COVID-19: NAVIGATING THE TURMOIL IN CANADA'S ENERGY SECTOR

EDC Economics

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Summary

- Since the start of 2020, the simultaneous fall in global oil demand due to COIVD-19 and increased oil supply on account of a breakdown of the OPEC+ agreement, have resulted in extremely low global oil prices, significant market turmoil and severe financial pressure on many oil producers.
- On April 12, a 23-country agreement was announced to reduce global oil production, over a period from May 2020 until 2022, by 9.7 million barrels a day—representing roughly 10% of global output. Initial market reaction suggests such production cuts aren't sufficient enough to fundamentally rebalance the market to sustainably raise prices, which are down sharply due to falling global demand.
- As a high-cost producer, Canada's oil and gas industry faces notable challenges and will likely need significant financial support to navigate this period of unprecedented turmoil.

CURRENT PANDEMIC PROFILE

In only three months, the COVID-19 global pandemic spread from a market in Wuhan, China, to most countries in the world. In the month of March, confirmed cases of COVID-19 rose from 90,000 to more than 823,000. By April 13, reported global cases had reached over 1.8 million, with more than 115,000 deaths.[1]

GLOBAL ECONOMIC OUTLOOK

In this context, EDC Economics' spring 2020 base case forecast includes a global recession involving G7 economies (Canada, the United States, Japan, the United Kingdom, France, Italy and Germany), as well as Mexico. EDC believes the world economy will be able to rebound once COVID-19 infection rates diminish, and containment measures end. This rebound is currently assumed to start in the second half of 2020 and spill into 2021.

SECTOR CONTEXT

Global Performance

- Entering 2020, the global oil market was in a position of over supply. Global trade tensions had reduced economic activity, and significant new oil supplies were coming onto the market from U.S. shale fields. Tensions between Iran and America led to some initial price increases in January. However, as the spread and impact of COVID-19 became clearer and various countries' containment measures ramped up, oil demand fell sharply, and the global economy dropped quickly into a sharp and synchronized recession.

[1] Johns Hopkins Coronavirus Resource Centre.

- On March 7, the OPEC+ cartel agreement—which had previously reduced oil supply from Russia, Saudi Arabia and OPEC members—dissolved as Russia refused to agree to further supply cuts. Saudi Arabia responded by cutting its oil price, while committing to add more than two million barrels per day to market. In total, more than 4.5 million barrels per day of additional supply were expected to come online as Russia, Saudi Arabia, the United Arab Emirates and others increased production.
- However, with global oil demand collapsing by nearly 30 million barrels per day due to the impacts from COVID-19 shutdowns, pressure increased on OPEC+ to reach a renewed agreement. On April 12, they agreed to cut 9.7 million barrels per day of global production in May and June 2020 before slowly phasing out the reductions.
- Although the agreed OPEC+ cuts are the largest in history, they still leave an extraordinary supply glut in place given the collapse of global oil demand. Without further cuts or a sharp rebound in global economic activity and oil demand, the limits of global storage capacity are likely to be tested in 2020 Q2.
- If maximum storage capacity is reached in local fields, production shut-ins will occur. According to IHS Markit, up to 10 million barrels per day of world oil production could be cut or shut-in from April to June 2020. This poses a significant problem for some basins as shutting-in production can damage facilities and future production capacity.
- By March 31, the eight largest global oil companies had announced investment cuts of more than US$28 billion, a 20% decline from previously announced spending plans of $142 billion.

Domestic Performance

- As a higher-cost oil producer, Canada has been grappling with the impacts of lower oil prices since 2014, as the sector has undergone some consolidation, bankruptcies and forced production curtailments implemented by the Government of Alberta.
- Taken together, the oil and gas sector including mining, accounts for $147 billion of Canadian economy in 2019, or more than 7% of Canada's gross domestic product (GDP). This sector has had thin profit margins (at 5.1%, well below the economy wide average of 11%), since the 2014-2016 oil price decline. Recent trends in oil prices are exacerbating the problem, especially for smaller producers.
- Due to its large infrastructure needs, the oil and gas sector requires well-above-average amounts of credit. In 2019, the sector borrowed $144 billion, with a debt-to-equity ratio of 90%.
- According to the Bank of Canada's Business Outlook Survey released on April 6, the majority of Canadian oil companies surveyed "viewed the current oil price shock as worse than the episodes of significant oil price declines in 2008 or 2015... because accessing financing has been more difficult."
- Since the global oil price war began in early March, Canadian petroleum producers have announced more than $5 billion in cuts to planned capital expenditures, equivalent to 20% of the total capital spending expected in 2020 by the Canadian Association of Petroleum Producers. The Bank of Canada's Business Outlook Survey, reported an even more pessimistic outlook, finding that oil companies have revised their 2020 capital spending plans down 30% compared with 2019 and were planning to cut employment immediately.
- A critical issue for Canadian oil producers is the lack of available storage capacity in Western Canada and reduced demand from U.S. refineries in the wake of COVID-19 travel restrictions. According to Rystad Energy (a leading energy consultancy), production may need to be slashed by 440,000 barrels a

day—equivalent to an output cut of roughly 11% of Canadian production—as available storage capacity within the region gets filled. Given that the regional storage capacity is generally thought to be around 40 million barrels, supplies could come to near that volume by the end of April at current production rates.

- Some Canadian production, such as oil sands mines, can be shutdown with minimal impacts on future productivity. However, other widely used methods in the oil sands (such as steam-assisted gravity drainage, or SAG-D) may experience damage to the reserves if production is shut in for a prolonged period.
- The first refinery shutdown in North America has occurred in Newfoundland and Labrador at the North Atlantic Refinery Ltd. in Come by Chance on March 30.

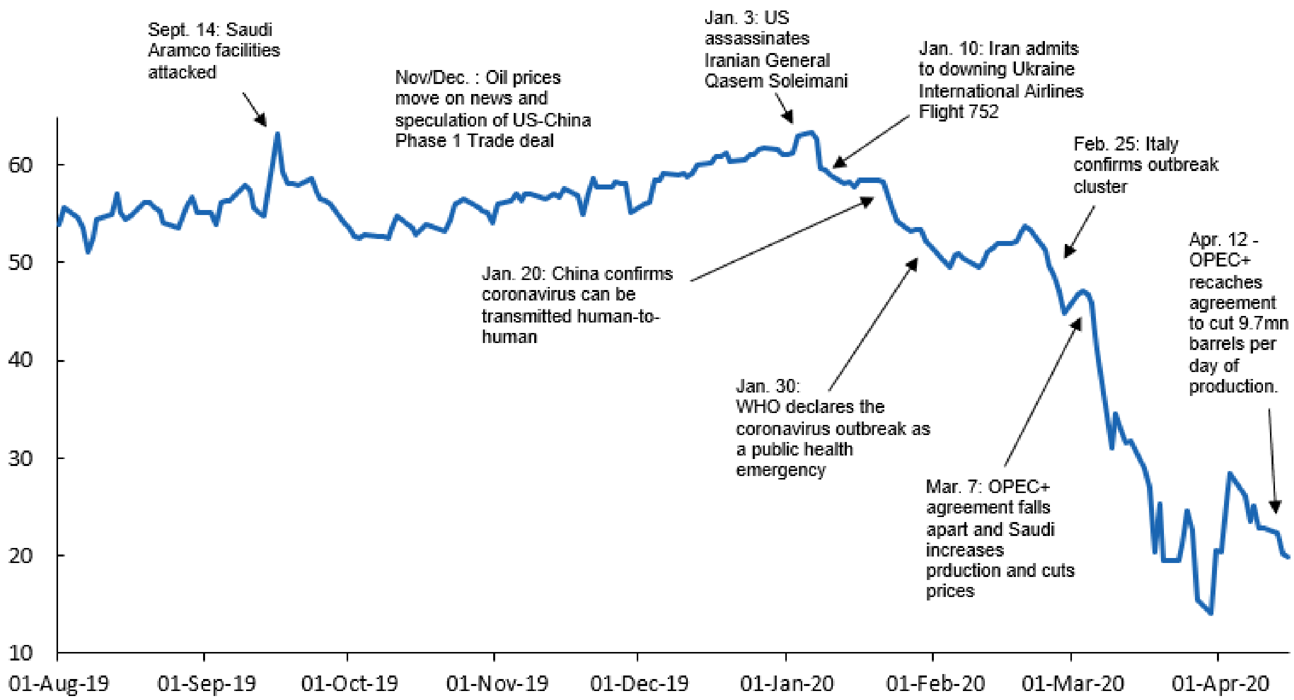
KEY PRICE OUTLOOKS

- EDC Economics' current oil price outlook from the Global Economics Outlook (GEO) is reported below, as incorporating developments up to March 12. Given recent developments, the balance of risks to this forecast are to the downside.
- A key assumption related to our oil price forecast is that global production will remain unconstrained for at least two years following the dissolution of the OPEC+ agreement. Saudi Arabia, Russia and other producers will battle for market share and attempt to squeeze U.S. shale and high cost producers from the market.

Global Economic Outlook	2019	2020*	2021*
Brent Crude Spot, *USD / bbl*	64.08	43.89	47.42
West Texas Intermediate, *USD / bbl*	56.99	38.84	42.89
Western Canada Select, *USD / bbl*	43.30	28.97	33.31

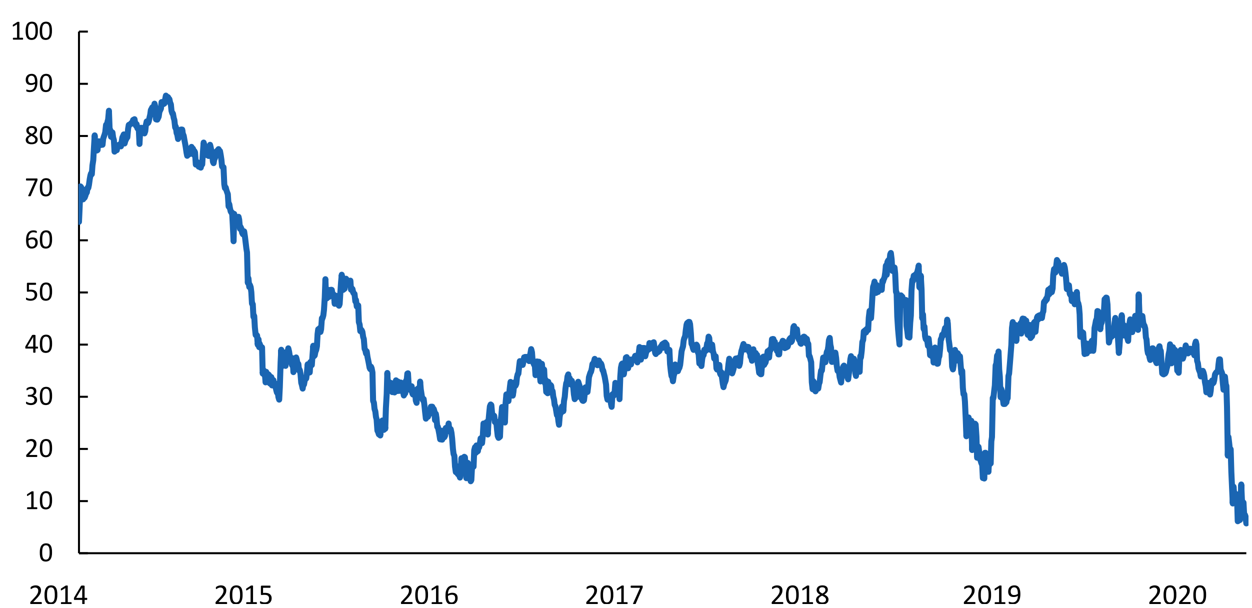
*Forecast period
Sources: *Global Economic Outlook*, March 2020, EDC Economics

WEST TEXAS INTERMEDIATE (WTI), US$/BBL



Sources: EDC Economics, Haver Analytics

WESTERN CANADA SELECT (WCS), US$/BBL



Sources: EDC Economics, Haver Analytics