Market Report Q1 2017

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Part 2, The Saudi Challenge: Will U.S. Producers Respond in 2017?

In Part 1, *Crude in 2017: Will the bulls give way to bears*? we explored three major factors likely to impact the price of oil in 2017. The OPEC/Non-OPEC agreement could fall apart, given the history of members cheating on production cuts. New Nigeria and Libya production could hit the market this year. Meanwhile, Canadian heavy crude production is expected to increase by 600,000 bpd in the next couple of years. Indeed, this is a lot of oil, but there is also an elephant in the room: U.S. shale production.

At the World Economic Forum in Davos earlier this month, Saudi Oil Minister Khalid al-Falih again downplayed supply concerns, suggesting U.S. exploration & production (E&P) companies need higher oil prices to meaningfully offset the recent OPEC/NOPEC production cut. However, not everything could be as rosy as Mr. al-Falih suggests. Let's drill down further into factors that could impact U.S. production in 2017:

Donald Trump's tax plan and regulatory changes could be a shot in the arm for many E&Ps and oilfield service providers. Reducing U.S. corporate tax rates from 35% to 15% could have a positive impact on U.S. producer break-evens. A word of caution, however: For Trump's tax plan to have any benefit for E&Ps and service providers, it would need to reduce their effective tax rates, which is the actual rate after application of various deductions and credits. Citi Research has estimated the average effective U.S. corporate tax rate to be approximately 27%.

However, Trump also campaigned on simplifying the tax code. If credits and deductions currently benefiting E&Ps are removed, it could diminish the positive impact of lower tax rates. There is also the proposed Border Adjustment Tax, which could have serious implications to global crude markets if enacted. However, it remains to be seen what Trump will actually do. Given that he has brought several prominent energy executives onto his team or within his vicinity—Harold Hamm, Rex Tillerson, and T. Boone Pickens—it

462, 11007 Jasper Ave.
Edmonton, AB
T5K 0K6
Office: 780.461.9399
Cell: 780.953.5820
Fax: 780.463.4388
info@avheng.com
www.avheng.com

could indicate he will not implement anything that is detrimental to U.S. energy markets. Stay tuned to Texas Republican Congressman and all-powerful U.S. Ways and Means Committee Chairman Kevin Brady, who will be responsible for overseeing possible changes to U.S. tax policy.

Beware of the stealth supply of drilled but uncompleted wells (DUCs). Rig count is traditionally an indicator of producer behaviour, but these days it may not be enough to get an accurate picture. Attention paid to DUC wells in the U.S. is increasingly important to forecasting the global supply picture. The number of DUCs in the U.S. appears to be increasing. According to the U.S. Energy Information Administration (EIA), DUCs in the seven most prolific plays rested at 5,379 in December 2016, equal to April and May earlier in the year. An increase of 305 DUCs is noted from the 2016 low of 5,074 in August.

While the Permian has received the most DUC additions, smaller increases are noted in the Bakken, Niobrara, Eagleford, and Haynesville as well. However, a strong word of caution: The current state of DUC reporting is complex and could be premature. There is real value to knowing the intent or state of each DUC. Is the DUC not economical for completion? Does the producer think prices will improve, justifying completion delays? Or is there a technical challenge? These details are critical. While the Saudi Oil Minister suggests U.S. producers have already tapped their cheapest and most prolific wells, the assumptions about what is "prolific" have likely changed since 2014. Which brings us to the next point……

Innovation and efficiency won't stop just because the price of oil is higher than last year. As Bloomberg has stated, "at 8.8 million barrels a day, the U.S. is already pumping as much crude as two years ago, with just a third of the rigs it operated at the peak." Any competitive business finds ways to improve even during the good times to avoid cost. It means more money for growth projects, paying down debt, increased dividends for shareholders, and cost certainty as insurance against a downturn. Moody's estimates overall earnings before interest, taxation, depreciation and amortization (EBITDA) to grow 20%-30% for U.S. E&Ps in 2017. Pad drilling, longer laterals, more frack per line, shorter completion times, and more careful selection of well-sites are responsible for shrinking costs amid the dramatic increases in well productivity. The upward trend in drilling activity and DUCs could be an indication that U.S. producers are building some 'insurance' against a possible oil price dip in 2017.

Though 2017 began with a new hope, the global energy industry is gutted. According to consulting firm Graves & Co., an estimated 440,000 oil/gas-related jobs were lost since 2014; one-third American. E&Ps and service providers have lasted two atrocious years and are pouncing with some renewed confidence in the market. However, as Bill Herbert, an analyst with Houston-based investment bank Simmons & Co., has stated, "*There's going to have to be a convergence between the growth aspirations of [U.S.] oil companies and the margins of the oil-field service industry. The system is already getting tighter and strained*." E&Ps and service providers that have survived are lean and mean; there is deep incentive to not get burned again. Perhaps the Saudi Oil Minister does not account for the new mindset of the North American energy worker and their drive to deliver increasingly more with less. Optimization bolted forward two years ago and, in 2017, could again ride the lightning.

Justin Ziebart, Analyst at AVH Engineering, is a contributor to the BOE Report – The Source for oil & gas news and information

462, 11007 Jasper Ave.
Edmonton, AB
T5K 0K6
Office: 780.461.9393
Cell: 780.953.5820
Fax: 780.463.4386
info@avheng.com
www.avheng.com