Intelligence MEMOS

From: Glen Hodgson

To: Canadian Energy Watchers

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Re: **The Goalposts Keep Shifting for the Canadian Energy Sector**

Canada's energy sector has been hit by an array of factors, global and domestic, that are constraining its capacity to operate and expand. The sector is being squeezed by uncertainty on many fronts – expansion of energy transmission infrastructure, unstable Western Canadian Select price discounts, access to investment capital, protracted regulatory approval processes, and a need to adapt to changing climate policy and limit GHG emissions from energy production.

The pandemic-induced shutdown and wobbly recovery is the latest shock, which has hit the energy sector hard. How are prospects for the Canadian energy sector being affected?

The International Energy Agency (IEA) recently released data for the initial shock of the shutdown, and the energy goalposts have clearly shifted. Global energy demand was down by 3.8 percent in the first quarter of 2020, covering only the beginning of the shutdown period. Oil demand was down nearly 5 percent due to the sharp and rapid drop in aviation and personal transportation, which together represent nearly 60 percent of global oil demand.

For the full current year, the IEA is projecting an incomplete recovery in economic activity and extended restrictions on mobility. Under this scenario, global oil demand would be down by 9 percent for the year, returning annual oil consumption to 2012 levels – a hard shock to revenue, jobs and investment. Oil demand is projected by the IEA to recover somewhat in the coming months, but it would still be about 3 percent below end-2019 levels at the end of 2020.

Global electricity demand has also fallen due to the pandemic-induced shutdown, with knock-on effects on the power supply mix. Demand fell for most conventional sources of electricity generation, including gas, coal and nuclear power. Gas demand declined by about 2 percent in Q1 and could fall for the full year.

Yet electricity output from renewables has been largely unaffected. Renewables were the only energy source that posted global growth in Q1, driven by larger installed capacity and priority being accorded for transmission and distribution. The IEA expects renewable power production to continue to increase, largely because of market forces – low development and operating costs, which are moving renewable electricity production to the front of the queue in power systems.

Not surprisingly, global CO2 emissions are projected to decline by up to 8 percent in 2020, returning to levels last seen a decade ago. Such a reduction in emissions could be up to six times larger than the previous record reduction in 2009 due to the global financial crisis.

Does the sharp drop in energy demand represent a temporary shift in the goalposts, or reflect a more persistent structural change? To address that question, three forces ought to be considered.

The first is the pathway for economic recovery and the impact on energy demand. Oil demand's recovery will encounter numerous hurdles. Air travel is likely facing a prolonged recovery period, as occurred after a previous shock like the 9-11 terrorist attacks. Expanded working from home and a hesitancy to use public transit would also influence the recovery in oil demand.

The second key force is the impact of market forces on the relative cost of producing energy. Natural gas is crowding out coal as a feedstock for thermal electricity generation in North America because of low prices for gas. Renewables have gained a material price advantage over conventional sources of electricity generation in many circumstances, feeding an ongoing structural shift toward renewables like solar and wind.

And, third, policy and business decisions are changing the overall global operating environment for energy. These include carbon pricing, regulations and subsidies designed to limit GHG missions. There are also rising expectations of disclosure and transparency by business generally, and particularly by the financial sector, on GHG emissions and energy investment.

The interaction of these forces points to a structural shift in favour of renewables, and against coal. The net impact on oil (and gas) in Canada and globally is less clear. The IEA had projected in November 2019 that global oil demand would reach a plateau in 2025, at around 106 million barrels a day. But with the shock to oil demand caused by the shutdown, the plateau in global oil demand will likely be lower (and perhaps reached earlier), at a time when Canadian producers were aiming to grow their market share through improved access to global and US markets.

In sum, multiple factors are at play in oil (and gas) markets. Market-determined asset values, and access to new capital, will be critical real-time indicators of what the market thinks about the prospects for Canadian oil and gas. We will only have certainty on developments after the fact, but it's hard to ignore the negative factors adding up.

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