



MIDYEAR OUTLOOK

2020 oil and gas
industry outlook

At the end of 2019, we produced our 2020 outlook for the oil and gas industry. Given the disruption and impact caused by COVID-19, we've evaluated the key trends, challenges, and opportunities that may affect your business and influence your strategy for the remainder of 2020. Check out our midyear trends:



Finding precedents for unprecedented times

The spread of COVID-19 has disrupted global financial and commodity markets, as well as the US oil and gas industry. Domestic gasoline demand fell by 45 percent, or almost 5 million barrels per day, in April, only partially recovering in May and June as restaurants and retailers began to reopen following sustained lockdowns nationwide.¹ Jet fuel fared worse, with commercial flights down 80 percent in April compared to January levels.² COVID-19-induced demand declines affected natural gas markets less, with consumption flat year over year as the virus reduced LNG exports.³ However, lower oil prices have led to shale well shut-ins, driving down associated gas production by potentially 10 billion cubic feet per day in 2020.⁴

This decline in energy demand appears to have no parallels. The drop in jet fuel consumption has been twice as deep and substantially more prolonged than after US flights were grounded in 2001.⁵ And while US petroleum demand has begun to rebound more quickly than after the 2008 financial crisis, the current drop is four times larger and could take months, if not years, to return to the pre-crash trajectory.⁶ In an industry used to the highs and lows of economic and commodity price cycles, 2020 poses one of the greatest challenges to oil and gas companies since Colonel Edwin Drake struck oil in Titusville, Pennsylvania in 1859.⁷

While the facts on the ground are changing rapidly, we see three key trends that could shape the rest of 2020, setting the ground for a challenging 2021 and a nascent recovery in the early-to-mid 2020s.



Oil demand

Companies are looking for the next normal in the oil market during the Great Compression

COVID-19 has hit fuel demand hard, and different parts of the value chain will likely recover at different speeds. Driving activity has begun to return to normal by some measures even as congestion remains below 50 percent of pre-COVID-19 levels in many American cities, echoing similar trends seen across the world.⁸ Flying, however, has not recovered. Not only did the number of commercial flights fall by 80 percent,⁹ but also only 10 percent of the number of passengers flew in the second quarter of 2020 compared with last year, with 74 percent of respondents in a recent Deloitte consumer sentiment survey saying they would be uncomfortable flying in the next three months, indicating a potentially slow path to recovery.¹⁰ Even once passengers start to return, the rebound in flying may be slow. The International Air Transport Association estimates that traffic will remain 30 to 40 percent below pre-COVID-19 estimates even in 2021.¹¹

The impact has been felt far and wide, with West Texas Intermediate prices falling from \$60 per barrel to under \$30 and May futures prices turning deeply negative before partially recovering.¹² US oil and gas companies reacted swiftly to the drop in oil prices, with more than 1.4 million barrels per day of production shut-ins announced and refinery utilization dropping



below 70 percent—levels not seen since the financial crisis or following Hurricane Katrina's 2005 landfall in Louisiana near the heart of the PADD 3 Gulf Coast refining complex.¹³

The first half of 2020 has proven challenging for the oil and gas industry. Despite the nascent economic recovery as many US states lift lockdowns, the second half could be almost as difficult to navigate. Oil and gas companies should tackle various challenges, including the following, over the next three months:

- Low prices and uncertain demand growth mean many companies may need to permanently lower their cost structure. Discharging debt and restructuring could be necessary for some; others should consider reducing spend by leveraging remote working capabilities ranging from videoconferencing to automated drilling and production processes.
- In the face of uncertainty, agility will likely be key. Several indicators are telling different, sometimes contradictory, stories, and oil and gas companies should be able to ramp up and down their capabilities to match external conditions. Streamlined asset portfolios could improve companies' operational flexibility.
- Following the 2014 oil price crash, many companies cut spending in part by deferring offshore and international projects. The reaction to 2020 looks to be similar.¹⁴ Productivity gains in shale that offset lower investment in the past five years could prove insufficient in the next five as oilfield service companies remain financially and operationally stretched. Companies should ensure capex cuts in 2020 do not reduce their ability to scale production in the near-to-mid-term.

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Natural gas markets

Adapting to “lower for longer” in the global natural gas markets

While headline declines in natural gas consumption appear modest compared with refined products, global natural gas prices signal an industry near crisis. The US-European natural gas spread is trading at its narrowest since 2008, and Japanese spot liquefied natural gas (LNG) prices hover near \$2 per million Btu, the lowest in 30 years.¹⁵ The futures markets is hardly more comforting, with European gas trading at a discount to the US Henry Hub.¹⁶ Based on the current strip, the regional differentials could widen but are expected to remain near the cost of transport and regasification for the next few years because of weak demand and the saturated LNG market.¹⁷

While the largest driver of the current price collapse may be COVID-19, fuel switching could dictate the recovery. Power demand fell almost 20 percent in March in several European countries, and despite the recent economic thaw across the continent, for many, demand remains 5 to 10 percent below expected levels.¹⁸ Even if power demand does rebound, that does not necessarily mean natural gas demand will. With little coal to switch from and the European Green Deal on the horizon, renewables could displace LNG imports in key European markets.¹⁹ However, natural gas still has a role to play in providing energy security in a lower-carbon world and can underpin economic growth in many developed and developing economies.

How can companies with large natural gas portfolios adapt to what may be a lower-for-longer international gas price environment? Three steps to consider:

1. US producers may find relief from low oil prices, because associated gas production is projected to drop by roughly 10 billion cubic feet per day in 2020.²⁰ Even as global gas prices are low, operators in the Marcellus and Haynesville shale plays might see their revenues rise, providing an opportunity to consolidate the fractured shale gas industry through targeted M&A.
2. LNG exporters should play the long game. While margins may be tight for the next couple years, international natural gas prices are volatile and traded in the double digits as recently as 2018. Cancellations in new projects may ease oversupply in the short term, but maintaining investment could be critical to ensuring security of supply and preventing a natural gas crunch later in the 2020s.
3. Future demand for natural gas will depend on distribution infrastructure with countries like India.²¹ Larger oil and gas companies with diverse LNG portfolios should consider investing through the cycle to build long-tail demand growth in a diverse number of economies in Asia and Latin America. Regasification terminals and regional pipeline would be a good place to start.



3

The energy transition

Companies balancing short- and long-term priorities in the face of low oil prices and the energy transition

The rapid fall in oil and gas prices has affected companies across the industry, including those investing the most in the energy transition—potentially reducing future outlays. That could slow the transition and lead to higher carbon emissions in the 2020s. Despite spending only a small portion of their budgets on clean technologies and renewable energy, large oil and gas companies have struck 60-plus cleantech deals per year since 2016.²²

Pessimism may prove unwarranted because, even as revenues drop, several companies have reaffirmed or expanded their energy transition spend, in part due to favorable comparative economics. While high commodity prices can incentivize consumers to switch to renewable energy, the recent drop in oil and gas prices has lowered the rate of return for conventional energy assets and made solar and wind projects' more modest but stable returns increasingly attractive.²³ Staying the course could pay dividends for many companies in the 2020s.

For oil and gas companies looking to invest in the energy transition and reduce carbon emissions, two considerations seem to stand out:

1. Expanding into renewable power generation is not the only evergreen cleantech opportunity. Many oil and gas companies have been able to lower their operating costs and increase revenues by replacing older equipment, identifying sources of fugitive methane emissions, and boosting energy efficiency. In times of tighter margins, the benefits of those programs should increase.
2. For large oil and gas producers and refiners, the consumer and investor push for lower-carbon energy sources will likely continue. Companies should consider expanding their research efforts into biofuels, carbon sequestration, and power trading and services so that they are better positioned for the economic recovery. That may be particularly true for companies with large footprints in Europe, where government support could target greener investments.



Short-term uncertainty undermining long-term energy investments

The oil and gas industry was already in flux prior to the spread of COVID-19. Five years of low oil prices have sapped upstream investment, LNG markets have been oversupplied, and the energy transition has taken off. The sharp decline in fuel and power demand has hit an already stressed industry, creating new challenges. The industry will not fully recover until COVID-19 has been successfully contained in most countries, either with the development of a vaccine or the implementation of a widespread test-and-trace program. Even as the number of new cases has been reduced in the hardest-hit countries in Asia and Europe, its spread is increasing in the Americas.²⁴

Recovery will likely require not only for the number of new COVID-19 cases to drop substantially but also for economic activity to return to its pre-virus levels. That includes GDP growth as well as other oil and gas-relevant indicators, including industrial activity levels; transport demand; and demand for goods like cars, appliances, and other consumer products. While driving has picked back up in the United States and elsewhere, public transit and flying remain at a fraction of the January levels.²⁵ Even as lockdowns have been lifted in many US states, US personal savings rates are at an all-time high, reflecting that many consumers still remain home and are refraining from new purchases.²⁶ It is clear that the economic thaw will likely take more than a few months, and even then, consumption patterns

could be substantially altered for the long term, with reduced personal interactions and extended work-from-home policies.

Oil and gas companies should prepare for what could be the next normal. In the coming months, they should balance the trade-offs between short-term cost-cutting and long-term investments so they are best positioned for the future. Even if energy demand drops in the coming year and the energy mix begins to change, the long-term demand for energy overall will likely continue to grow. Those who can demonstrate agility and flexibility while building new production capacity are more likely to remain competitive despite these headwinds.



Let's talk



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