Market Update: Oil & Gas – August 2015

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Oil & gas markets: monthly roundup

Crude oil prices in July and early August continued in a downward trajectory – with both the Brent and WTI benchmarks falling below a key psychological support level at 50 US dollars (US$) per barrel (b).

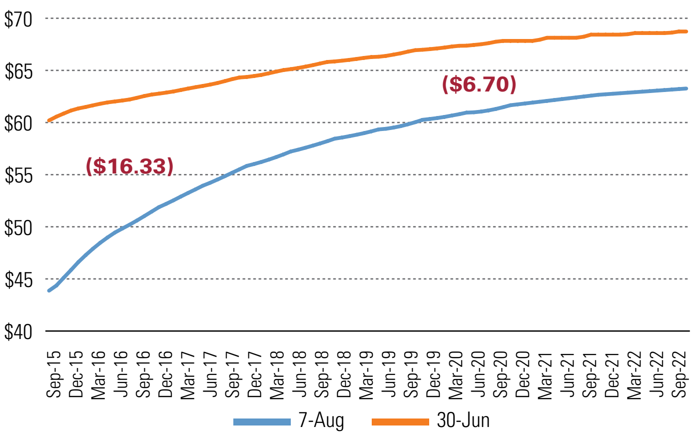
Sentiment remained on the bearish side both fundamentally and across non-commodity bourses throughout July and early August as concerns over the health of the global economy and the crude oil over-supply situation continued to weigh on market prices. The Greek debt crisis, the Chinese stock market crash and Iranian P5+1 nuclear deal were all seen to place downward pressure on oil prices. On 27 July, the Shanghai Composite index plunged 8.5 percent – the largest one-day percentage drop since 2007.

On 7 August, the ICE Brent futures contract sunk to its lowest level since early 2009, eventually closing at US$48.61 per barrel (b), the US NYMEX WTI contract was also trading close to 6-year lows, closing at US$43.87/b.[1]

US production growth

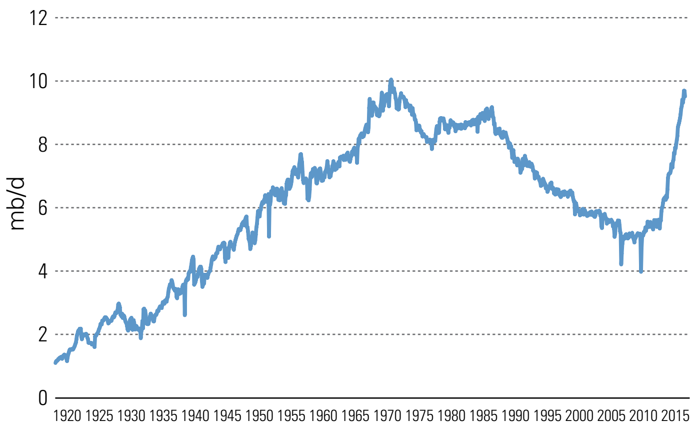
Despite the recent price fall in crude oil benchmarks, crude oil production in the US continues to remain resilient in the face of bearish fundamentals.

NYMEX WTI Futures



Source: Bloomberg, CME

US Crude Oil Production



Source: EIA

Recent data published by the Energy Information Administration (EIA) revealed only a small decline in US production with volumes remaining in the vicinity of the all-time high set in 1970. A survey of North American oil producers' quarterly reports shows mixed results through June of this year. According to our survey of 15 US oil producers, oil majors (BP, Shell, Exxon, Chevron and ConocoPhillips) have reduced oil output by approximately 102 thousand barrels per day (kb/d), or 5 percent of their production volume, compared to the previous quarter; and around 80 kb/d, or 4 percent, of their volume on a year-on-year basis. Independent producers reported a moderate increase in production for the quarter and a 15 percent increase in production year-on-year (for Q2).

NA Oil Production	Majors	Independents	Total
Sample Size	5	10	15
Q-o-Q Change, kb/d	(102)	10	(92)
Q-o-Q Change, %	(5%)	1%	(2%)
Y-o-Y Change, kb/d	(80)	216	136
Y-o-Y Change, %	(4%)	15%	4%

Source: Company 10-Q's, KPMG Analysis

[1] Source: Bloomberg

Iran: a US$10 market-mover?

After signing the nuclear deal on 14 July 2015, Iran's deputy oil minister for commerce and international affairs, Hossein Zamaninia, announced plans to increase Iran's oil production by 500,000 b/d within a week after the removal of sanctions, and by 1 mb/d within a month after all sanctions are lifted. The World Bank estimates that Iran's full return to the global market will result in US$15 billion in oil revenues for the country in the first year – culminating in a 5 percent growth in GDP by 2016. The minister expects to sign 50 oil and gas projects, worth US$185 billion, over the next 5 years.

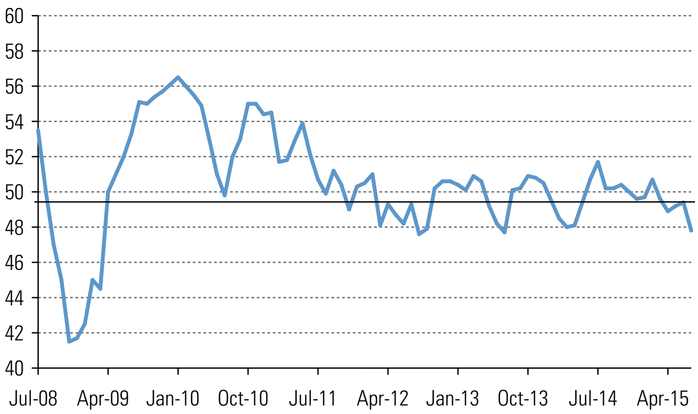
The World Bank estimates that the return of Iranian production could lower global oil prices by US$10/b by 2016. The drop in oil prices could result in oil export revenue losses as high as US$40 billion for the likes of Saudi Arabia who have been pumping in excess of 10 mb/d. The OPEC quota meanwhile continues to be breached with the latest OPEC production data revealing 31.38 mb/d in June, well-above the 30 mb/d quota.

China: In focus

In recent months, China's economy has been afflicted by a barrage of sedate economic data. In July, the closing reading of the Caixin/Markit purchasing managers' index (PMI) showed China's manufacturing sector contracting to a two year low. Indeed, falling new export orders and output led manufacturers to slash production at the fastest rate since November 2011.

Caixin Purchasing Managers' Index (PMI)

Above 50 refers to expansion; Below 50 refers to contraction



Source: Bloomberg

Within the same month, the Shanghai Stock Exchange (SSE) Composite, experienced its second biggest fall in history, with the index ending down 8.5 percent at 3,725.25. Clearly, there are growing concerns surrounding the long-term economic prospects.

In an effort to ease downturn concerns, the Chinese government has taken pro-active measures to balance the economy. Government rhetoric and economic stimulus policies, emphasizes the desire to build a sustainable and more self-reliant economy, one which is not export-driven but increasingly consumer-led. This transition is particularly evident in the oil and gas sector.

Shanghai Stock Exchange Composite Index

Source: Bloomberg

As China's economic performance weakens and the US dollar strengthens, the country's demand for crude oil imports has declined, compounding the downward price pressures on international crude benchmarks. On the New York Mercantile Exchange (NYMEX), WTI crude for September slipped below US$45/b, a level it has not touched since March. Indeed, China's crude oil imports in May were equivalent to 5.5 mb/d, down from 7.4 mb/d in April. In terms of oil products, demand was down six percent.

As symbolized by the recent signing of the Eastern Route Russia-China gas pipeline, energy security through import diversification will remain a prominent feature of Chinese foreign and energy policy. Under the 30 year gas purchase and sales contract, Russia will supply 38 billion cubic meters (bcm) of natural gas annually to China.

Yet, China's drive towards energy security and self-sufficiency remains bold. Although there are a number of technical and environmental hurdles to overcome, China has invested

vast sums into developing its shale oil and gas output and looks determined to make its shale bet a success. Moreover, China has ploughed resources into diversifying its energy framework: investing aggressively in nuclear power, renewable and hydro-energy. Such policies will further impact oil and gas import potential in the long run.

Ultimately, a moderating and transitioning Chinese economy will add downward pressure on oil and gas prices. However, it is important to make the distinction that although China's economic growth rate will be slower, it will still be relatively strong. Indeed, for the foreseeable future, the country is likely to remain the world's largest net-importer of crude.

Supply side headlines

- Non-OPEC oil supply growth in 2015 is expected to be 0.86 mb/d, up 0.18 mb/d from earlier estimates, due to increased supply from US, Latin America and the FSU. (OPEC)[1]
- Iran's full return to the global market will eventually add 1 mb/d, lowering oil prices by US$10 per barrel next year. (World Bank)[2]
- In 2016, non-OPEC oil supply is projected to grow by 0.30 mb/d to average 57.69 mb/d. (OPEC)[3]
- Britain, China, India, Turkey and Saudi Arabia are among the countries most likely to see the largest rise in post-sanctions trade with Iran. (World Bank)[4]
- In June 2015, OPEC production increased by 283 kb/d to average 31.38 mb/d. (OPEC)[5]
- Gross inputs to the US refineries exceeded 17 b/d in July, a level not previously reached since EIA began publishing weekly data in 1990. (EIA)[6]

Demand side headlines

- World economy is forecast to grow 3.5 percent in 2016, marginally higher than 2015 growth of 3.2 percent. OECD economies are expected to expand by 2.1 percent in 2016, compared with 2.0 percent in 2015. Chinese growth is expected to decelerate to 6.5 percent from 6.9 percent in 2015, while India is forecast to achieve higher growth of 7.7 percent in 2016, compared with 7.5 percent this year. (OPEC)[7]
- Global oil demand growth is expected to be 1.2 mb/d in 2016, compared to 1.4 mb/d in 2015 (IEA)[8]
- OECD oil demand is expected to register positive growth of 0.18 mb/d, while non-OECD consumption is projected to grow by 1.16 mb/d. (OPEC)[9]

Analyst estimates: oil

Brent forecasts remained relatively unchanged from last month as analysts maintain their prediction of a medium-term recovery in prices. The major downside risk remains the uncertainty of OPEC production, however, the recent cuts to capital expenditure and low spare capacity could offer support to crude oil prices.

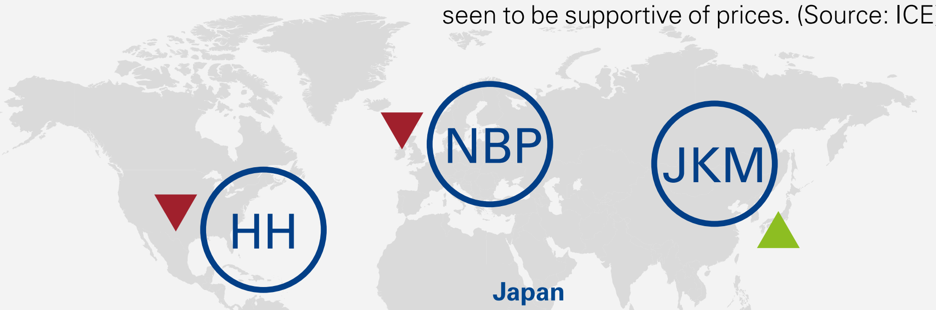
Brent (US$/bbl)	2015	2016	2017	2018
June Avg	62.0	69.8	80.2	85.1
July Avg	62.2	69.7	80.2	85.1
June Median	61.8	70.0	80.0	80.0
July Median	61.5	70.0	80.0	80.0
Number of estimates	19	17	11	7

Source: based on a poll of 19 external energy market analysts

1 Monthly Oil Market Report, OPEC website, 13 July 2015, accessed 10 August 2015
2 "Iran: Lifting of Sanctions Will Lower Oil Prices and Boost Domestic Economy If Managed Well, World Bank website, 10 August 2015, accessed 10 August 2015
3 Monthly Oil Market Report, OPEC website, 13 July 2015, accessed 10 August 2015
4 "Iran: Lifting of Sanctions Will Lower Oil Prices and Boost Domestic Economy If Managed Well, World Bank website, 10 August 2015, accessed 10 August 2015
5 Monthly Oil Market Report, OPEC website, 13 July 2015, accessed 10 August 2015
6 U.S. refineries are running at record-high levels, EIA website, 7 August 2015, accessed 10 August 2015
7 Monthly Oil Market Report, OPEC website, 13 July 2015, accessed 10 August 2015
8 Global oil demand to slow in 2016: IEA, CNBC website, 10 July 2015, accessed 10 August 2015
9 Monthly Oil Market Report, OPEC website, 13 July 2015, accessed 10 August 2015

Gas markets: monthly roundup

Industry benchmarks



UK

ICE UK Natural Gas Futures increased marginally, by 1 percent, month-on-month to 42.94 pence per therm (p/th). Lower supplies from Norway were seen to be supportive of prices. (Source: ICE)[11i]

US

Natural gas prices at the Henry Hub delivery point fell 2 percent for the month of July, averaging 2.84 US dollars per million British Thermal Units (MMBtu). Natural gas injections for 2015 (season runs from April to November every year) has totaled 1,436 billion cubic feet (bcf) – 20 percent higher than the five-year average, but are 7.5 percent lower than last year's record-high levels over the same period. The increased injections are primarily driven by higher production levels leading to a deterioration in price.[10]

Japan

The Platts Japan Korea Marker (JKM) for August deliveries averaged US$7.395/MMBtu, down 2.7 percent month-on-month and 34.9 percent year-on-year. The m-o-m decline in prices was due to reduced demand from northeast Asia, which was unlikely as August is typically a peak month of summer buying due to increased demand for power generation[12]. In other news, the Japanese OTC exchange (JOE) saw its first liquefied natural gas (LNG) non-deliverable forward deal concluded during the month of July. The 5,000 tonne deal for September delivery was the first of its kind since the market launched 12 months ago[13].

Analyst estimates: gas

Henry Hub forecasts showed minimal movement from last month for 2015/16. Lower estimates for 2017/18 will cause intrigue across the global LNG market with many US export contracts linked to the Henry Hub price benchmark.

Henry Hub (US$/MMBtu)	2015	2016	2017	2018
June Avg	2.9	3.5	4.0	4.3
July Avg	2.9	3.4	3.9	3.9
June Median	2.9	3.5	4.0	4.4
July Median	2.8	3.4	4.0	3.9
Number of estimates	17	17	10	5

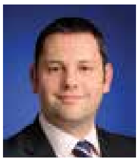
Source: based on a poll of 17 external energy market analysts

10 Natural Gas Weekly Update, EIA website, 5 August 2015, accessed 10 August 2015
11 "ICE UK Natural Gas Futures #1 (M1)," Quandl website, https://www.quandl.com/data/SCF/ICE_M1_FW-ICE-UK-Natural-Gas-Futures-1-M1-Calendar-Weighted-Adjusted-Prices-Roll-on-First-of-Month-Continuous-Contract-History, accessed 10 August 2015.
12 Platts JKM for August-delivered LNG down 2.7% from previous month, China Weekly News, 30 July 2015, accessed 10 August 2015
13 Reuters website: http://uk.reuters.com/article/2015/07/31/japan-lng-trade-idUKL3N10B30820150731
i "ICE UK Natural Gas Futures #1 (M1)," Quandl website, https://www.quandl.com/data/SCF/ICE_M1_FW-ICE-UK-Natural-Gas-Futures-1-M1-Calendar-Weighted-Adjusted-Prices-Roll-on-First-of-Month-Continuous-Contract-History, accessed July 2015.

A global insight

Points of view from KPMG's Oil & Gas subject matter experts

UK



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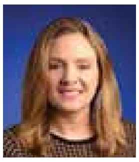
M&A update

"Iranian supply (and existing storage) entering the market will continue to depress current oil prices. An extended period of lower prices will compound the already depressed M&A market, where financially robust buyers are keeping their powder dry as they wait for quasi distressed or portfolio rationalization processes to bring high value assets to the market at competitive valuations. In our view, although the scale of Iranian resources is significant, and there appears to be a willingness from the Iranian government to reform the industry, there are a number of political, fiscal and capital hurdles to be addressed before Majors will be comfortable investing. Large independents with a greater risk appetite may see the opportunity to access high value deals."



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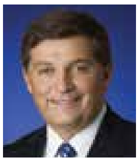
Iran post-sanctions: risk and reward

The easing of sanctions could present huge opportunities for those looking at the Iranian market. "Due diligence" remains the watchword. Key risk themes to address include: i) Complex and convoluted corporate structures that link back directly or indirectly to state-owned enterprises or government actors. How do you know who you are really doing business with? Are you associating yourself with corruption and/or a sanctioned entity? The Iranian Revolutionary Guard Corps –IRGC- has significant influence in the oil and gas sector, for example; ii) The gulf between official government-decision-making structures and the reality of contract negotiation and bid influencers. You need to understand the agendas of government counterparts who may influence your bid; To protect yourself from commercial, reputational and sanctions risks in Iran, it is as important as ever to know who you are dealing with, what their strategies are, and what your exit strategy might look like.

US



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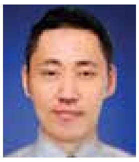
Oversupply widens contango

"Crude oil forward curves continue to shift lower signaling producers to reduce supply. The crystal ball for crude prices remains cloudy as the apparent reluctance of the US producer community to collectively curtail production makes it difficult to predict when and if oil prices will stabilize or increase. The widening contango is also another signal of over-supply. Since the end of June, the WTI forward curve contango between the prompt month and the Jan-20 contract has widened by $9.60 per barrel or almost $0.19 per barrel per month. Over the coming months we expect inventories on land and sea to increase, especially during the fall when refineries typically undergo maintenance turn-around."

ASEAN



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Potential Opportunity in Commodity-linked Currencies?

"In parallel with the Chinese economy losing steam, commodity prices have slumped. Resource rich, export-led countries that have their currencies indirectly linked to commodities, such as Australia and Canada - are beginning to feel the pinch through the subsequent currency devaluation. It will be interesting to see at what point commodity consumers look at physical assets and cargo prices and decide 'now is a prime opportunity to capitalize on low price market.'"

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