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2017 outlook on oil and gas

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As we enter the final stages of 2016, it is a good time to reflect on another interesting year for the oil and gas industry, the legacy of this historic oil price downturn, and what the future may hold for 2017.

A brief review of 2016

We entered 2016 in a state of uncertainty. The sustained low prices of 2015 had not resulted in the collapse of the industry that many expected; and, as I noted in this publication last year, 2015 was a year underscored more by what did not happen (massive bankruptcies and widespread mergers & acquisitions (M&A)) than what did.

So, we started 2016 with the sense that other shoe may drop; and, very quickly, it did. We saw West Texas Intermediate fall to $26 per barrel in February 2016,[1] which led to a survival mindset from many industry players and continued reductions in capex and headcount. In April, reserve base loan redeterminations yielded dramatic declines in borrowing bases and a rash of bankruptcies and debt restructurings.

The air of pessimism began to lift around June as the impact of falling US production helped narrow the supply-demand gap and cause prices to strengthen. At the same time, the cost reduction strategies implemented across the industry, especially by US unconventional producers, began to take hold. The result has been a more range-bound price between $40 and $50[2] and a reducing cost structure that, while not leading to substantial profits, seemed to offer a path to survival.

The US natural gas sector continued to be resilient in 2016 with US Lower 48 production declining by only just over 1 billion cubic feet per day,[3] despite continued low prices; with the historic emergence of the US as an LNG exporter; and the equally historic rise of natural gas as a power generation fuel, overtaking coal as the leading source of electric generation for the first time on an annual basis.

Oilfield services continued to have a difficult year as upstream capital spending remained under extreme pressure. Several large-scale consolidations were announced in this challenging business environment and layoffs continued. However, the US rig count began to recover as early as June. By the end of October, over 150 rigs had been put back to work, compared to the end of May 2016.

The midstream segment largely stayed in a holding pattern in 2016 as upstream retrenchment reduced the need for new pipeline investment. Again, this created an environment in which consolidation was a logical response from some of the major players in this space. Equity values for midstream players suffered with the rest of the industry, especially after a bankruptcy court terminated a long-haul pipeline contract, thus setting off concerns about more widespread contract abrogation or renegotiation.

In the downstream sector, refiners went into 2016 concerned about the potential impact on their business of newly authorized crude oil exports, both on throughputs and margins. Thus far these concerns have, to a large extent, proved unfounded, with an increase in domestic demand and exports offsetting weaker crack spreads. Refined products exports have continued to rise alongside the upturn in crude oil exports associated with the opening of new markets, while refinery utilization has been running at over 90 percent and US refined products demand looks set to increase for a fifth year in a row.[4] All-in-all, while not as strong as 2015, this still looks like a fairly good year for downstream.

As we enter the end of 2016, a sense of cautious optimism has crept into the industry. We saw the beginning of an increase in M&A and acquisitions and divestitures activity, OPEC finally announcing production cuts of 1.2 million barrels per day in 2017,[5] and rig counts growing, albeit slowly, once again. There is a sense that better times are ahead. However, let's first take a look at the long-term impact of this downturn.

Long-term impacts of the downturn

The impact of the extended oil price downturn, which we have experienced since June 2014, will likely have long-term effects on the industry in a number of areas, including capital allocation and people.

Capital allocation

The survival mentality I mentioned earlier seems to have also resulted in a mindset shift toward shorter-cycle projects. $620 billion of projects through 2020 are estimated to have been deferred or canceled as a result of the downturn,[6] and the appetite for long-term, complex major capital projects has waned, despite a few notable exceptions. Although this shift is probably not surprising, given the beating the industry has taken over the last few years, the growth of short-cycle unconventional projects makes for a different investing landscape than in previous cycles. While this trend certainly seems to lower the risk of individual companies in the industry, it may pose some broader questions regarding energy supply and security. Where will supply come from in 2020 and beyond? Are there enough short-cycle projects to fill the supply gap?

Will the capital markets support the long time horizons acquired to develop more complex projects? As a rule, I believe in the efficiency of markets to drive capital to the right places, but I think it's essential we do not lose sight of the important roles different players have in our energy ecosystem. We will likely need the long-term perspective that international oil companies have always brought to this industry, in addition to the nimble, short-cycle players and the more pure-play exploration companies, to meet the supply needs of the future.

People

Prior to June 2014, one of the common challenges facing the industry was talent. Would the industry find the skilled workforce needed to fulfill the potential of shale revolution as well as the growth in deep water and related mainstream projects? In the wake of massive layoffs, these concerns seem very distant. However, the question for the industry is: Will the people come back to the industry when the recovery begins in force?

As the shale revolution took off in the United States, our industry initially largely struggled to draw people with the critical disciplines needed. Over time, the success of the industry, coupled with university partnerships, resulted in more talented, young people pursuing careers in oil and gas. However, the downturn and resulting layoffs across the industry threaten to damage the industry's brand as a career destination. This seems to make it more imperative than ever that oil and gas companies be innovative in their approach to talent acquisition, development, and deployment. As a large number of senior employees head toward retirement, companies should find ways to transfer this wealth of knowledge to the next generation of employees. When thinking about potential constraints on the recovery of the industry, we should view people as equally, if not more, critical to capital.

Outlook for 2017

While I called 2016 the "year of tough decisions," I'd characterize 2017 as "the slow road back." Supply and demand balances are still slow to return to a sustained equilibrium, although the OPEC decision to cut production should help accelerate the drawdown of global oil inventories, even if OPEC countries do not completely deliver on their announced production cuts. This should be supportive of crude oil prices as we go into 2017, but it remains to be seen how quickly and to what extent US shale oil drillers might respond by resuming more active drilling programs.

Overall, there are reasons to be positive and reasons to not be positive (I prefer this to "negative") that largely offset each other. Thus, my view that we are on a slow path to recovery.

Positives

- Supply and demand imbalances seem to be tightening.
- Most outlooks call for supply and demand equilibrium by early 2017.
- OPEC has announced production cuts.
- Global and US oil demand continues to show moderate but steady growth.
- More US LNG export capacity is expected to hit the market.
- Oil companies have learned how to operate in a lower price environment, returning to a healthier focus on capital and operating cost discipline.

Not so positives

- Iran could actually bring more production on line.
- US production could begin to ramp back up following the rig count upturn.
- Massive crude oil and refined product inventories have been built up during this downturn that may take time to go down even when demand exceeds supply.
- Confidence in big capital projects will likely take more time to re-establish, in deepwater plays and the oil sands for example.

Additionally, big picture issues often cloud the longer term of the industry. Climate change concerns, the rise of the electric vehicle, self-driving vehicles, and ride sharing (see Deloitte paper on the Future of Mobility) make historical estimates of perpetual demand growth seem less likely than they once did. Some large oil companies are even predicting peak demand within the next 20 years.

When faced with a number of offsetting factors, I like to go back to the simple things I know:

1. The world needs a significant amount of energy.
2. Although renewables are growing rapidly (and most think that is a good thing), fossil fuels should be very important to the energy mix for a long time (note my very specific prediction here).
3. Low cost suppliers can be fine for a very long time.
4. Long-term thinking and investment horizons will likely be needed; we just don't know how long is long. 20 years? 40 years? 100 years?

I know one more thing. The oil and gas industry is incredibly resilient and has some of the brightest, most innovative people I have ever met. This is clearly what leads to my overall optimism about the industry for 2017 and beyond.

Endnotes

1 U.S. Energy Information Administration (EIA), "Cushing, OK WTI spot price FOB," http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RWTC&f=D, accessed November 18, 2016.

2 Ibid.

3 EIA, "Short-term energy outlook (Table 5a: US natural gas supply, consumption, and inventories)," November 8, 2016, http://www.eia.gov/beta/steo/#?v=15, accessed November 18, 2016.

4 EIA, "Weekly US percent utilization of refinery operable capacity," http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=WPULEUS3&f=W, and "Short-term energy outlook (Table 4a: US petroleum and other liquids supply, consumption, and inventories), http://www.eia.gov/forecasts/steo/tables/?tableNumber=9#, accessed November 18, 2016.

5 Nayla Razzouk, Angelina Rascouet, and Golnar Motevalli, "OPEC Confounds Skeptics, Agrees to First Oil Cuts in 8 Years," Bloomberg, November 30, 2016, https://www.bloomberg.com/news/articles/2016-11-30/opec-said-to-agree-oil-production-cuts-as-saudis-soften-on-iran, accessed December 9, 2016.

6 Near-term upstream investment slashed by US$370 billion since oil price fall, Wood Mackenzie, May 2016, p. 1, https://www.woodmac.com/reports/upstream-oil-and-gas-near-term-upstream-investment-slashed-by-us370-billion-since-oil-price-fall-38758308, accessed November 18, 2016.

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