Upstream Oil and Gas Investment: Impacts of a Weak Global Economy

CSIS B1 Conference Center
June 3, 2009
2:00 pm – 3:30pm

Summary

On June 3, the CSIS Energy and National Security Program hosted a panel of distinguished experts to discuss the impacts of a weakened global economy and the financial crisis on upstream investment in the oil and gas sector.

Guy Caruso, Senior Adviser at CSIS, opened the session with several remarks to frame some of the issues to be discussed by the panel. He described lowered expectations for upstream capital expenditures in 2009, projected by the International Energy Agency to decline by 20 percent, and juxtaposed this with the challenge of delivering future supply given requirements to expand on and replace (due to natural production decline) the current system. In particular, Caruso noted the amplified effect of the downturn on companies of medium and smaller sizes who carry higher debt-to-equity ratios than the majors and National Oil Companies. The good news, he stated, is that costs are coming down across the sector as prices for materials and other service inputs for infrastructure are reduced. Caruso emphasized the important role of demand uncertainty. The shape and timing of the economic recovery will be a prime factor in determining whether or not there is a return to tight markets characterized by upward pressure on prices.

Adam Sieminski, Chief Energy Economist at Deutsche Bank, spoke about the slowly improving global macroeconomic situation and its implications for the market. He showed the dramatic effect that the weakening global economy has had on oil demand, sinking from roughly 87 to 83 million barrels per day, and thus prices. Sieminski remarked that one outcome of the downturn, and the corresponding decline in investment, will be the purging of bad ideas. In terms of the outlook for the global economy, he referenced the rise of the Baltic Dry Freight Index, which suggests increased worldwide shipping activity and transfer of goods. Other economic data are also showing signs of recovery, including for gasoline demand, although it may again be suppressed due to rising prices and income elasticity. Sieminski also posited several drivers behind the current rise in oil prices: optimistic views on the economy and an impending recovery; the decline of the dollar, which has an inverse relationship with oil prices; and/or a surge of funds into commodities like oil.

Susan Farrell, Senior Director for Upstream and Gas at PFC Energy, addressed critical questions facing oil and gas companies in the current economic climate. Among these are: should they invest; can they invest; where should they invest; and should they invest now or later? Farrell remarked that the challenges confronting majors and smaller independent exploration and production companies differ considerably, but ultimately both must reinvest in order to stem natural decline rates and replace a diminishing resource. Whether companies are able to invest,

she stated, is another matter. Smaller companies highly leveraged with debt, such as many of the independents, will experience more distress in comparison to the larger majors and National Oil Companies, whose investment plans have not changed dramatically. Smaller independent companies, however, comprise nearly half of global exploration spending and if many of these disappear a significant gap could emerge upstream. Farrell also contrasted the portfolio choices of majors versus independents. Larger projects that provide steady output over the long-term – deepwater, oil sands, liquefied natural gas – attract significant investment from the majors. Independents are invested heavily in unconventional gas, a source expected to account for an increasing share of supply growth in the coming years. Finally, Farrell explained that retreating costs for materials and equipment will improve companies' internal rates of return and prompted her to challenge the notion that it is always better to invest today rather than later.

Alan Crain, Senior Vice President and General Counsel for Baker Hughes Incorporated, discussed challenges in the current market from the perspective of a service company. Service companies have an important role as providers of advanced technologies and highly skilled personnel to oil and gas producers. Displaying U.S. and global (drilling) rig counts, Crain emphasized the cyclic nature of the market and the acute impact of downturns on the services sector in particular. Internationally, rig counts have dropped 10 percent since peaking in the summer of 2009, but have dropped off considerably more in the U.S., plunging some 50 percent in the same time period. The focus of service companies, Crain remarked, is on technology and people. As such, service companies must continue to spend on engineering and research in order to retain a competitive advantage, although capital expenditures will decline modestly in the coming year. In closing, one of the most serious challenges for service companies and others more broadly, he noted, is to maintain a robust workforce of skilled personnel through difficult economic times in preparation for the times during which the industry must work to expand and replace supply.