 90% of it coming from oil imports. It is interesting to note that the prices for retailers have not been reduced since the government is using the buffer to fund its expenses. However, once the lockdown ends, the government can face increased pressure to reduce the fuel prices for consumers.

Keywords: Covid 19, Oil& Gas , Crude Price

INTRODUCTION

Indian oil companies, especially the E&P space (upstream) like ONGC and Oil India, may face tough times ahead because of increased pressure to sell their products at lower prices ahead. The refiners and distributors (downstream) like HPCL, Reliance and IOCL are likely to see improved margins in the coming quarters, once the demand picks up again. As for the storage, if the Indian companies can manage their stockpile well, this is a good time to buy and reserve oil for future use.

As per the Reserve Bank of India, India's current account deficit (CAD) stands at 0.2% of GDP, as of December quarter in FY20 as compared to 2.7% in same quarter in FY19. Since, India imports more than 80% of its oil consumption, lower oil prices are likely to reduce the CAD for the economy. The current savings in CAD can, then, be used to continue financing the urgent relief measures against the domestic Covid-19 outbreak. The Indian Oil & Gas sector can be divided into Upstream and Downstream segments. The Upstream segment in the Oil & Gas industry includes organizations involved in exploration and production (E&P) activities. Exploration is carried forth by NOCs (National Oil Companies); ONGC and Oil India through a nomination regime and private companies and Joint ventures through various bidding rounds. In this report, we have presented an impact analysis of COVID-19 on the upstream segment of the sector.

Unlike Brent crude that is produced near the North Sea and settled in cash at expiry, West Texas Intermediate is produced in landlocked areas and has to be delivered physically, thus, making costs a burden for the latter from a transportation standpoint. This leads to greater uncertainties revolving around WTI prices than Brent crude as can be seen from the fact that Brent crude prices declined less dramatically on Monday and were still trading at levels close to US$25/barrel.

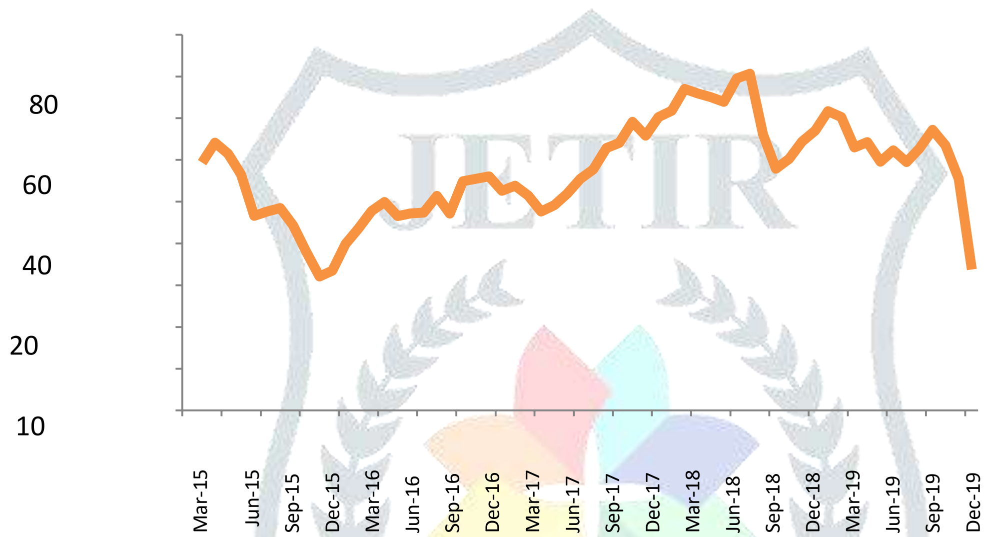
What this means for the global economies? With no recovery in sight in the foreseeable future, the key issue of oil storage is likely to stay. If the oil stays at pennies, the US shale companies would have to pay to dispose the excess stock off! As a result, they may have to further reduce the production by shutting down their rigs and oil wells to avoid plunging into deeper financial troubles. Note that the global demand has shrunk by c. 20MMbpd and oil production has already been slashed by 10% after OPEC and Russia reached a truce earlier this month.

Keeping aside the theoretical aspects, there are additional operational and strategic challenges in cutting production. Operationally, there is only up to an extent that a company can do so. To cut production further, they may have to seal their oil wells and thus, risk losing the asset permanently. Strategically, this would mean recurring capital and abandonment expenditures when the market revives and losing its market share to its competitors in the longer run. If major oil producing nations like the OPEC countries choose to do this, their currency might devalue significantly.

A silver lining to this fiasco, from a consumer's standpoint, is that reduced oil prices help in slowing inflation. A condition called 'Super Contango' has sent the oil markets into frenzy. The primary reason behind this freefall is the lack of fuel demand across the world followed by a glut in global oil markets leading to an acute dearth of available storage capacities. Thus, increasing the number of market participants who are unwilling to risk doing physical deliveries anymore. Instead of obeying the future contracts at expiry, the idea of relentlessly selling the front month's contract at the open market and rolling it over to the next month, appears more feasible.

Crude Price witnessing double shock

After a range-bound couple of years of crude price movement, the crude price has fallen sharply since early March 2020 and has fallen as low as USD 22/bbl. The price fall is much steeper than was witnessed during Oct-December 2015 as the current situation is not only a result of over-supply it has also been triggered on account of a decline in demand due to COVID-19.



On March 09, 2020 the price of Brent crude fell by 24% to USD 34/bbl, steepest one-day price drop over the last three decades. This was the result of a price war between two of the large oil producers – Saudi Arabia and Russia post OPEC meeting on March 06, 2020, at Vienna. Both Saudi Arabia and Russia flooded the market with oversupply of crude oil thereby impacting the price. The crude price was further adversely impacted on account of COVID19 and tumbled further in the absence of demand. In order to control the damage of COVID-19, countries worldwide have implemented lockdowns with measures such as travel restrictions and manufacturing plant shutdowns leading to a sharp fall in demand for crude oil and natural gas. Although in early April 2020 the OPEC+ members have decided to cut the production levels we believe that the magnitude of the demand shock is way too large that can be addressed through supply cuts.

Falling prices to impact realization and total income of upstream companies

The Upstream segment in the Oil & Gas industry includes organizations involved in exploration and production (E&P) activities. The sales realization and operating profit margins of the domestic crude oil producers largely depend on the crude oil prices globally and in the domestic markets. A lower crude price in international markets directly results in lower sales realization for the upstream companies. CARE Ratings believe that given the current price scenario of crude, upstream companies will witness significantly lower total income during FY21 on account of a sharp deterioration in their price realization as well as lower production for the next two quarters.

It is noteworthy to mention that the current sharp fall in crude oil price is due to supply as well as demand-side pressure and thus an immediate respite is not on the cards. CARE Ratings believes the price of crude oil will go up from here and range between USD 30-35/bbl in short-run in response to the supply cuts. However, there are chances of oil price to fall again from USD 30/bbl to USD 25-27/bbl as countries extend their lockdown period which will further affect the demand prospects of oil. Overall the production has been on a lower trend during the past couple of years and with a sharp fall in prices, upstream companies would further reduce production as they would tend to avoid investments in new fields and Enhanced oil recovery (EOR) measures. With the COVID-19 outbreak, a lot of upstream companies are also witnessing a shortage of contractual workers and long lead equipment due to lockdown and thereby hampering the overall production.

Profitability expected to get squeezed

There is a strong positive correlation between the operating profit margins of upstream players and prevailing crude oil prices. Higher crude prices have a positive impact on profitability while lower crude oil prices exert pressure on the profitability and might even report cash losses in case the realization falls below the cost of production. In the current low crude oil price regime, we believe with lower realization upstream companies will witness substantial pressure on their profitability and the margins are expected to squeeze significantly leading to cash losses also in some cases. The major cost for upstream companies includes the operational expenses, depreciation, depletion, and amortization (DD&A) and taxes levied by the government.

Major operational expenses include work over rig hiring charges, chemicals & consumables, and other services costs that are fixed in nature in the short-term. Upstream companies have medium to short term rig hiring contracts wherein the day rates for rigs are fixed in advance. Thus, an immediate change in operational expenses seems difficult for the domestic upstream companies given the fact that the rig rates are already at their lows. Furthermore, NOCs also have deep-water projects which have higher cost on account of greater logistical and operational complexity which keeps the operational cost high. Also, as the majority of the oil and gas fields in the country have aged they require Enhanced oil recovery (EOR) measures to sustain the production levels and thus higher cost too. Another important cost component for upstream players is the taxes and levies such as cess, royalty and profit petroleum which limits their profitability. The upstream companies in country have to pay Oil Industry Development (OID) cess of 20% ad-valorem (for nomination and pre-NELP) on the production of crude and natural gas (changed from Rs.4,500/tonne of crude to 20% ad-valorem in the Union Budget 2016-17. Additionally, they also need to pay royalty to the state government (Nomination – 20%, NELP – 12.5%). Over and above the cess and royalty, the upstream players also need to share certain profit petroleum after cost recovery. CARE Ratings believes that it would be difficult for the domestic upstream companies to tweak their cost in medium-term and therefore adverse impact on profitability is inevitable in immediate quarters. The only respite we believe can be witnessed if they are able to quickly renegotiate their service contracts and if the Government extends some relief in the form of cuts in cess and royalties.

Impact on Gas segment The upstream companies are also expected to get impacted in the gas segment with lower demand and realization of their gas outputs. The domestic gas price for locally produced fields (NOCs) has also been revised downward to USD 2.39/mmBtu from USD 3.23/mmBtu for six months starting from April 01, 2020.

Furthermore, the ceiling price for gas to be produced from difficult fields such as deepsea (Reliance Industries Limited's KG D6 fields) has declined to USD 5.61/mmBtu from USD 8.43/mmBtu. Domestic gas prices are governed by the New Domestic Gas Policy, 2014 which considers the volumes and price of natural gas in the USA (Henry Hub), UK (New Balancing Point), Canada (Alberta Gas) and Russia (Russian Natural Gas) with a lag of one quarter. We believe a further decline in gas prices for the six months starting from October 01, 2020 (to be based on the average price of May 2019 to June 2020). The production cost of gas for upstream companies hover around USD 4/mmBtu (higher for difficult fields) which makes the operations highly unprofitable for FY21 given the current prices and expected price for H2FY21.

Impact on Capital expenditure and exploration activities

A sustained drop in crude oil prices may derail the capital expenditure plans of some of the domestic upstream companies for FY21. With a moderate operating cost of the fields, the domestic upstream companies in short term may reduce their capital expenditure on exploration activities in order to reduce their depreciation, depletion, and amortization cost and thus absorbing some impact of low crude oil prices. Table 2: Expected capital expenditure for upstream companies Upstream players Expected capital expediture ONGC Budget of Rs. 32,501 crore for FY21 OIL Budget of Rs. 3,877 crore for FY21 Cairn India Plans to invest around Rs.55,000 crore towards development of 30 blocks bagged under the first round of Open Acreage Licensing Policy (OALP) auctions Reliance Industries Limited Plans to invest around Rs. 35,000 crore in Krishna Godavari basin block along with JV partner BP Plc Source: ONGC, OIL, CARE Rating

Conclusion

The Indian Oil & Gas (O&G) industry is notable in the global context – it contributes to 5.2% of the global oil demand, is among the top three large markets in demand growth and 4th in the world in refining capacity (~249 MTPA). India is also very imports-dependent, with oil imports at 84% and gas imports at 53% of their respective annual demands. Incidentally, O&G imports constituted 25% of India's import bill in FY'19. Therefore the impact of COVID-19, whether due to the wide-spread demand destruction, or the downward spiral of crude prices, is of enormous concern for all of the Indian O&G industry participants.

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