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2014 Outlook on Oil & Gas
My Take: By John England

Over the past several years, oil and gas companies have focused on making favorable investments and acquisitions in North American shale assets, oil sands, and the Gulf of Mexico's deepwater in order to grow their reserves. The early stage of the North American energy renaissance was primarily an upstream exploration and production (E&P) phenomenon, with E&P spending rising 46 percent from $243 billion[1] in 2009 to $355 billion[2] in 2013. As E&P investment dollars flooded into North America, the midstream sector struggled to keep up with demands to move production from newly producing regions or to increase flows from currently producing regions.

As we move into 2014, investments in the energy renaissance will continue to shift from the upstream sector to midstream infrastructure, refinery operations, and petrochemical facilities. Upstream operators will focus on harvesting value from recent discoveries and acquisitions through more efficient operations and the application of new technologies. Evidence of this spending shift is already being seen in company capital expenditure budgets. According to the Oil & Gas Journal's 2013 projections, upstream E&P capital spending in North America stayed flat over the past year, rising only slightly from $354.4 billion in 2012 to $354.8 billion in 2013, while midstream capital spending has surged 263 percent from just $12.8 billion in 2012 to $46.4 billion in 2013.[3] Downstream capital spending is also ramping up with spending rising 11 percent in 2013 to $24.7 billion[4] over 2012 and is up 60 percent from 2010 when capital spending was just $15.5 billion.[5]

Year-to-date analysis shows merger and acquisition (M&A) activity in the oil and gas industry is down 29 percent, both in deal value and deal count, indicating companies are focused on project operations rather than inorganic growth. As of the first half the year, total deal value in 2013 was just $79.9 billion, down from $113.2 billion in the first half of 2012.[6] Part of the decline in M&A activity is a result of companies seeking to complete transactions in 2012 ahead of any potential tax increases in 2013. Furthermore, companies that have acquired large-acreage positions are now focused on optimizing production, streamlining operations, and maximizing the return on assets of their holdings. Natural gas prices have also firmed over the past year, giving potential sellers' incentive to hold on to their assets and focus on production. As companies see rising liquefied natural gas (LNG) export approvals, a revitalization of the U.S. petrochemicals industry, increased demand from power generation, and growing adoption of natural gas for vehicle fleets, many natural gas-focused companies may hold on to their stakes waiting for prices to rise further.

Challenges facing the oil and gas industry in 2014

A new chapter in the energy renaissance is starting to emerge – one focused on the effective execution of capital projects. As the size and complexity of capital projects grows, the ability to effectively execute, often on multiple large projects, becomes a critical competency for many companies. 2014 will be a critical year for many companies as they attempt to successfully deliver major capital projects. In many cases, the result of the projects will significantly influence their stock price, as well as their liquidity.

To be successful in this promising, yet challenging future, oil and gas companies will need to proactively address the following challenges:

Financing and capital effectiveness

As companies take on more megaprojects concurrently, they will consume a larger portion of annual company cash flows. Research shows that in 2013 oil supermajors are undertaking three to five megaprojects concurrently, which account for 24-35 percent of their annual cash flows. Even some of the larger independents are undertaking two to four megaprojects concurrently, which account for 12–115 percent of their annual cash flows.[7] This level of spending creates significant risks in terms of attracting capital at a reasonable cost and managing the volatility of price cycles for key inputs like oilfield services and engineering, procurement, and construction services. Managing this price volatility and anticipating future swings are critical aspects of attracting sufficient capital to the industry. Furthermore, competition for financing will be stiff, as the number of players in the industry continues to increase with the influx of independents.

The North American oil and gas industry will likely require more complex financing structures to meet the level and breadth of investment forecast.

Government and regulatory uncertainty

Many current incentives and taxing regimes that can significantly affect the economics of these investments remain in flux. Companies investing capital in oil and gas plays will need to navigate government and regulatory uncertainties to maximize their investments, including areas such as:

- Development of unconventional plays in states that have little experience regulating the oil and gas industry.

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- Federal and state tax regimes aimed at collecting a portion of the economic value generated by the oil and gas extracted from shale formations.
- Delays caused by the rising tide of permitting requests resulting from the increased number of wells needed to develop an unconventional reservoir.
- The impacts of existing trade restrictions such as those causing delays in the approval of the Keystone XL pipeline and the ability to export domestic crude supplies.
- The potential for additional environmental regulations to address concerns about drilling processes, possible water contamination related to shale development, drilling moratoriums, and offshore regulations regarding production safety systems and equipment.

Engineering, procurement, and construction (EPC) resource capacity

EPC spending in North America will continue to rise in 2014, resulting in further backlogs for planned megaprojects. Although the growth in orders is generally good for the EPC industry, backlogged EPC companies will face hiring challenges and will find their technical capabilities stretched thin as they try to maximize the talents of their best people. Given the reliance of the oil and gas industry on EPC companies for megaproject execution, it will be critical to the success of the North American energy renaissance to effectively address the challenges the EPC industry will face.

Talent

Another related key challenge for the industry will be sourcing enough skilled workers to execute projects already underway and new planned projects. The U.S. Department of Labor estimates that 50 percent of the oil and gas industry's workforce will be eligible for retirement within the next five to ten years.[8] The upcoming vacancies will need to be filled and competition for skilled talent will put upward pressure on wages, which will pinch project margins. Already, the industry has been hiring at a rate that far outpaces the rest of the economy. According to Bureau of Labor Statistics data, private sector employment has risen seven percent since January 2010, while employment in the oil and gas industry has risen more than 25 percent.[9] As a result of rising industry employment, hourly wages for the oil and gas industry are up 27.3 percent since the beginning of the shale revolution in 2006, outpacing wage increases in the general economy, which are up just 17.8 percent over the same period.[10] Controlling fixed costs for projects, including wages, will increasingly be important for the industry as companies look ahead to the "big shift change."

Costs

As companies focus on maximizing value, reducing the cost of operations will be a key component. After a disappointing 2013 third quarter for several companies in the industry, many shareholders are pressuring oil and gas companies to cut back on expenditures and focus on buying back shares and increasing dividends. Several of the supermajors have already announced their capital spending may currently be at a peak. This renewed focus on lowering spending could put oilfield services companies and equipment manufacturers under pressure to control costs. As oil and gas companies squeeze contractors to lower costs, oilfield services companies will need to increase operational efficiency as well.

Public perception

An overarching challenge that the industry continues to face is the public perception of the industry. Public perception influences public policy and regulatory scrutiny, as well as impacts the industry's ability to recruit the best and brightest talent. In the era of the 24-hour news cycle and pervasive Internet connectivity where individuals have their own Twitter feeds, YouTube channels, and blogs, technology provides an amplifying effect for industry critics. In order for oil and gas companies to maintain the social license to operate, they must communicate a clear commitment to environmental care, safety, and community engagement, all of which will benefit the long-term growth of the industry. Fortunately, public perception is already beginning to turn around with positive perception of the industry rising 11 percent since 2008.[11] As can be seen in the industry's effect on U.S. employment, the oil and gas industry is creating jobs, moving thousands of workers back into the workforce, and increasing wages and standards of living. The industry should continue to brand itself as a high-tech, innovative industry that cares about people and the environment, and is critical to the U.S. economy.

1 Marilyn, Radler, "Special Report: Capital budgets to rise this year in North America and worldwide," Oil and Gas Journal, March 7, 2011, http://www.ogj.com/articles/print/volume-109/issue-10/general-interest/special-report-capital-budgets-to-rise-this.html.

2 Conglin Xu, "Capital Spending in the US, Canada to rise led by pipeline investment boom," Oil and Gas Journal, March 4, 2013, http://www.ogj.com/articles/print/volume-111/issue-3/s-p-capital-spending-outlook/capital-spending-in-us-canada-to-rise.html.

3 Ibid.

4 Ibid.

5 Marilyn, Radler, "Special Report: Capital budgets to rise this year in North America and worldwide," Oil and Gas Journal, March 7, 2011, http://www.ogj.com/articles/print/volume-109/issue-10/general-interest/special-report-capital-budgets-to-rise-this.html.

6 PLS Inc. and Derrick Petroleum Services Global M&A Database.

7 Company 10-K filings, Annual Reports, FactSet, and Deloitte analysis.

8 Jill Tennant, "Making informed human resources decisions based on workforce outlook," World Oil Online, September 2012, http://www.worldoil.com/September-2012-Making-informed-human-resources-decisions-based-on-workforce-outlook.html.

9 U.S. Department of Labor, Bureau of Labor Statistics, accessed June 4, 2013, http://www.bls.gov/news.release/empsit.toc.htm.

10 Ibid.

11 Jeff Jones and Lydia Saad, "Gallup Poll Social Series: Work and Education," Gallup News Service, August 7-11, 2013, http://www.gallup.com/file/poll/164099/130823IndustryRatings.pdf.