Rising Oil Volatility: Suncor Energy Inc.'s CEO Has Some Words of Warning

Description

Are you ready for a wild oil market?

Oil prices will experience increasing volatility over the coming years—at least that's what Steve Williams, CEO of **Suncor Energy Inc.** (TSX:SU)(NYSE:SU), wants you to believe. His reasons are simple: underinvestment in production and uncertain demand growth.

Will his prediction come true? Let's start with the underinvestment-in-production argument.

There is no doubt the supply side is out of whack

The quick swing from US$100 oil to US$30 back to US$50 has created a difficult environment for hundreds of oil and gas producers. Indebted and over-leveraged companies found it difficult to survive the fall to US$30; many of them folded or liquidated their assets. The ones that survived still have very little excess capital to direct towards long-term production projects.

But still, the rapid speed of shale producers can swing output forecasts with incredible speed.

According to a report by the Bloomberg Intelligence, nearly half of the wells located in the Permian Basin and Eagle Ford can remain profitable even when crude prices fall below US$30 a barrel. A whopping 85% can maintain profitability with prices at US$50 or below.

Predicting North American output has become a nightmare. Still, a systemic imbalance has been created due to the current oil environment.

At US$30 oil, the world's biggest oil and gas producers faced their longest period of investment cuts in decades. Capital expenditures for the industry fell by $250 billion in 2015, falling another $70 billion this year.

Due to the lack of investment, OPEC now believes $10 trillion will be necessary over the next 25 years to ensure adequate oil supplies. About $250 billion each year will have to come from non-OPEC countries.

Rystad Energy research shows that while the oil industry "needs to replace 34 billion barrels of crude every year—equal to current consumption, investment decisions for only eight billion barrels were made in 2015." This amount is less than 25% of what the market requires long term.

So, Suncor's CEO is correct about the underinvestment in oil projects. What about his views on uncertain demand?

Demand is surprisingly uncertain

Both OPEC and the International Energy Agency (IEA) had predicted a steady, reliable 1% annual global growth for oil. That assumption is now under attack.

The IEA recently released a report outlining an unexpected trend: demand growth hasn't kept up its historical pace. While growth was expected to ease over the next few decades, it's now slowing at a pace faster than previously thought.

"For 2016, a gain of 1.3 million barrels a day is expected," the IEA report said. That's a downgrade of 100,000 barrels a day from its previous forecast. "Momentum eases further to 1.2 mb/d in 2017 as underlying macroeconomic conditions remain uncertain." That would represent the lowest growth figure since the oil price downturn began.

Stick with proven winners

Energy investors should consider companies that have tailwinds beyond simply the rising price of oil. **Husky Energy Inc.** (TSX:HSE), for example, just settled a contract dispute with **CNOOC Ltd.** (NYSE:CEO) and is looking to grow substantially over the next year or two. Even if oil prices weaken, free cash flow will likely rise.

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