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Texas Crude Limit Debate Reveals Tension in Supply Chain

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Predictable divisions would pit the majors and large independents on one side against every other producer in any industry skirmish, but those mundane concerns pale in comparison to the internal conflicts exacerbated by the oil price collapse.

As Texas regulators contemplate whether to limit oil production at the behest of Permian Basin juggernaut Pioneer Natural Resources and pureplay Parsley Energy, key executives across the supply chain are sharpening their knives. The friction was nowhere more apparent than during the Texas Railroad Commission (RRC) hearing on the matter on Tuesday. Dozens of stakeholders spoke during the 10-hour hearing, which ended without a resolution. The agency meets again on Apr. 21.

To a person, testimony in opposition to prorationing cited the “free market” principles that dictate rhetoric both within the industry and conservative Texas politics. But Pioneer CEO Scott Sheffield, as well as Commissioner Ryan Sitton, insist the free market no longer applies to oil because it’s a global industry under wide-ranging government regulation (IOD Apr.13'20).

Market Freedom?

“After 35 years as a CEO, I've never seen a free market. Many of the companies speaking after me are asking for government debt bailouts, tariffs, carbon tax credits. Is that free market?” Sheffield said. “Most of the companies using this [argument] have the worst track record in shareholder returns and return on capital employed. They are not efficient and causing economic waste.”

Indeed, Sheffield called out his peers at Marathon Oil, Ovintiv and Occidental Petroleum, each against prorationing, for their heavily leveraged balance sheets during an exclusive interview with Energy Intelligence.

Firmly in opposition, Marathon CEO Lee Tillman followed Sheffield’s presentation.

“Texas operators are already shutting in the least profitable wells in response to market forces the way a free market should work,” he said.

Tillman also appeared to take issue with Sheffield’s reference to Marathon’s leverage and went on the attack.

“When a vocal minority takes a position in favor of artificial market manipulation that is so far removed from the consensus of a vast majority of operators, one can only surmise that their motives and objectives are primarily company-specific as opposed to broadly industry-supported,” he said.

Marathon operates in states other than Texas, and Tillman said companies are the “ultimate arbiters of the economics” within the fields in which they operate, adding that each public company already has to answer to its shareholders they don’t need the state to get into the mix.

Nevertheless, Pioneer has one of the strongest balance sheets among oily independents, and Sheffield had noted that of the group, only Pioneer and EOG Resources, which opposes the motion, can boast a return on capital employed of more than 10% (OD Feb.21'20). The industry average in 2019 was less than 6%.

The arguments for-and-against prorationing Texas’ 5.3 million barrels per day of production go well beyond economic philosophy.

Similar to various pressures weighing on Saudi Arabia, Russia and others during the marathon negotiations to find consensus on 9.7 million b/d in reductions, the potential impacts of curtailment tug at the three elected RRC members. Indeed, every action they could take will elicit reaction more broadly than that of the exploration and production (E&P) sector, said William Wood, a principal attorney in McKool Smith’s international business practice in Houston.

“There's so many different consequences to anything they do with respect to producing volumes of oil. If you're going to curtail production, then you're going to impact the future of transporting that oil and the different locations,” he told Energy Intelligence. “It’s not something that’s going to be done lightly.”

Dismal oil prices raise problems throughout the supply chain, from midstream transporters to manufacturers and retailers.

From the opposition camp, Tony Bennett, president and CEO of the Texas Association of Manufacturers (TAM), said manufactured goods comprise more than 90% of all exports from Texas, which exports more than any other US state.

“Manufacturers are amongst the largest consumers of energy and have also benefited from affordable access to products derived from oil and gas,” Bennett said. “TAM’s priority is to promote policies that encourage stability and the long-term growth of the Texas oil and gas industry to ensure continued access to affordable energy and essential by-products.”

No Middle of the Road

Pipeline veteran Jim Teague, co-CEO at Enterprise Products Partners, is also firmly against prorationing. He got straight to the point during the hearing.

“Frankly, for the life of me, given a 25 million b/d hole, I don’t see the rationale of those pushing for this,” Teague said. “Do you really think that a cut by Texas can fill a 25-million bbl hole?”

What's more, he said the motion raised questions about the real agenda of prorating supporters.

"Are they really trying to fix a problem, or do they want to argue that government action by you gives them the opportunity to get out of some of their obligations?" Teague asked.

If Texas opted to limit production, it could give producers a way out of shipping contracts by declaring "force majeure."

For now, pipeline companies can turn away companies that don't have a direct buyer at the end of the line, essentially telling them they can't ship volume that doesn't have a destination, a particularly acute problem for small producers.

Experts say the demand implosion from the coronavirus outbreak acts like the first domino to tumble in a row; lower consumption causes product storage to fill up and weighs on refinery margins, prompting refiners to cut operations, thus displacing crude, straining crude storage capacity and weighing heavily on producers' bottom lines (IOD Apr.16'20).

"We've had to make difficult decisions in the last month on our pipelines, our plants and our docks. We've made those decisions based on our own economics and we will make more difficult decisions based on what the market gives us at the time," Teague said. "But we believe in the free market, and we believe the markets will ultimately balance."