Our View: BPT Collapse

Philip K. Verleger, Jr.
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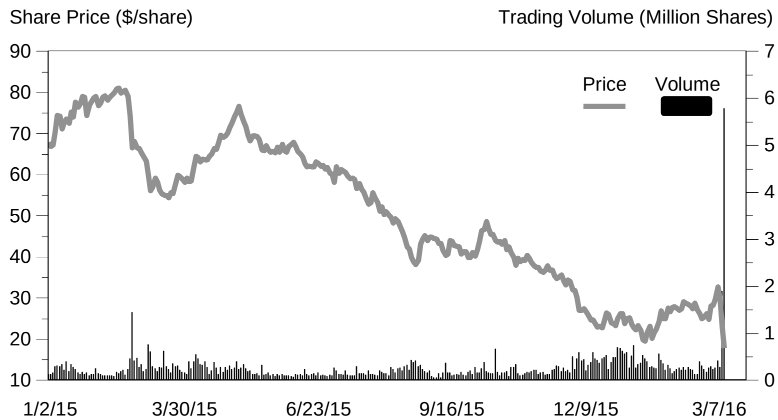
The share price of the BP Prudhoe Bay Royalty Trust (BPT) declined $14.89 from Monday through Thursday. (It is trading at $19.41 per share today as this is being written.) Specifically, shares closed March 7 at $32.66 and then fell to $17.77 Thursday night, as Figure 1 shows. The graph also shows that trading volume on Thursday was almost six million shares, a number almost six times the daily volume observed over the last fourteen months.

Figure 1
BPT Share Price and Trading Volume, January 2015 to March 2016



Source: Yahoo Finance.

We have followed BPT since the shares were first introduced in 1989. The royalty trust was created by John Brown, then CFO of Sohio and later CEO of BP, as a way to introduce commodity price optionality into debt instruments. The Commodity Futures Trading Commission took great exception to the BPT, but it has remained a key indicator of oil price expectations for more than twenty-five years.

We have written academic articles on the trust. We have used it in IRS disputes to illustrate contemporaneous expectations regarding oil prices, expectations we have shown to be far more accurate than the random numbers presented in the Energy Information Administration's forecasts. In short, the BPT has been a valuable guide. This week, though, it may have lost its relevance.

The price decline has been tied by CAS Investment Partners (a firm unfamiliar to us) to the following statement in the BPT 10K released February 29:

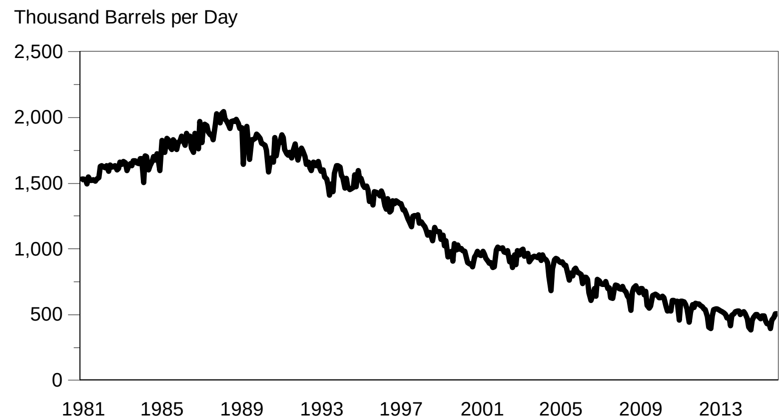
> Based on the 2015 twelve-month average WTI Price of $50.28 per barrel, current Production Taxes, and the Chargeable Costs adjusted as prescribed by the Overriding Royalty Conveyance, it is estimated that royalty payments to the Trust will continue through the year 2020, and would be zero in the following year. Therefore, no proved reserves are currently attributed to the BP Prudhoe Bay Royalty Trust after that date.

The CAS reasoning seems wrong. Markets do not generally react so slowly. Instead, the BPT share price decline seems to be explained by an announcement made late Monday by BP. Platts reported on the event briefly. *The Alaska Dispatch News* gave it much greater attention and provided more detail:

> BP will reduce the active rig count at Prudhoe Bay from five drilling rigs to just two, a decision caused by low oil prices that is expected to impact oil production and more than 200 contracting jobs while sending negative waves across the state's oil-dependent economy.[1]

This is an important story for the BPT and Alaskan production. The cuts will further reduce Alaskan output. (Figure 2 shows the declining trend in North Slope production.) For the BPT, the decrease means a decrease in the volume of output allocated to the trust. The BPT has a claim on roughly sixteen percent of the first ninety thousand barrels per day of BP Prudhoe Bay production. In 2015, the area produced an average of eighty-four thousand barrels per day. This production was sustained by drilling. The reduction in drilling will lead to lower output and lower volumes for the BPT. We have no way of predicting the fall rate for the BPT volume nor, to our knowledge, do shareholders. We are sure, though, that it will drop.

Figure 2
Monthly Crude Oil Production from Alaska's North Slope, January 1981 to December 2015



Source: US DOE.

That said, there is a much more significant implication for the drilling cutback. In short, it could mark the beginning of the end for Prudhoe Bay production or at least the end of winter shipments. Volumes have been falling already. This makes operation of the Trans-Alaskan Pipeline (TAP) more difficult in colder weather because as volumes drop the flow of oil slows and the pipeline is only partially heated. The minimum flow rate seems to be about three hundred fifty thousand barrels per day according to a TAP low-flow study.[2] Throughput in 2015 averaged five hundred eight thousand barrels per day, down eighteen percent from 2010. The drilling reduction will likely lead to a much quicker drop-off between 2015 and 2020.

By 2020, the situation may be such that the pipeline must close in winter unless more capital is spent on heating it, an unlikely event in today's investment environment. In addition, the drop in output will dictate that the current pipeline tariff of $6.50 per barrel must be raised. A significant volume decrease

[1] Alex DeMarban, "Oil Giants to Sharply Reduce Rigs Working in Prudhoe Bay, Affecting Hundreds of Jobs, *Alaska Dispatch News*, March 7, 2016 [https://goo.gl/72anQ7].
[2] See Alyeska Pipeline, "Low Flow Impact Study," June 15, 2011 [http://goo.gl/N4whwV].

could push the tariff to $10. Absent a substantial price increase, the netbacks to Alaska North Slope (ANS) producers could fall to levels that prompt them to shut in Alaskan production within a few years.

Given the uncertainties, the BPT price collapse is understandable. Again, BP's March 7 announcement seems to be the event that triggered it. The high trade volume suggests that one or more large BPT shareholders liquidated their holdings.

We used to say "In BP we Trust" in reference to the BP Prudhoe Bay Royalty Trust. Harsh economics have now undermined that "Trust."