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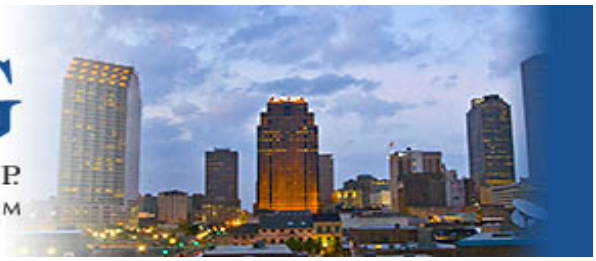

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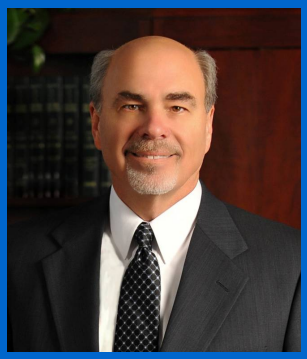
Surviving Low Oil Prices (Part 7) Free Market Rules

May 8, 2020



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The objective of any governmental intervention should be to advance the public good.

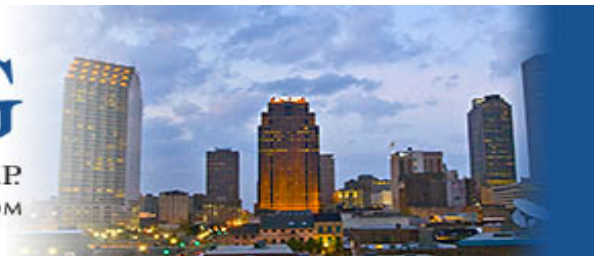
Government to the Rescue -- Or Not

In the last article we noted that it is starting to feel like the energy industry has been thrust into a reality show about *Survival* - my favorite show name being *Life Below Zero* (prices). Some of you have suggested other great show names depicting these times, such as "*Cast Away*" and "*Apocalypse Now*". Unfortunately, those titles accurately reflect the current state of our industry and our jobs.

We have been considering ways that an operator can "self-regulate" and put the brakes on production volumes without jeopardizing their lease positions or other contracts. Some companies have taken that approach and have voluntarily shut-in or curtailed production, saving those non-renewable oil reserves for a day in which they again have true value. This benefits the producer and the the royalty owner, including government royalty and severance taxes - often based on a % of the price received.

In today's article we will consider whether the government should step in to reduce production allowables, grant severance tax holidays or take other actions to support the industry in this chaotic time of reduced market demand. As we know, this reduced demand is not a natural causation, but caused mostly by governmental stay-in-place orders reducing demand, simultaneous overproduction and depleting storage.

The objective of any governmental intervention should be what is needed to advance the public good. However, governmental intervention has evolved to be more "political" than "need based". Some believe that business can't be trusted and government intervention is required to keep firms accountable, stopping monopoly power, prohibiting high prices to consumers and to promoting free competition. Governmental intervention has also been undertaken to support or subsidize certain industries that are in favor or in need of support. In many cases, subsidies to favored industries work to create businesses that cannot stand on their own merit. For example, the current subsidies for development of "clean energy" or for ethanol in gasoline were political decisions that were made to advance causes that the party in power "believed in" (i.e., supported their political beliefs), even though those industries could not exist for long without the use of taxpayer dollars to promote the



cause. The oil industry has had its share of incentives over the years to encourage the development of our domestic energy supplies, some of which have worked well to advance needed development of our domestic oil and gas reserves. In the long run, it is not helpful to an industry if it becomes dependent on government help to survive.

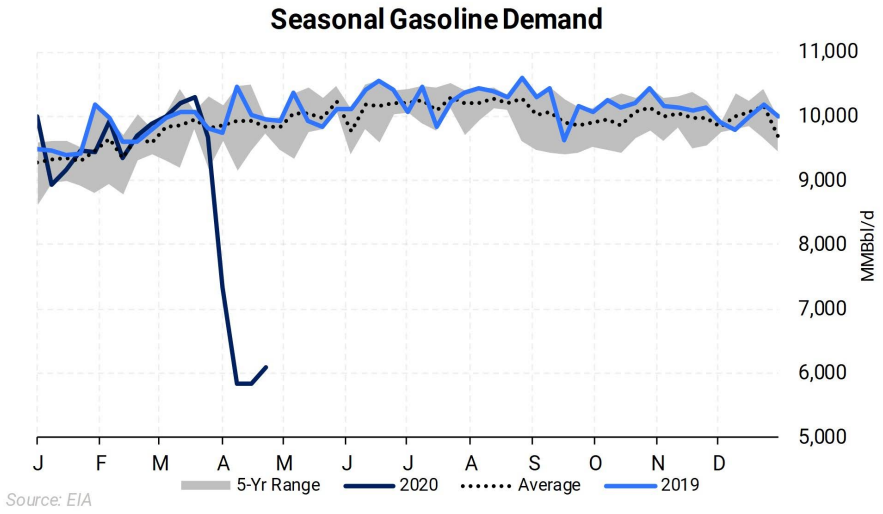
The long-term view must consider whether governmental intervention is needed not only for today, but also whether future action is need to head off pricing that could collapse our domestic energy industry.

Today, we all know that government intervention is not needed to stop high oil prices. The issue in today's market is whether critically low prices will hurt our economy by crippling the US energy industry, resulting in high prices for the future. We don't have to look back very far to see how high oil prices soared when we were dependent on foreign oil to fuel our economy. If we become dependent again on foreign energy supplies, prices are guaranteed to rise (because the foreign countries will have the monopoly). The long-term view must consider whether governmental intervention is needed not only for today, but also whether future action is need to head off pricing that could collapse our domestic energy industry.

These charts show, in large part, why the oil price declined to such critically low levels.

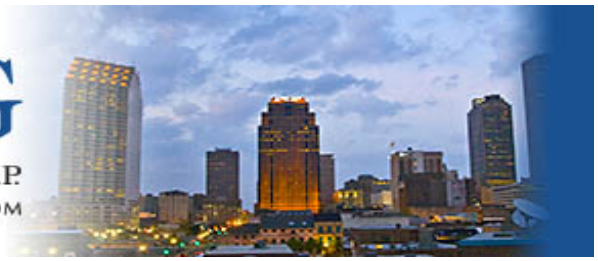
Before discussing various ways states or the federal government might help (or hurt) the industry, take a look at the below charts showing that demand dropped severely but production supplies did not have a similar decline. These charts identify, in large part, why the oil price declined to such critically low levels.

The first chart shows how 2020 demand for gasoline (the primary demand factor) took a nose dive in late March:



The solid black line shows the drastic decline in demand for gasoline after the Covid-19 Shelter-in-Place Orders were issued. Other products ... took a similar drop in demand.

The solid black line shows the drastic decline in demand for gasoline after the Covid-19 Shelter-in-Place Orders were issued. Other products (such as jet fuel, diesel and others) took a similar drop in demand.



Unless production supplies dropped at similar rates of demand, the laws of supply and demand were guaranteed to reduce the price of oil.

The next chart shows that oil production for 2020 did not drop as demand did, and in fact was higher than production levels for 2019 when demand was up.

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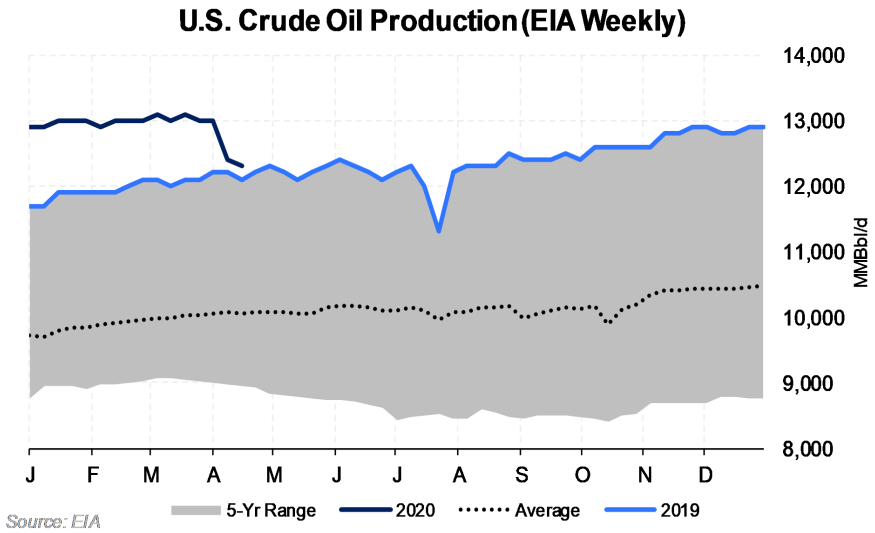


The above charts clearly show why prices declined severely, even into negative territory. The continued production of more oil than we could either use or store resulted in this crisis of oversupply, low demand and filling storage facilities.

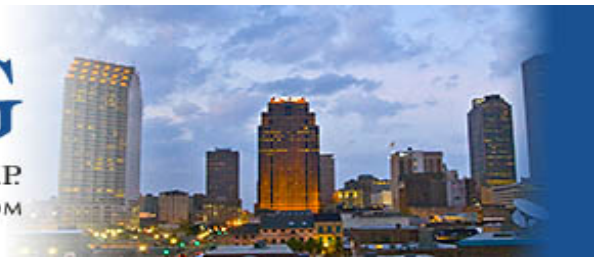
State Action (or Inaction) on Economic Waste

State regulation of the domestic oil and gas industry has historically been based on laws designed to prevent "waste".

State regulation of the domestic oil and gas industry has historically been based on laws designed to prevent "***waste***". These laws normally regulate how many wells can be drilled to efficiently and economically develop an area or field (through spacing or unitization), and the maximum allowable rate of production that will not harm the ultimate recovery from a well. The objective is to prevent a type of economic waste caused by excessive drilling or overproducing not needed to exploit a field. That is, regulations were adopted to stop the industry from spending more money than was reasonably necessary to develop a field, and to designate maximum production rates.

... the industry today is facing a different type of "economic waste".

However, the industry today is facing a different type of "***economic waste***". The issue today is whether governmental action should be taken to stop an operator from producing oil at wasteful prices. This is not focused on unnecessary operations, but instead on production of non-renewable resources at uneconomic prices. This would



be an expansion of regulations for most states. Should state regulatory agencies get involved and expanding their jurisdiction to cover this type of economic waste? Does the current law even grant this type of power over the energy industry?

The Texas Railroad Commission (TRCC) recently decided (in a split decision) not to impose forced production cuts in allowables.

The Texas Railroad Commission (TRCC) recently decided (in a split decision) not to impose forced production cuts in allowables as they have done in the past (latest in in 1973). Instead, the TRRC decided to leave production cuts up to the individual producers and the free market. In New Mexico and Oklahoma, rules were announced to allow operators to temporarily shut-in without loss of lease, but they did not mandate a cut in production allowables. On May 11, the Oklahoma Corporation Commission will consider mandating production cuts by a reduction in production allowables. The North Dakota Industrial Commission has also announced that the Oil and Gas Division of the Department of Mineral Resources will hold a special hearing on May 20 (comments due May 15) to address whether current oil prices constitute waste under North Dakota Century Code @ 38-08-02(19) and whether state action is necessary to prevent the waste of North Dakota crude oil production. Other states have announced plans to defer or temporarily reduce severance taxes or royalty rates. On Monday, a bill moved out of the Louisiana House of Representatives (HB 506) to reduce severance taxes by ½% per year for the next eight years, despite the huge deficit the State is now facing. So as of now, no state has mandated production cuts, but many are looking at ways to help the industry survive.

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Although well meaning, not all governmental interventions turn out to achieve the desired result. I recall the 1980's when the Natural Gas Production Act was passed, with the intent to reduce prices for natural gas. The prices for old gas was capped but new reserves from drilling were allowed to have a much higher. Without going into detail, suffice it to say that natural gas prices for the consumer soared to historic highs, reaching over $10 MMbtu at one point in time. What was intended to reduce overall consumer costs for natural gas actually increased the price of gas and drove up electricity rates – all unintended. This is just one example where "the road to hell is paved with good intentions". The NGPA did some short-term good for the industry, but eventually continued the boom or bust cycles fueled by governmental interference. Even well meaning governmental regulations can backfire or not achieve the desired result. The lesson here is that governments must act carefully and thoughtfully, but even then it is doubtful that all pitfalls will be properly evaluated.

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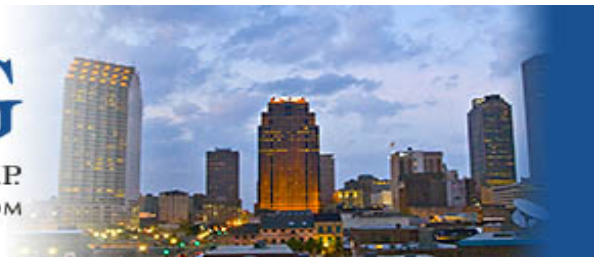
There are many business factors that a state must consider before taking action to interfere with the free market of supply and demand, including the following:

- Will the governmental action (such as production cuts) be "too little, too late"?
- Would a cut penalize producers that had the foresight (or luck) to have "hedged" their production so their prices are still higher than current spot markets?
- Should a more efficient operator be penalized?



- Some fields have more favorable economics and shouldn't be penalized?
- Will production cuts cause irreparable well damage or leave a field offline because it will be too costly to resume operations?
- Should marginal fields be exempted?
- How can exemptions be verified timely?
- Are there contractual obligations that these proration orders would affect?

This is not an exhaustive list, but points out that state governments must move cautiously. Although no state has mandated production cuts yet, any "help" for the industry must be carefully evaluated and weigh "survival" vs. "ultimate dependency".

Federal Tariffs on Foreign Oil

Needless to say, the USA has little control over volumes produced by foreign nations.

The oversupply of oil on the market by the OPEC+ nations was a large contributor to the oversupply situation. Needless to say, the USA has little control over volumes produced by foreign nations. We may have some diplomatic leverage, but today's market shows they are not enough to change the law of supply and demand. Assuming foreign overproduction needs to be stopped, are there any options federal government has to stop foreign oversupply or dumping of oil on the market? What about enacting a tariff on imported oil to set a floor ($40 Bbl., for example)?

Tariffs are a tax on imports.

Tariffs are a tax on imports. The fed's have imposed tariffs or a duty on foreign imports determined as being sold at unfairly low prices, normally because that commodity is supported by foreign government subsidies. The foreign subsidy works to undercut prices and drive out domestic competition. Any tariff will likely raise the price of the commodity, as they are typically passed on the ultimate consumer. But will a tariff on foreign oil work for the public good of our country, including the health of our domestic oil and gas industry?

There has been much debate as to whether a tariff on foreign oil would work to benefit our country, and particularly whether it is needed to stop illegal "dumping."

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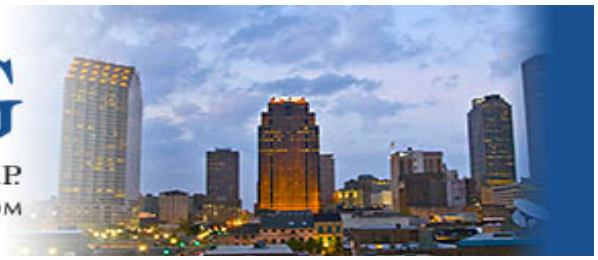
There has been much debate about whether illegal "dumping" of oil is occurring. *The true meaning of "dumping" is to sell a product in a foreign market below the marginal cost of production*. Many argue that oil exporters to the USA have not been selling at prices below their own marginal cost. If a foreign country can produce oil at a cost of $5/Bbl. and sell it for $12/Bbl., while US production has a cost of, say, $30/Bbl., then the foreign country is not technically "dumping." They are simply a lower cost producer. If domestic oil becomes unprofitable at the prevailing world price then many would argue that domestic oil is simply too expensive to compete in the free market. Others correctly point out (as we discussed in a prior article) that the foreign oil is not produced on a level playing field, and the US producer is at a disadvantage. One major disadvantage is the net revenue interest retained by the foreign country is not reduced by payment of royalty to the private lessor in the USA. This type of disparity, and others, simply cannot be leveled up by imposing a tariff.



Another reason against placing a tariff on foreign oil is that cheap oil benefits our economy. Low energy costs usually result in lower prices to the consumer and higher profits for the manufacturer. Two major industry groups, the American Petroleum Institute and American Fuel & Petrochemical Manufacturers, told President Trump recently that tariffs on oil imports would jeopardize the domestic refining business as some plants depend on foreign crude. If a tariff is imposed, will it ultimately be to the detriment of public good?

On the other hand, we have seen in the past that without a strong domestic oil industry, our economy becomes vulnerable to supply shortfalls and sharp increases in the price of imported oil. Most worrisome is the real possibility of a collapse of our domestic energy industry, which would lead to dependence on oil from unstable regions. We have previously seen this happen. The oil price is guaranteed to eventually soar to new heights when we become dependent on foreign energy sources, as when oil was above $100/Bbl. not long ago. Any dependence on the good intentions of a foreign country for our critical energy sources poses a dangerous threat to the defense of our nation, our existence as a world power and ultimately our freedom. Further, as President Trump recently noted, while lower gas prices might be beneficial to some Americans, it will "hurt a lot of jobs". I feel confident in saying we all understand the devastation that results from the loss of our jobs and the lack of work resulting from an energy crisis.

Any dependence on the good intentions of a foreign country for our critical energy sources poses a dangerous threat to the defense of our nation, our existence as a world power and ultimately our freedom.

If ever there was a time for government intervention, now would seem to be it. However, a little patience may prove that governmental intervention through tariffs or proration orders is not needed in the long run. And if needed, it may only be short-lived, as the free market may force the needed corrections. The OPEC+ curtailments just took effect just a few days ago on May 1. Those cuts, along with domestic curtailments, may be enough to let the free market resolve this crisis.

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The Bottom Line

For the past several weeks we have been examining how US producers can take matters into their own hands to fight low prices by curtailing or shutting-in production. These actions must be evaluated on a case-by-case basis, as opposed to possible unintended consequences of sweeping governmental orders impacting broad sectors. According to a May 8 report on *Reuters*, many US producers already plan to shut-in or curtail approximately 1.7 Million barrels of oil per day by the end of June. When these (self imposed) US production cuts, along with the OPEC+ cuts, take effect on the market, we should see some upward movement in the price without government intervention.

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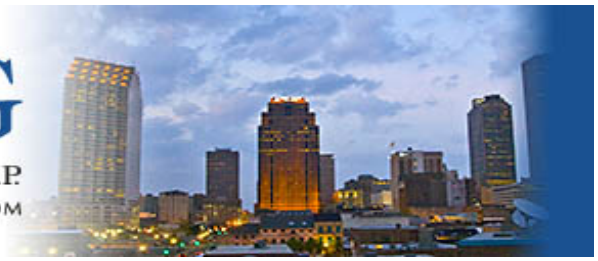
My position is "let the free market reign," at least for now.



My position is "let the free market reign," at least for now. Some short term help - like reducing severance taxes and royalty rates - can help and should be enacted. If the crisis continues and the free market does not self correct, then I would support revisiting governmental intervention. But even then, we must tread lightly to avoid unintended consequences.

I say the above knowing that my bottom line (in the bank account) will be directly impacted negatively by a continuation of this depressed market. But I also fear that governmental "help" could have unintended longer-term consequences on the country, and make our industry less healthy as a result of dependence on shortsighted governmental intervention.

As I complete this paper, WTI is "up" 45 cents to $24/Bbl. I hesitate using the word "up" when prices are still so low, but that is the state of our industry today. Despite all this bad news, I remain confident that the best operators will put contingency plans in place, take the time to better understand the industry and their contracts, and adapt to changing times. Hopefully we will all make smart choices and get through these times together, as we have done in the past. This is not our first rodeo riding a disruptive market. Each time we have been thrown off by an unruly market, we got back up and rode to new heights. I feel confident we will do so again. Keep your heads up!

This is the last article I plan to write on the topic of Surviving Low Oil Prices. However, if you would like a discussion of any other issues related to this topic, please email or call me, and I would be happy to consider additional postings.

Despite all this bad news, I remain confident that the best operators will put contingency plans in place, take the time to better understand the industry and their contracts, and adapt to changing times.

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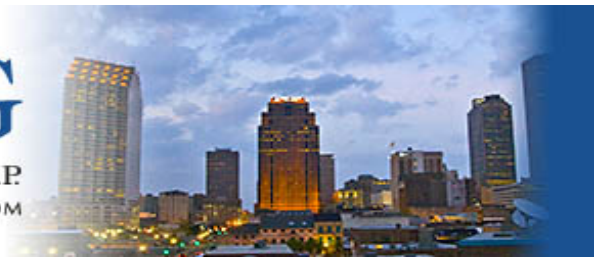

Experience when you need it.

Please feel free to contact me if you have any questions or need help.

God bless and stay safe,

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