

2016 Outlook on Oil and Gas My Take: John England



What happened, what didn't, and hope for the future

As we enter the final weeks of 2015, I am struck by what a unique year this was in the always-fascinating and dynamic world of oil and gas. 2014 was a year marked by a price shock that rapidly brought us from our “new normal” (or so we thought) of \$90-100/barrel to prices around \$60/barrel by the end of the year. In 2015, oil prices continued to trend lower, getting down to the \$40-50/barrel range since mid-summer and dipping below \$40/barrel in December. In less than a year, upstream oil and gas companies faced 50 percent drop in revenues. The industry responded by experiencing the five stages of grief:

- **Denial**—“This is just a blip and won’t last long” (this view died by March)
- **Anger**—“It’s OPEC’s fault” (for producing as much as they can...a lot like US producers)
- **Bargaining**—“If only we had invested for returns, not growth, for the past five years”
- **Depression**—“Cash flows continue to diminish, and balance sheets continue to weaken”
- **Acceptance**—“I guess we’d better prepare to ride this out for as long as it takes” (current view of most players)

For the most part, 2015 saw the exploration and production sector of the industry pull out the 1980’s playbook for a severe price decline:

- Cut capital expenditures and defer major capital projects
- Cut operating expenditures and headcount
- Push suppliers for better pricing
- Hope for better prices

The first three have been quite effective at reducing costs and preserving cash. The fourth one is still in progress, and although I often hear “hope is not a strategy,” it sure beats “no hope,” at least when it comes to morale.

The industry continued to deploy new technology and innovation to some degree and in doing so, saw costs go down dramatically on a per-unit basis. In fact, despite much lower capital expenditures and rig counts, total US production did not start to fall until early summer of 2015 as production efficiency gains offset rig count reductions. As we approach the end of 2015 and “lower for longer” becomes the new mantra, I reflect on what did happen and what did not.

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— John England

The endgame is an oil and gas industry that will be stronger, leaner, and built to last.

What did happen?

- Global oil supply has continued to increase throughout 2015, led by OPEC nations (up one million barrels per day) and US (0.8 million barrels per day)
- US production declines accelerate (month over month)
- Earnings and stock prices declined dramatically for all integrated oil companies, upstream independents, oilfield service companies, and, to a lesser degree, midstream companies
- Downstream continued to shine as crack spreads stayed strong
- Headcount reduced in the upstream and oilfield service sectors
- A significant number of projects were deferred and canceled
- A few very large M&A deals were announced (Shell-BG, Halliburton-Baker Hughes, Schlumberger-Cameron, ETP-Williams)
- A deal with Iran was reached, which puts them back in the global oil market
- The Chinese stock market went crazy for a few days and made everyone very nervous and gave the Fed more reasons to wait on a rate hike (see *what didn't happen* below)

What didn't happen?

- A massive wave of M&A
- A massive wave of bankruptcies or reorganizations
- Significant decline in US oil production
- A Fed rate hike

So to some degree, we end 2015 like we started it: prices are bad, cost cutting is top of mind, and we are still waiting for the M&A wave to happen.

What's different? No one believes prices are going up much any time soon, so people are battening down the hatches like a hurricane is coming. (I personally bought water and batteries just to be safe, but maybe I took the analogy too literally).

We need to also consider the relative resilience of the natural gas side of the business. Despite moderate US gas prices since late 2011, US gas production continues to grow, hitting new records every month. A number of important factors to note:

- US has one of the most prolific gas basins in the world, particularly with the Marcellus, which has grown from one billion cubic feet per day to about 16 billion cubic feet per day in the span of about five years
- Traditional US gas markets are expanding—residential, commercial, industrial, and power generation demand is rising year over year. And, huge investments are under way in the chemicals sector to take advantage of abundant, moderately priced US gas

- Expanded gas use, especially when displacing coal, is good for the environment and positions the US well for additional carbon emission reductions post-Paris.
- New markets for US gas are opening up
- First cargos of liquefied natural gas (LNG) expected in Q1 2016 from Sabine Pass
- Gas is well positioned to penetrate heavy truck and marine fuel markets

Bottom line—the natural gas value chain from wellhead to burner tip seems to be thriving in an extended moderate price environment. This begs the question—are there lessons learned to draw from for oil?

Hope for the future

(Yes, I know “hope is not a strategy”)

We do see some positive development that should get us to a better place from a pricing perspective:

- **Demand** – US demand is responding to lower oil prices in the usual let's-go-buy-a-new-car, or better yet, a-massive-SUV kind of way. As auto sales go up, expect to see increased US demand. More broadly, Asian demand, beyond just China is showing strong growth. China itself, despite the stock market jitters of the summer, remains a huge source of global demand and China's move to allow two children per family, rather than one, promises to double the numbers of drivers (and thus, fuel buyers) at some point in the future. (Let's just say I used very rough math on this prediction).
- **Decline** – Why is decline in the hope section? Because natural reservoir production decline, which has historically been 4-5 percent globally, means that even without demand growth, the oil and gas industry must produce another four million barrels per day every year just to keep up with current demand. This naturally puts upward pressure on pricing.
- **Production** – As noted above, total US production finally started to decline and that trend is expected to continue in 2016. More broadly, billions of dollars of investments have been deferred due to the low price environment, which translates to millions of barrels that will not be produced in the years to come. This sets the stage for a price rally.
- **A leaner, stronger industry** – More than anything else in business, I believe in the power of free markets. Just as I believe the high prices of natural gas were a critical impetus for the development of the shale gas revolution, I believe today's low crude prices are forcing an equally powerful innovation in the way oil is being developed and produced. Price forces innovation and I believe we are still in the early stages of what can be achieved in terms of reducing unit costs of oil production and ultimately increasing unit margin and achieving higher return on capital employed. The endgame is an oil and gas industry that will be stronger, leaner, and built to last.

Let's talk



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John serves as the Vice Chairman, US Oil & Gas leader, Deloitte LLP. John works closely with our oil and gas clients to bring the deep capabilities of the firm to solve problems and enhance value. John brings a unique mix of commercial, risk management, operational, and financial knowledge and the experience of 26 years serving the industry. He holds a BBA in accounting from Stephen F. Austin University and is a CPA in the state of Texas.

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