HD **The Plunging Oil Price And LNG**

BY By Greg Peel

WC 1,939 words

PD 30 October 2014

SN FN Arena

SC FNAREN

LA English

LP

Goldman Sachs believes the recent sell-off in oil has been exacerbated by large shifts in positioning among participants, beyond that suggested by fundamentals. When the West Texas Intermediate crude oil price traded at US$80/bbl earlier this week, it had fallen 25% from its June high. But despite Goldman's questioning of the drop, the broker has brought forward what was previously a medium term bearish oil outlook. Goldman now forecasts prices to decline further in 2015, and has lowered its average 2015 WTI forecast price to US$75/bbl (Brent US$85/bbl) from a previous US$90/bbl (Brent US$100/bbl).

TD

The forecast is predicated on three assumptions. Firstly, that OPEC will no longer act as the first-mover swing producer tasked with maintaining a floor price for oil. The recent increase in global oil production is not of OPEC's doing, but is a result of accelerated North American shale oil production. Secondly, the scale and sustainability of North American shale production is driving the global cost curve lower and entrenching cost deflation. Thirdly, accelerating global production outside both OPEC and North America will outpace demand growth.

Up until recently, notes Goldman, a tight global oil market required strong OPEC and shale production to meet growing demand, but it was only a matter of time for supply would begin to exceed demand. That time has come, earlier than analysts had previously assumed, given shale production in the US alone now grows by an amount every year equivalent to the entire production capacity of Libya. US production growth now needs to slow, Goldman suggests (as does OPEC). Pricing dynamics in the oil market have now moved away from being dependent on OPEC production quotas and towards the marginal cost of US shale production.

Goldman is not alone in downgrading its oil price forecasts. Indeed, for the past couple of months there has been a parade of broker downgrades, many brokers being forced to shift more than once. Goldman Sachs is nevertheless the first major house to stick a "7" in front of an assumption.

Goldman Sachs may be negative on 2015, but Macquarie "remains cautiously optimistic" on prices over the balance of 2014.

Strategic Petroleum Reserve fills could add as much as 25 million barrels of demand between China and India over the balance of the year, Macquarie suggests. New refinery start-ups could also add around 140,000 barrels per day of demand. With the Brent forward price curve now in "contango" (future prices above spot prices), end-users may look to buy into storage, further increasing near term demand.

The broker also notes the December quarter tends to be the strongest demand quarter of the year. And Macquarie suggests improving economic data in China, South East Asia and India could lead to positive surprises.

There is nevertheless no escaping the fact Australian listed energy producers have taken hits in their share prices as the price of oil has fallen. This includes the big LNG export aspirants, given seaborne LNG is priced on an oil price-indexed basis. But as FNArena's last LNG industry update noted (More On The Outlook For Oil And Gas Prices), Asian LNG customers are not inclined to risk longer term supply security by using a volatile oil spot market as an excuse to haggle on contract pricing. Asia will still "pay up" for energy security, although clearly if the longer term oil price is to stabilise nearer today's prices than the plus-100 numbers we had become accustomed to, the future revenue assumptions of Australia's LNG producers and soon-to-be producers will need to be reassessed.

Australia's energy sector majors have recently all published their September quarter updates. For the LNG aspirants the question at present is not so much one of pricing but one of timing, with regard first gas after years of facility development.

Oil Search ((OSH)) is already producing LNG at the PNG facility of which it is a major stakeholder. Given production came in ahead of schedule, the question now is just when, and by how much, Oil Search will begin to reward patient shareholders with increased dividends. To that end the company will increase its profit payout ratio from 30-40% to 35-50%, six months earlier than analysts had previously anticipated.

The balance will be held for further capital expenditure with an eye to growth, but Oil Search will stick to PNG, its brownfield developments and exploration potential. A third train at the PNG LNG facility is in the company's sights. This is comforting news for those worried Oil Search, which is strictly an explorer/developer and not an operator, might tick off PNG and spend newfound revenues on the hunt for more gas in some far flung corner of the earth.

Santos ((STO)) is a minor stakeholder in PNG LNG. Unscheduled outages impacted on Santos' existing Cooper and Carnarvon Basin production in the September quarter but analysts are not concerned given future valuation depends enormously on the company's GLNG project in Queensland, which is now 90% complete. First gas is expected next year.

BG's neighbouring QCLNG project will just pip GLNG at the post on first gas, which will provide either a positive or negative barometer for initial GLNG success. Thereafter, sufficient gas supply remains an issue for Santos but the company is exploiting and pursuing various developments from Cooper Basin joint ventures to Surat Basin acquisitions. Santos, notes UBS, is the Australian energy major most exposed to fluctuations in the oil price.

Origin Energy ((ORG)) is both an upstream producer and downstream distributor of energy (domestic gas and electricity). After a difficult FY14, shareholders were disappointed at the company's AGM that greater detail, and some numbers, were not provided with regard to FY15 guidance. Rather, management simply provided a "subdued" outlook for FY15, but then as JP Morgan noted, Origin typically never offers quantitative guidance at its AGM.

FY15 is somewhat academic for Origin nonetheless, given management expects a solid return to growth from FY16, corresponding with the start-up of the company's APLNG facility.

Woodside Petroleum ((WPL)) is the odd one out amongst Australia's energy majors, given the company is not looking forward to any new LNG start-ups in the near future. Woodside already exports LNG via its legacy North West Shelf interest and more recently from its Pluto facility in Western Australia. Not only will Woodside play wallflower as PNG and the three Queensland CSG LNG facilities fire up in the next two years, the company has very little in the way of current growth prospects beyond the longer term.

Woodside is instead currently a dividend play, at least until any worthwhile acquisition or expansion opportunity comes along. To that end Woodside posted a very solid quarter of production in September. But while dividends are providing shareholders with a solid yield right now, the quantum of payments can only decline as revenues decline without growth. A lower oil price will also mean lower dividends (although a lower share price acts to keep actual yield steady).

While the share prices of Australia's listed oil majors may have suffered of late due to falling oil prices, the impact on mid-cap producers has been more pronounced. The mid-caps cannot look forward to step-jumps in revenues from pending LNG start-ups, but rather are producers reliant on exploration, development of unconventional prospects, joint venture partnerships and the price of oil.

To JP Morgan, however, falling share prices have delivered the mid-caps into the range of more attractive valuation, and the potential for sudden and sharp share price rallies were the oil price to bounce.

AWE Ltd ((AWE)) is JP Morgan's stand-out among the mid-caps, given a strong production outlook which is not as leveraged to the appraisal of unconventional sources as peers. The broker has an Overweight rating on AWE, and last week lifted Drillsearch Energy ((DLS)) to Overweight, largely because of its pronounced share price plunge. Senex Energy ((SXY)) is upgraded to Overweight for the same reason.

Beach Energy ((BPT)) is similarly upgraded, but only to Neutral from Underweight. JP Morgan previously believed the market was overvaluing Beach's unconventional production outlook, beholden to extensive time and cost, but a share price pullback has brought the stock closer to valuation reality in the broker's view.

With regard the longer term picture for LNG, Macquarie notes the Canadian province of British Columbia has now released its long anticipated tax terms for the growing number of west coast LNG project proposals (18 at last count) and suffice to say, the terms are considered favourable to the industry and a lot better than feared. Given Canada's LNG hopefuls are also targeting the Asian market, Canada poses a real threat to Australia's longer term LNG export aspirations.

The total capacity of the projects proposed to date would equate to around 240mtpa, Macquarie estimates, about the equivalent of last year's globally traded LNG volume. Growing prospects in Canada thus point to growing headwinds for Australia, says Macquarie, but realistically the broker only expects three or four of the 18 to actually proceed.

That said, given the US is hoping to export around 80mtpa of LNG by 2025 by virtue of its abovementioned shale **oil**/gas production, Australia, Canada and East Africa are being pushed up the cost curve, Macquarie notes, and will have to fight aggressively for buyers. Attractive tax cuts in British Columbia will only add yet more competition to "what is already looking like the most competitive LNG environment we have ever seen" from 2020-25. Speed to market will therefore be crucial. Macquarie estimates global LNG capacity could grow to 400mtpa by 2025 when it will fight over 80mtpa of incremental demand growth over the same period.

Woodside would be most impacted by such a development, Macquarie suggests. Browse, off Western Australia, is the **company**'s only nearer term potential project (~2021 completion) and JV partner Shell may become increasingly focused on Canadian opportunities instead. This would make Woodside even more reliant on acquisitions in order to maintain reserves.

Santos' future is more about delivering existing (albeit marginal, in Macquarie's opinion) developments rather than looking for new ones. Santos is thus least exposed among the majors, the broker suggests, at least until contract renegotiation time rolls around when buyers will be able to exercise more bargaining power.

Oil Search is lower down the cost curve hence will have less trouble finding buyers, Macquarie notes, albeit via lower export prices, hence a third train at PNG appears less threatened by Canadian progress. Added competition could nevertheless erode returns.

Technical limitations

If you are reading this story through a third party distribution channel and you cannot see charts included, we apologise, but technical limitations are to blame.

RF 88980A41-B915-CC23-1435E6A8259C1005

CO opexpc : Organization of the Petroleum Exporting Countries | gldmns : The Goldman Sachs Group Incorporated

IN i814 : Banking | i831 : Financial Investments | i83101 : Investment Banking | ibnk : Banking/Credit | ifinal : Financial Services | iinv : Investing/Securities

NS m143 : Energy Markets | c314 : Pricing | mengpr : Energy Prices | c31 : Marketing/Markets | ccat : Corporate/Industrial News | m14 : Commodity Markets | mcat : Commodity/Financial Market News | ncat : Content Types | nfact : Factiva Filters | nfce : C&E Exclusion Filter | nfcpin : C&E Industry News Filter

RE austr : Australia | apacz : Asia Pacific | ausnz : Australia/Oceania

PUB FN Arena Ltd.

AN Document FNAREN0020141030eaau0002t