November 1, 2022

Nick Piquard
Hi, everyone, I'm Nick Piquard, PM (Portfolio Manager) and Options Strategist here at Horizons ETFs, and welcome to the latest episode of Generation ETFs Podcast. Now, I've spent the last several years focused on the commodity markets, and in the past year, commodity volatility has been the highest since the global financial crisis. Oil prices have surpassed $100 this year, for the first time since 2014, and come back down, while gas prices in Europe have reached all-time record highs following Russia's invasion of Ukraine.

To help us make sense of the oil and gas markets, we've invited Dan Payne, Managing Director and Research Analyst at the Energy Group at National Bank Financial. Dan, welcome to the podcast.

Dan Payne
Thanks a lot for having me, Nick, and look forward to discussing the topics.

Nick Piquard
Perfect. So, we've seen a lot of volatility in the oil and gas market this year, from the Russia-Ukraine conflict to anticipation of decreasing demand following a possible global recession. What do you think of the current state of the oil and gas markets today?

Dan Payne
Yeah, it's an excellent question. I'd say it's probably the most dynamic we've seen it in a long, long time. I mean, I think that we're seeing the market try and balance what I would call short and medium-term macro headwinds to what you described there as the demand risk from inflation rates and recession. But we're balancing that against this longer-term fundamental outlook, which is actually really well-supported. And it comes from the fact that generally we've under-invested in hydrocarbons, we're under-supplied, and ultimately that should be relatively supportive for pricing if we look out the curve here.

So, I would say that on balance, the market, and I would say us, we're cautiously optimistic for the long-term and it's just a matter of getting through some of these transient elements on the macro in the short to medium-term, to really gain better visibility for that and better confidence in that. But yeah, very dynamic environment and cautiously optimistic would be how I would present our views.

Nick Piquard
Interesting. And if we look at what's happening in Europe, obviously this is a situation in Europe that nobody really predicted, they're now talking about with the natural gas shortages over there, they're talking about a possible cold winter, where they possibly run out of natural gas.

And with the Nord Stream pipeline being offline after the explosion earlier this year, what do you think happens now for Europe and the price of natural gas over there? Will the US for example, and Canada, be able to ramp up and supply the fill gap or where's the shortage going to come from? Is it going to come from elsewhere in the world, from Qatar, from Australia?

Dan Payne
Yeah, that's an excellent question. So, from one standpoint, I think the Russia-Ukraine conflict, it's brought something into light here that I think was not predicted, and that's this bifurcation of the global energy complex and very much a divide as far as where supplies will come from and where they will flow. And that's both on gas and crude.

Now, just given the reliance of Western Europe on Russian imports of gas, I think that that is one of the starkest places to look and so, it's the best example of this bifurcation where European energy demands, particularly in the residential and commercial, heating and cooling demand and the industrial sector, they really need those molecules and they are massively short without imports from Russia and now with the disruption to the Nord Stream pipeline. So, it's the best example that we have of the disruption here and frankly, the challenges that we're facing as a globe from energy security.

So, I think that Europe has been fortunate so far in that because China has been in lockdown and some of the demand in China has been lower, that means that there's been a greater elasticity of LNG (liquefied natural gas) cargoes globally. And Europe really has been the benefactor of that, year-to-date, such that they've been able to refill natural gas storage levels to pretty healthy levels. And I would say that everything we look at from a market forecast standpoint suggests that in a normal weather scenario, you're probably fine, you'd probably make it through this winter.

Now, there's going to be rolling blackouts, there will be demand destruction, you might have industrial shutdowns at some of the bigger complexes. But in general, I think you can navigate this winter, price dependent, of course. The real question to me and that we see increasingly in the market is, okay, that's this winter, what happens next winter? And the scenario then starts to really speak to, again, energy security and higher prices, because you've likely emptied your natural gas storage through this winter, and China likely comes back online to some degree in 2023 and competes for those LNG cargoes, such that you might not have the opportunity and ability to refill storage to the same degree next winter as you were fortunate to have done this winter.

Dan Payne
And that would speak to massive economic stress from very high energy prices, large scale industrial shutdowns, which would be very detrimental to the economy. So, I think it is incumbent on the rest of the Western world to try and backfill that, obviously. But sources to backfill that are challenging, right? I mean, North America, we are, we were, pardon me, until very recently, a closed system for natural gas. And we've seen an advent of LNG exports in the Gulf Coast region, but those are structural and capped. They're not elastic.

So, we do see a few BCF (Billion Cubic Feet) a day of incremental LNG exports building out of the US complex over the next couple of years, but in general, US exports of LNG are going to be static in that 14-ish BCF a day range with some visibility to growth over the coming years, but not really much you can do from the standpoint of incremental energy deliveries. So, it really is a question as to where the rest of those cargoes will come from. Again, I think it's challenging to suggest that Qatar or Australia would really be able to deliver an increment. So, it is just generally a big question mark as to how Europe would source their energy needs long-term if this dynamic persisted.

Nick Piquard
So, it seems to me like even though people are looking at this winter season as potentially the problem it sounds, from what you're saying is we should actually be just as interested of what might happen in next winter after we potentially get a recovery and demand from China and whatnot, where's that extra supply going to come from?

Dan Payne
I think that's exactly right. And I think it begs the question, or it brings something into focus, which is even if the Russia-Ukraine conflict resolved itself soon, I don't think that the global energy supply complex recouples itself that quickly. Does Western Europe really want to rely on Russian molecules? Now, they sort of have to.

Nick Piquard
Understood. But it sounds like from what you're saying, we could probably expect higher natural gas prices and especially in the LNG space for a longer period of time?

Dan Payne
I think so, yeah.

Nick Piquard
So let's switch over to oil and the role OPEC has played so far this year. With the advent of the crisis and the attempt to sanction Russian oil, the US has been pressuring Saudi Arabia to produce more and fill that gap. But actually recently Saudi Arabia announced that they wanted to cut production. So what do you see OPEC's role here going forward? So far, the US hasn't had much of an ability to have an influence there. Are they going to be able to fill that role, increase production? And can America and Canada and non-OPEC oil producers boost supply to reduce the reliance on the cartel?

Dan Payne
Yeah, it's interesting. If we go back to when oil prices broke down in 2014, and this is just a little bit of background, one of the reasons that happened was that US supply had grown and OPEC and the Saudi regime wanted to try and gain market share. So they wanted to claw market share back. And to a degree that sort of worked, but not really because US production kind of marched its way higher. And so OPEC's focus is very much now emphasizing just maximization of returns. So trying to maintain a very healthy price cap for every barrel that they sell.

So they're doing that by managing their volume complex. And I think from one standpoint, you look at what they did last week by cutting 2 million barrels a day, that probably looks more like a million barrels a day off the market net of what has just been under performance to compliance targets. But if you look at what they've done, they're responding to, again, that short, medium term macro narrative that we're seeing everywhere. From that standpoint, you would say that seems logical. But longer term, it speaks to the fact that there's this OPEC put in the market, which is suggested in and around that $90 Brent level, which tells us that that's where they want prices to be.

Now, the US side of things here feels a little self-serving around midterm elections and gas prices and inflation. But to be fair, if you're going to rein in inflation, you probably need to lower some of the primary energy costs, and the only way that they're going to be able to do that is to grow their domestic supply. OPEC is not going to accommodate them here, as they've shown. Now that brings us to the US domestic market which, again, to one degree has been supported by releases from their strategic petroleum reserves. We're now at the lowest levels we've been on in the SPR (Strategic Petroleum Reserve) in recent memory. And that compounds an already very low crude and product inventory level.

So you're sitting right now in the US you're probably short, call it, 200-250 million barrels in inventory, including the withdrawal from the SPR. So you're undersupplied and you're in deficit in inventory domestically. Your domestic production complex really needs to step up to try and backfill that. And that's an enormous challenge to fill that at this point. If we look at EIA (U.S. Energy Information Administration) numbers, they would suggest that we're globally undersupplied here for the time being. So not only do you have to bridge the gap of undersupply, you then also need to refill inventories. This is a very, very big and lofty goal, particularly in the context of the fact that the inventory, and by inventory I mean drilling locations, is kind of in question in some of the core places in the US. That's one of the elements.

Dan Payne
The second element of things and presenting an impediment to this growth narrative is there is an undersupply and an under investment in the services sector. There's not a lot of services available to be able to deploy at a low cost towards addressing the supply issue. And over and above that, you do have labor challenges in the market. So for us to sit here today and say that the US supply complex could grow, it's challenging to suggest that. Now, there's a whole other element to this as well, which is would the US supply complex grow? And the "would" hinges on the strategic orientations of the producers, which have very much pivoted towards discipline and sustainability towards large scale return of capital. So we don't even have the same amount of money in the system to accommodate that growth if any of the first elements were there. So it does present this very interesting dynamic where I think growth is necessary, but the opportunity to actually manifest that growth is pretty limited.

Nick Piquard
Well, that paints a fairly bullish backdrop for prices, and you would think that that would be very positive for North American oil producers, including of course, the Canadian oil producers here in Canada. And despite that, we've seen recently that the differential between Canadian oil and gas and West Texas Intermediate gas has been increasing this year. What do you attribute that to and do you think that's going to hurt Canadian producers?

Dan Payne
Yeah, it's a really good question, and we've seen the differential environment blow out pretty considerably here. And there's a few reasons for that. One is that the SPR barrels that have been released to date have been relatively heavy sour barrels, which are in direct competition with Canadian barrels. So there is just a competitive balance with those SPR barrels, number one. Number two, there's various refinery outages in some of the larger complexes and states that are conspiring against demand for, again, our heavier barrel. And then number three, you see other supply chain type bottlenecks as a, for instance, just low water levels on the Mississippi River and ability to ship and barge cargo and crude and so on down to the Gulf Coast. That's also an incremental drag. So today we see differentials having blown out pretty materially.

Now, I will also say, we see this happen intermittently. Differentials, if we look out to 2023 are called at $20 American. That's not totally untenable. It's a wider differential, but it is to a certain degree accommodated within the context of a decent benchmark pricing in and around that $80 level on strip on WTI. Plus, you get a very favorable currency backdrop to provide a tailwind to that, such that, even on the heavy barrels, your realizations on 2023 strips still look like they're in and around $80 a barrel. And on a light barrel, which has seen less of an impact from the differential landscape, you're still realizing a hundred dollars a barrel Canadian.

So it's one of these elements, and I've covered this space for over 15 years, but the differential and natural gas basis conversation is something that comes up frequently. And I would say from what we've seen historically, this is the lowest emphasis I've seen on this from the investment community. It just feels like we have an appreciation now for the fact that this happens intermittently. It is transient and the solution for this type of price environment is low prices, which will slide us back the other way in the medium term. So I think that we're looking through what's occurring right now on the differential landscape and still holding optimism towards a more normalized environment in 2023 and beyond, but also being conscious of the fact that these differential blowouts will continue to happen intermittently forever.

Nick Piquard
Understood. And if you take your point about the SPR release and how that type of crude has affected the differential, the fact that Biden has said that he intends to refill the reserve as it's come down to decade low levels at this point, would there be a potential for that to cause the opposite effect the other way?

Dan Payne
Yeah, I think that's a fair comment. And you probably start drawing on the lowest cost barrels to try and accommodate that. They've indicated that they want to refill in around a $70 price level. Okay, well the Saudis have indicated that they'd like to realize a $90 price level, so you're going to need to search for some cheaper barrels. And just by virtue of where we exist on the pipeline system and the net quality and transportation differentials that relate to Canadian crude, we probably are that marginal barrel to refill SPR at some point. And so that probably does support the relative differential landscape longer term.

Nick Piquard
Excellent. So in the short to medium term, I think the outlook looks very positive for oil prices and oil and gas producers. But taking a look at the longer term on the demand side, do you think there's, with the world trying to electrify and the Biden administration targeting 50% of all cars purchased in the US by 2030 to be electric, what are your longer term forecast in terms of oil and gas demand? Is lowered oil and gas demand going to be offset by the fact that we haven't invested enough oil supply in the past several years? What do you see that shaping out? Is the world going to be switching to more lithium, more copper and less fossil fuels, less oil?

Dan Payne
Yeah, it's a very good question, and it's something we think about a lot in the sense of, these are longer term initiatives, longer term targets, but you have to keep an eye on where the market is going to. So from the standpoint of, let's just talk about crude demand first. Crude demand globally is a demographic thing. So it basically has a perfect correlation with population growth. That's globally. And so if there is a big disruption in demand in one region, that means that you probably just need to find other markets for your product. So that would be what I would say the worst case scenario is, is you're just redistributing your product to different markets, longer term. In the short term, it remains to be seen that there would be any demand destruction from the theme of EVs (electric vehicles).

Dan Payne
Now, as it relates to the opportunity for this transition to EVs and high proportion growth in that market, and we saw that commentary from Tesla yesterday, is that, yeah, we are going to need more of everything, more of every commodity. Copper, cobalt, lithium, everything to build these items. And I would also say plastics and petrochemicals to drive that, because these are generally lighter cars. So I think we need more of everything. And that's the reality of this, the demographics of consumption globally. And I think that one of the biggest read-throughs for our group, and certainly Canadian energy, is natural gas. Natural gas will remain one of the highest efficiency commodities to generate power for the electric grid to support what is increasingly an electrically driven transportation market. So I think gas is going to be a big benefactor of that longer term. And again, all of this will have to be supported by more of every commodity.

Nick Piquard
Understood. So for investors looking that are interested in oil and gas investing, what do you think are the key aspects of the sector they should be looking at in near and long term? And we've seen pipelines sell off recently due to the higher rate environment. Is this a potential play, a way to play the sector, given the sell off?

Dan Payne
Yeah, it's a good question. The way I would present this is to say we've just laid out a relatively optimistic, long-term commodity outlook. So we feel like the commodity is well supported. We also referenced that the upstream EMP companies are acting in a disciplined and sustainable fashion. So they are going to try and target a growing return of capital mandate, dividends, and buybacks through those healthy commodity prices over the long term. So you have higher implied yields being generated by the EMP companies for the first time in recent memory, and that's offering a pretty interesting value proposition when you pair it against a low risk profile as a function of almost no debt on the balance sheet anymore. So this is set up for a very unique circumstance for the EMPs, where I think they are competing for capital more broadly as a function of sustainable returns. The pipelines and midstream group, they do, to a degree, take the other side of that in the sense of, well, there is not a lot of incremental growth being offered from a throughput standpoint, so that needs to be considered. Plus, you have headwinds from the rate environment. So I think that our disposition right now, where we do see outsized yield propositions, is in the EMPs. Again, just benefiting from and hopefully outstripping the yield pressures that you're seeing from the rate complex.

Nick Piquard
Yeah. Well, especially as they deleverage and they have these high cash flow yields. They're definitely very interesting time for that part of the sector. Now, finally, in terms of ESG factors, oil companies are diversifying their business away from fossil fuels, especially the larger multinational oil companies. What should investors be looking at when considering ESG factors?

Dan Payne
ESG is important, and we've all acknowledged that. We've acknowledged that as a sector. And I think that there has been a big sentiment change towards the fact that oil and gas energy, the entire complex, needs to have a greater emphasis on all of the ESG parameters, each one of the three. And from our perspective, I think that there's a lot of efforts and initiatives being made from the energy sector to execute upon that, whether that be carbon capture initiatives that we're seeing very broadly executed or other governance items that we see as well. I think that there's a lot of positive strides being made there.

I mean, I think ESG, it's structural, it's entrenched in the sector. I think that we are, and to quote a colleague of mine, we are transitioning maybe from ESG 2.0 to ESG 3.0, though, where I think the market is taking a more pragmatic and practical view towards ESG as opposed to the draconian view that I think was being applied through ESG in the prior ESG 2.0 regime, let's call it. So I think the sector is improving in all those parameters. It's making strides, making efforts. And I think that that is being recognized by investors and stakeholders. And I think that that's ultimately going to be positive towards the perception of the industry and its long-term sustainability

Nick Piquard
Now, interesting, because when you're looking at ESG factors, it's been years, if not decades, since there's been a lot of concerns about the Canadian Oil Sands and attempts by the companies operating there to improve their ESG billing because the concern about oil sands even predates a lot of the ESG investing. Did that give them an advantage in terms of potentially being ahead of the curve?

Dan Payne
Yeah, I think it did. And I do think that there is... We, as a Canadian industry, were painted with a brush earlier than the rest of the industry. And so, there has been a lot of initiatives to address a lot of these things. And I think that this brings into context something that's really important, is that, as a world, we consume 100 million barrels a day of oil, and some of the cleanest and most ethical barrels that are produced come from countries like Canada. And so, I think there needs to be an acknowledgement and some respect ascribed to that, and the efforts and the advancements that the industry has made and will continue to make as they seek to institute large investments and things like carbon capture. I mean, these are very important, very differentiated, and they're not something that you can tangibly say are happening necessarily in other parts of the oil supply complex, globally.

Nick Piquard
Excellent. Well, Dan, thank you so much for being with us today and taking us through what's happening in the oil and gas sector. It was a fascinating conversation. We hope to have you again some time.

Dan Payne
You bet, Nick. Thanks for having me.

Nick Piquard
All right. Take care.

Dan Payne
Take care.

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