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Blog Post

Unprecedented Solutions to Unprecedented Challenges: A North American Response to the Oil Crisis

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As the U.S. shale industry continues to deal with supply and demand imbalance in the oil markets, a number of producers and governmental representatives across North America have started to discuss a coordinated effort among North American-based energy companies to manage production and restore higher oil prices. This potential shift in approach is happening as other oil-producing countries around the world are eyeing a broader, global effort to restore market balance.

Recent Actions Signal Shift in Attitudes Toward Production Cuts, Tariffs

Government officials from both the U.S. and Canada have engaged in preliminary dialogue regarding a coordinated approach to stabilize the industry. Last week, Deputy Prime Minister of Canada Chrystia Freeland confirmed that she had spoken with U.S. Secretary of State Mike Pompeo about imbalance in the oil market. Canadian Prime Minister Justin Trudeau later confirmed that Canada and the U.S. are actively engaged in discussions about a joint effort to provide relief to the oil sector. The idea of production curtailments is not a novel concept in Canada as the provincial government in Alberta (Canada's main oil-producing province) already has mandatory production curtailments in place. Those restrictions, which limit output for the 16 largest oil producers in Alberta to under 3.8 million bpd, were originally imposed in 2019 because of the glut in oil storage and have been extended through 2020. At the beginning of the year, the current provincial government expressed hope that the curtailments would be lifted in 2021, but that seems unlikely now given that the storage issues have significantly worsened.

In Texas, as we previously outlined, the Texas Railroad Commission has sheduled an emergency virtual meeting for April 14, 2020, to determine whether production restrictions are appropriate within the state of Texas. The constitutionality of a regulator's authority to prorate to address market demand has been litigated and upheld in the past (see *Champlin Refining Co. v Corporation Commission*, 286 U.S. 210 (1932)). Further judicial challenges could follow if the Texas Railroad Commission implements market pro-rationing orders, but producers operating in Texas should be prepared to comply with potential restrictions.

The Trump administration is also weighing the imposition of tariffs on imported oil, particularly from Saudi Arabia and other OPEC+ member countries. The purpose of the tariff is to raise the effective price of imported oil to a level where domestic producers can compete in the marketplace. The idea has been met with mixed reaction, including support from some U.S. Senators such as Kevin Cramer and opposition from many industry members and groups, including the American Petroleum Institute. Senator Cramer's view is that there is little sense in importing Saudi oil when they are largely to blame for the price war. He also points out that import prohibitions could be enacted by President Trump under the International Emergency Economic Powers Act, which he relied upon when imposing tariffs on Mexican exports.

Potential Obstacles and Side Effects

Regardless of one's normative position on a coordinated North American approach to production levels, the reality is that the approach faces significant hurdles. Paramount among them is the fact that unlike Saudi Arabia, which has one oil company (state-run Saudi Aramco), U.S. oil production is attributable to more than 9,000 producers across the country. Further, there are a host of regulatory and legal challenges to consider, including antitrust violations and the varied pro-rationing authority of the states, making mandatory production cuts susceptible to lawsuits for trespass on property rights or governmental takings.

The U.S. imported roughly 6.76 million bpd of foreign crude in 2019, with Saudi Arabia providing about 8.7% of the total imports. Thus, a tariff on Saudi oil would itself be unlikely to lead to oil shortages in the U.S. However, an oil tariff would likely raise prices on U.S. consumers for oil-based products, including gasoline. Further, these tariffs may negatively impact relations between the U.S. and Saudi Arabia, with whom the U.S. has been allies for several decades. There are still other obstacles to consider, including the fact that domestic refineries are designed to process different types of crude oils, many of which are imported from foreign countries. Any import restrictions would

therefore need to include some flexibility for trading oil internationally to adjust for domestic refinery processing capabilities.

Historical Perspective

The U.S. has previously attempted to regulate domestic oil prices on a national scale. President Eisenhower, for example, imposed oil imports quotas starting in 1959 under the Reciprocal Trade Act. The quota was one of several key factors that led to the formation of OPEC. The import quota, along with a strong economy, led to higher oil prices, which in turn led to a series of price control laws in the U.S. starting in 1971. Those laws were complex and were amended several times, but their primary focus was on prices charged by the largest oil companies, as the world oil market at the time was dominated by seven multinational oil companies commonly referred to as the "Seven Sisters." The price control laws led to unintended consequences, including a gasoline shortage at independent retailers. Congress responded by adopting a two-tier price control regime, one for foreign oil and one for domestic. That new regime led to further market distortions, including hoarding, shortages and increased imports. By 1981, all price control laws were effectively removed, but they were replaced with a "windfall profit tax" in the form of an excise tax on domestic production — in other words, the opposite of a tariff on foreign oil. The windfall tax was repealed in 1988 and oil price regulations have been virtually non-existent in the U.S. since 1990.

Looking Ahead

The idea of coordinated efforts — previously viewed as impractical within the U.S. — is gaining traction, particularly among small and medium-sized independent producers with higher breakeven costs that are desperate for relief from low commodity prices and increasing storage capacity constraints (see our previous blog post regarding storage capacity constraints). In contrast, some multinational producers with fully integrated operations, which may profit from cheaper oil through their refining capabilities, have expressed their disapproval with the measures, citing traditional, free-market forces.

It remains to be seen whether a coordinated approach by the U.S. and Canada could be successful and/or whether these efforts would be enough to encourage Saudi Arabia and Russia to curtail production. If Saudi Arabia and Russia agree to a substantial curtailment of production, North American producers will breathe a sigh of relief. A

large production cut would go at least some way toward securing a global reduction that could boost oil prices.

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