Intelligence MEMOS

From: Glen Hodgson

To: Canadians Concerned about COVID

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Re: **THE OTHER CANADIAN THREAT: THE OIL SECTOR PRICE SHOCK**

Canada's leaders and policy thinkers are rightly focused today on COVID-19, and its health and economic impacts.

A recession in the first part of 2020, which could be very deep, is a realistic expectation as demand collapses because of public health restrictions.

And regions and firms in the oil sector also face the sharp drop in oil prices today, compounded by rapidly changing prospects for global oil demand.

The deep economic slowdown in China due to COVID-19 contributed to dropping oil prices. And the OPEC effort to regulate supply and stabilize prices has devolved into a price war between Saudi Arabia and Russia, driving down global oil prices.

The key North American reference price, West Texas Intermediate or WTI, has tumbled below US$25 a barrel. The pain is even greater in Canada, where Western Select prices have fallen below US$10 a barrel. A sharp slowdown in cashflow for the sector is anticipated in 2020, perhaps by as much as 75 per cent, with a severe pullback in investment spending and cuts in jobs and salaries.

For Canada as a whole, the net impact of lower oil prices is negative – consumers benefit, but the oil sector and its supply chain suffer, as do investors. For Alberta, as well as Newfoundland and Labrador, this is the latest episode in a painful period stretching back to the previous sharp drop in oil prices in late 2014. Alberta's economy contracted by around 3.5 percent in each of those years and unemployment jumped to 10 percent.

Alberta is now facing yet another recession in 2020, after an expected contraction in 2019. The pressure is acute on the entire provincial economy and on public finances. Large capital investment in the energy sector, drawing upon engineering services and construction, is being deeply affected in the current price environment. The policy initiative to clean up for orphan wells is a welcome stop gap, but very short term. When combined with the impact of COVID-19, we should recognize the prospect of deep recession and the acute impact on many Albertans.

As if that's not enough, the prospects for global oil demand and production are also evolving rapidly, even if oil prices recover to more normal recent levels.

Global oil demand is likely to contract for at least the first half of 2020 because of COVID. And contraction was already in the long-range forecast. After repeatedly under-estimating the growth in energy from renewables, the International Energy Agency (IEA) last November provided two scenarios for oil's long-term outlook. The Stated Policies (or baseline) scenario projected global demand growth that is fairly robust to 2025, but slows sharply thereafter. Global oil demand is projected to increase by only 0.1 mb/d annually on average during the 2030s, eventually reaching 106 mb/d in 2040.

The landscape changes much more quickly in the second IEA scenario, with global policies implemented for achieving faster reductions in GHG emissions, plus more rapid technological change. Global oil demand soon peaks under this scenario and then steadily drops to under 67 mb/d in 2040, which is around two-thirds of current production.

The challenges to the oil sector and producing regions are obvious and will ripple across the entire economy. The negative impact of low prices in the short term could well be joined in coming years by a fight for global market share in a world where oil demand reaches a plateau sooner than many have expected.

For affected firms and for governments, assuming a return to "business as usual" may no longer be realistic or prudent. At this stage, companies and governments need to include multiple scenarios, examining a range of possible outcomes, to inform decision-making. To cope with the extraordinary forces at play, planning and action by both business and government ought to be founded on realism, adaptation, and innovation – and a readiness to continually adjust.

Diversification options like significant expansion in petrochemical production, development of diverse services expertise, and high-value agricultural expansion all become more pertinent. And in the immediate period, significant economic stimulus and adjustment assistance for the affected regions will be required to help mitigate the pain.

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