

# The Long-Term View

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The landscape has certainly changed as the oil and gas industry heads into a new year. Last year was one of the most volatile on record for oil prices, which rose to more than USD 145/bbl at mid-year before losing two-thirds of that value by last month. The new year begins with uncertainty as prices continue to fluctuate and the crisis in the credit market has dried up financing. Already, some projects have been delayed or are being re-evaluated, and operators are renegotiating contracts with service companies.

Anecdotal evidence suggests a pullback in upstream activity, particularly for less conventional plays, as could be expected. Canada's Nexen is scaling back investment in its Long Lake oil sands project in Alberta and Shell has announced that it is also delaying some Canadian oil sands development. The Canadian Association of Petroleum Producers has cut its forecast for medium-term oil sands output because of these and other expected delays. Large Russian companies, and others that rely heavily on debt financing, have been affected as well.

The collapse in the credit market has created liquidity challenges for smaller-capitalized oil and gas firms, and merger and acquisition activity is down sharply. The first half of 2008 witnessed a minor decline in transaction activity year on year, reports Ernst & Young, while the second half saw a more marked 30% decline. A survey by the consultancy showed that more than 70% in the industry believe it will be another year before merger and acquisition activity heats up again.

Global demand will likely continue to contract. The US Department of Energy predicts that demand will fall this year as well as last, marking the first time in 30 years that demand has fallen for consecutive years. Demand fell by 50,000 BOPD last year and will drop as much as 450,000 BOPD this year, the agency says.

But the long-term outlook does not look much different than it did a year ago. The current downturn is demand-driven while the long-term supply picture remains challenging. As several speakers noted during the recent International Petroleum Technology Conference in Kuala Lumpur, the underlying industry fundamentals remain strong, and the industry will remain hard-pressed to meet rising world demand, especially from emerging countries. ExxonMobil's latest *Outlook for Energy: A View to 2030* predicts that global energy demand will increase by an average of 1.2% a year to 2030, with oil, gas, and coal meeting the vast majority of that demand.

The real danger of this downturn is that it cancels or delays much investment in upstream projects and research and development, and that when global demand recovers, the industry will be straining to catch up after months of underinvestment. The industry's aging upstream profile and declining reserves replacement rate has not changed. From a historical perspective, USD 40/bbl oil—although only a third of its value at the mid-point of last year—is still on the high side. It was only a few years ago that OPEC's target price was USD 28/bbl, and from 1990 to 2004, oil prices drifted in a USD 20-30/bbl range.

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