OIL & GAS, ENERGY, AND CHEMICALS IN 2017

As we embark on 2017, the oil and gas, energy, and chemical industries must grapple with uncertainty that stems from various factors including the OPEC deal, Donald Trump's election, Brexit, slowing emerging economies, electric vehicles, and new regulations. The ADI team has assessed these factors and uncertainties in our outlook for 2017. We welcome feedback at info@adi-analytics.com and look forward to continuing the conversation in the New Year.

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UPSTREAM - OIL

- Oil prices have recovered following the OPEC deal – that Russia has joined too – to cut output although it's too early to say if the deal's contribution is purely sentiment or an actual price floor. Uncertainty around compliance with the deal will continue to foster anxiety especially since OPEC nations had elevated productions to begin with.
- Rising oil prices will encourage shale operators to bring uncompleted and, potentially, new wells online – with lower costs and higher productivity – and the North American resource is increasingly likely to serve as a price ceiling.
- Credit, which was financing capital spending for upstream independents and dividends for majors, is drying up. So, oil and gas players relied on divestments for cash flow and were supported by inflated acreage valuations particularly in the Permian and Appalachia M&A deals last year.
- Oil demand growth is slowing in the medium term thanks to rising fuel economy of automobiles, growing penetration of electric and autonomous vehicles, declining role of energy-intensive manufacturing in emerging economies, and demographic shifts away from car ownership. In the near term, oil demand growth is fragmenting as large emerging economies are slowing while smaller emerging economies are surging.
- President-Elect Donald Trump's promise to cut regulations has little policy detail but will support the positive industry sentiment.

UPSTREAM - NATURAL GAS

- The global natural gas resource base continues to be robust but supply is likely to moderate with North America likely to finally cut natural gas production in 2017. Even so, LNG production is likely to grow further with new trains coming online in 2017 at Gorgon, Ichthys, Wheatstone, and Sabine Pass.
- Natural gas exports to Mexico, cold weather prospects, growing share of gas-fired power generation, and rising LNG exports are all likely to strengthen natural gas demand although it is not growing fast enough relative to supply.
- Slowing supply and rising demand are more likely than seen in the recent past to strengthen natural gas prices although there is considerable uncertainty.
- LNG markets are struggling with oversupply leading to a renewed push among large buyers, e.g., Japan and South Korea, to weaken oil price indexation. Japan is liberalizing its LNG purchasing policies, Singapore is positioning itself as a regional hub, and India is actively trading LNG cargoes thereby increasing supply liquidity in the Asian market. In Europe, pipeline gas suppliers have reacted to protect market share in the wake of abundant LNG supply.

- Technology development and innovation around natural gas production and utilization continue to advance rapidly. In 2017, shale breakeven costs are likely to drop further, Petronas is closing in on shipping the first cargo ever from a floating LNG unit, and FSRU adoption is growing quickly.

MIDSTREAM AND NATURAL GAS LIQUIDS

- Natural gas liquids (NGL) production grew at a slower pace in 2016 as lower prices impacted drilling across the board.
- In 2017 (and 2018), ethane and LPG exports will continue but half a dozen ethylene crackers will also be commissioned driving up demand for ethane well beyond likely supply (including ethane that is currently being rejected) leading chemical producers to other cracking feedstocks, e.g., propane, butane, natural gasoline, and naphtha.
- Thus, NGL pricing may pick up and the frac spread will likely widen. However, improved pricing is unlikely to spawn a whole lot of new capital investment given that midstream players are struggling with surplus capacity.
- Consolidation will likely move past the false starts in 2016 and intensify in 2017 as players struggle with overcapacity and contract abrogations and renegotiations, and capital supply improves for top-tier performers.

DOWNSTREAM, REFINING, AND FUELS

- Refining margins around the world declined dramatically in 2016. U.S. crack spreads fell due to lower product prices in export markets and higher crude oil prices relative to Brent while Asia and Europe were oversupplied from capacity and exports.
- Companies that had built exposure to midstream and trading capabilities performed better than pure-play peers and will continue to be advantaged in 2017.
- Consolidation among the pure-play refiners is likely to continue in 2017 and international participation in the U.S. downstream segment will likely increase too.
- Fuel regulations around sulfur limits, rising octane barrel values, crude oil and refined product exports, and pricing challenges with renewable identification numbers will occupy industry players in 2017.

OILFIELD SERVICES AND ENERGY EQUIPMENT MARKETS

- Upstream capex declined a little over 20% in 2016 better than the cuts exceeding 25% in 2015. Led by North American and national oil companies, upstream capex will rise by about 5% in 2017.
- In addition, oil and gas operators are clamping down on costs frustrated by the industry's rising capital intensity. Since 2008, oil and gas capex growth has exceeded 6% but production has grown only 2% annually.
- Capital spending will be allocated to smaller and near-term projects and it will likely be several years before operators will consider new deepwater, oil sands, large-scale LNG, and refining projects
- In such an environment of depressed capital spending, the share of aftermarket services in the oil and gas equipment market will continue to rise.
- Mergers and acquisitions, which intensified in 2016 with Technip-FMC Technology and the GE-Baker Hughes deals being prominent examples, will likely continue in 2017 as players struggle with depressed capex and pricing flexibility.
- Oilfield service companies and OEMs may see some revenue growth in 2017 mainly driven by new business activity and not from higher prices.

POWER

- President-Elect Trump's policies may address the power sector but are anticipated to have limited impact driven mainly by costs and economics. Thanks to the shale revolution, natural gas-fired power generation is more competitive especially when uncertainties around coal in the long-term are considered. In the case of renewables, states' renewable portfolio standards and continued production and investment tax credits will support new capacity additions.
- New infrastructure spending – if approved by the Congress – may, however, drive significant new investment in modernizing the grid and upgrading transmission and distribution infrastructure.
- Energy storage costs are falling and the technology is advancing rapidly. Its adoption will grow at a faster pace in 2017 driven by both operational and business model innovations supporting power generation from both natural gas and renewables.
- "Clean coal" may make a comeback driven by President-Elect Trump's promise to coal workers although its impact may be limited.

CHEMICALS

- Economic strife in China, overcapacity, and weak private investment significantly hindered global chemical industry growth in 2016.
- An emerging light vehicle market, positive trends in construction, and significant shale-linked capital investment is expected to spurn a recovery in 2017.
- In 2017, chemical players will shift their focus to high-growth emerging markets and segments, e.g., automotive and housing, to reduce exposure to businesses that are struggling with depressed demand.
- Further consolidation is expected to happen in 2017 as there is still a difficult economic climate and chemical manufacturers are seeking opportunities to increase operational scale and optimize cost.

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