Market Report-Q1 2017

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Part 1, *Crude in 2017: Will the bulls give way to bears?*

2016 was yet another wild year for oil prices, and 2017 could be just as volatile. No amount of OPEC "jaw-boning" will create a sustained medium to long-term stability in the price of oil, and there are serious questions about the arguments and optimism of oil bulls in recent months. It is clear, however, that operational excellence and optimization of assets will continue to be the name of the game in this third year of abundance in global energy markets. The pressure to deliver value by controlling cost will continue to lurk over every boardroom meeting, each work site, and especially each worker. There is no turning back to the 'good old days' of growth at any cost, where North American producers benefitted immensely from over a decade of resource scarcity that drove marginal, capitally intense and unconventional projects into economic viability. The lesson learned, which is etched into the minds of those who have survived the onslaught of the last 2 years, is quite simple: optimize assets to lower costs and increase value, or perish. Three key factors to watch for in 2017 are:

1) **The arrangement between OPEC and non-OPEC producers to remove 1.75 million barrels per day from global markets**. Historically, OPEC arrangements have been prone to cheating, which reduces the effectiveness of achieving an oil price objective. Recent examples of cheating on production cuts occurred in the early 2000s when two OPEC arrangements fell apart. Today, there is an incentive for OPEC/NOPEC members to share production cuts to increase prices. However, there is also an incentive to cheat, given that nations reliant on oil revenues have been hit so hard for so long. In addition, Saudi Arabia's 600,000 bpd production cut can be easily reversed if there are supply

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disruptions in the market, dampening any sharp price increases in 2017. A good portion of those 600,000 bpd would likely be classified by the U.S. Energy Information Administration (E.I.A.) as spare capacity, because it is "the volume of production that can be brought on within 30 days and sustained for at least 90 days." Historically, Saudi Arabia has had more than 1.5 to 2 million barrels per day of spare capacity to manage the global oil markets.

2) **Significant production coming online from Canada, Nigeria, and Libya, to which the recent OPEC/NOPEC agreement does not apply**. Alberta's oilsands are expected to produce approximately 3 million bpd by 2019, which is an increase of about 600,000 bpd. Total Western Canadian oil production is expected to increase by 500,000 bpd to 4.1 million bpd, due to a drop in non-oilsands production. Nigeria produced about 1.45 million bpd in December 2016, or about 700,000 bpd less than the 2.2 million bpd in 2015. But, if Nigeria can create a lasting ceasefire with militants in 2017, at least some lost production can possibly be expected to come back online. Like Nigeria, Libya also remains a wildcard for production due to militant activities. However, the country has managed to increase production by 580,000 bpd to 700,000 bpd. There is a plan for further increases to 1.2 million bpd by the end of 2017. If Nigeria and Libya can sustain peace, it could mean a significant supply for global markets, potentially up to 1.5 million bpd.

3) **U.S. shale production and its ability to respond to the 50% increase in the price of oil.** Goldman Sachs recently suggested Saudi Arabia's Oil Minister, Khalid al-Falih, is wrong to suggest that U.S. shale producers will not respond to OPEC/NOPEC production

cuts in 2017. The sentiment against al-Falih's position has also included the future Secretary of State and former Exxon Mobil CEO, Rex Tillerson. There are a number of factors to consider. To start, Donald Trump's tax plan could be a shot in the arm for Exploration and Production (E&P) companies and service providers if effective tax rates are lowered. Keeping an eye on the stealth supply of U.S. inventories, known as drilled-but-uncompleted wells (DUCs), is becoming increasingly important for analysts. Also, the U.S. Federal Reserve is expected to boost lending rates three times in 2017, in part because of a stronger U.S. economy. If implemented, rate increases could impact the ability of E&Ps to borrow more money. Labour availability to service new E&P activities could also be challenged, given that the U.S. suffered a major gutting of its industry in 2015-2016. Will E&Ps be hampered by worker shortages and associated cost inflation? Perhaps more barrels will be produced with incrementally fewer resource inputs (workers included). Innovation and efficiency aren't likely to stop just because the price of oil has been on a tear the last 6 months. (More on U.S. shale production in Part 2).

From the supply side, it is clear there are a number of market factors that could turn sentiment from bullish to bearish in 2017. Al-Falih has suggested global oil demand will increase by 1 million barrels per day in 2017, but his estimate may be a touch optimistic given new geopolitical realities. The global economy in 2017 could see major consequences from trade protectionist and nationalist sentiment that has re-surfaced in recent years. Donald Trump is now President-Elect, Prime Minister Theresa May is charged with an orderly British exit from the European Union (E.U.) and, on the horizon, the French and German elections could result in leaders with similar worldviews. It may be too soon to speculate, but the global political order appears to be changing. The institutions and frameworks that defined the last few decades are not just being challenged, but may be marginalized or dismantled entirely. NAFTA, the E.U., the U.N. and the various climate-change accords could be affected.

In addition, the Trans-Pacific Partnership (TPP) is in doubt, a U.S.-China trade war is brewing, Venezuela is a hyper-inflationary mess, the E.U. is still grappling with mass migration issues, Russia is a global power again, conflicts and tensions continue in the Middle East and Africa, which could be exacerbated by a decline in hydrocarbon revenues. All of these factors could have serious implications for global demand and supply of energy commodities for 2017. Buckle up, folks; 2017 could be quite the ride! There will be more to discuss in Part 2, *The Saudi Challenge: Will U.S. Producers Respond in 2017*?

Stay tuned.

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