Best Time To Invest In Building Pipelines Might Be The Next Few Years

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Body

Few commodities illustrate the macroeconomic realities of supply and demand as well as oil or natural gas. Even OPEC, which controls nearly 40% of the world's oil supply, unhappily finds itself on the tail that is wagged by demand. The recent global economic downturn has predictably affected oil and gas demand and demonstrated to OPEC as well as producers that demand is not perpetually elastic.

Decreased demand is likely to continue at least through 2009. Decreases in demand inevitably affect E&;P investment, but downward demand trends have another effect that is not often considered: reduced investment in infrastructure, particularly construction of new pipelines.

Work on new natural gas infrastructure will continue through 2009 and beyond, if only because many dedicated projects commenced before demand decreased. On the other hand work on new oil E&;P or pipeline projects has already slowed, and that may take longer to return. For a number of reasons, however, the next few years may offer the best opportunity in recent memory, and for the foreseeable future, to make new investments in pipeline infrastructure.

Changing Demand

The demand for energy generally, and oil and gas specifically, has increased markedly over the past decade. In part, this is due to rapid growth in the economies of China and India; the economic booms in those countries in recent years helped create the first "demand" driven energy shock, creating rapidly rising and record prices per barrel. Oil consumption in China has more than tripled since 1980 and has doubled in India since 1992. India and China are predicted to approach U.S. oil consumption by 2030, if not before.

As demand has risen over the past decade, so has the price of oil. But when the price of oil reached its demand threshold in the U.S. in 2008, consumption behavior changed dramatically and quickly. As the biggest consumer of oil worldwide - at 21-22 million barrels per day (or roughly 25% of the world oil supply) - it was surprising to many observers just how quickly the American public modified its energy consumption habits when faced with higher oil prices.

Perhaps even more surprising was how quickly the global demand for energy changed in 2008. For the first time in at least 25 years, global demand for oil decreased in 2008. That decrease was driven by the financial decline of Wall Street, as its global impacts became manifest. We are now seeing the effects of the financial sector's collapse, and that event continues to influence energy demand globally, even while the price of oil has dropped significantly.

These demand trends tend to mask another development that will continue to affect energy usage in the U.S. in the coming decades: changing demographics across the continental U.S. If oil and gas pipeline planners were to sit down today to draw ideal transportation routes to end users, the resulting infrastructure grid would undoubtedly look quite different than what currently exists, given the distribution of population growth and changes in industrial sector use since the bulk of our current infrastructure was built in the 1950s, '60s and' 70s.

Of course, infrastructure planning and investment decisions are never aided by something as simple as drawing the most efficient distribution lines on a map. Availability and cost of easements, time and costs associated with permitting, and efforts necessary to resolve public concerns associated with right-of-way (ROW) must all be factored into new infrastructure planning. The transaction costs associated with new ROW and pipeline construction have increased dramatically over the past several decades, largely because of land use and demographic changes, increased permit requirements, etc.

These demographic changes, combined with current and anticipated market trends, will continue to affect oil and gas economics for years. So, too, will the increasing costs of continuing to rely on aging existing pipeline infrastructure (higher maintenance and repair costs, increased liability concerns, etc.). All of these factors will affect decision making on investment for new pipeline infrastructure.

Natural Gas Future

When President-elect Barack Obama introduced key members of his new energy and environmental team in late 2008, he reiterated his goal to make America energy-independent. This is more than just post-campaign hype; both public policy and political mandates are supporting "energy independence" for the U.S., and that theme further encourages increased development of natural gas resources and infrastructure in the States.

Couple the political climate with the fact that the U.S. Energy Information Agency (EIA) predicts that global energy consumption will increase by 50% from 2005 to 2030, according to its International Energy Outlook 2008 (June 2008). Of that, natural gas consumption worldwide is expected to increase from 104 Tcf in 2005 to 158 Tcf in 2030.

All of these factors point to continued growth in demand for natural gas and a distinct need for new infrastructure to connect new and unconventional sources to either existing distribution lines or new demand locations. Additionally, the continued legislative, administrative and judicial interests in regulating greenhouse gases (GHG), and in mandating renewable portfolio standards (RPS), suggest there

will be an increased reliance in the U.S. on natural gas, as other traditional fossil fuels are transitioned to other sources.

Oil Future

As the price of oil climbed toward record highs over the past few years, unconventional sources of oil were profitable to explore and produce (e.g., shale and oil sands). The economics of those investments changed quickly in 2008, however, and we have already seen reductions in unconventional oil-recovery investment. Many observers predict that both the global and U.S. demand for oil will likely remain on a subdued plateau for the near future, if not decline slightly as natural gas and renewables seek a larger percentage of the energy mix.

Demand for oil will never disappear, however, and even as development costs increase, a certain level of demand will always remain (even allowing for peak oil considerations, it is widely agreed that a supply of oil will be available long into the future and that declining supplies will simply affect price). In order to capitalize on changing markets and change in demand, oil interests must carefully examine the future needs for the commodity (both geographically and quantitatively).

Investment in new pipeline infrastructure may be more prudent now than ever. Attempts to time the market are rarely successful, whether the issue is financial investment or capital projects. Attempting to plan capital projects as large as new interstate pipelines is even more challenging, as significant assumptions need to be made about long-term projected demand, cost of service, etc. That said, the current political climate is more supportive of infrastructure projects, and of energy independence as a concept, than it has ever been.

If costs of building new oil and gas pipeline infrastructure are greater today than several decades ago (due to changes in land-use patterns, more complex permitting requirements, increased public scrutiny and a more litigious society), mere is no question that future costs will be even greater. More overlapping demands for land use, increased public scrutiny and more threats of litigation will inevitably develop over time. Permitting regimes will only grow more complex.

The oil and gas industry may look back on these next few years as offering a rare window for investment in infrastructure. There is both political and public support for energy independence at present, and there is a clamor from many sectors for more infrastructure improvement projects. Public and political support may never be greater than it is today for new infrastructure associated with "energy independence."

By way of example, the Securities and Exchange Commission (SEC) recently revised its disclosure requirements for unconventional oil and gas reserves, signaling recognition of increasing investments in companies with such holdings. In a Dec. 29, 2008 statement, SEC Chairman Christopher Cox commented that the revisions will allow consideration of information that is "of significance to investors in making informed investment decisions."

If the present value costs of future infrastructure projects will only increase over time, and if public and political support for such projects is unlikely to ever be better than today, then the most challenging variable affecting many decisionmaking processes may be that of projecting future demand. The one certainty is that mere will always be demand, for both oil and gas. The "how much" and "where" for calculation ofthat demand variable is a more nuanced consideration, but planners are much more informed on those issues today than they were decades ago during the last major push in infrastructure expansion.

Summary

The U.S. and global economies are both in rare retractions at present. Oil and gas interests are directly affected by those financial developments and it is difficult to predict the near-term future for oil or gas demand. Some things are clear, however: (1) the law of supply and demand clearly does affect oil and gas; and yet (2) there will always be a demand for oil and gas (even though that demand may not be as elastic as was once thought).

Declining oil and gas prices provide immethate feedback to E&;P investment decisions. Such price declines also affect longer-term decisions such as planning and investment in new oil or gas pipeline infrastructure. Although it may seem counter-intuitive, the audiors suggest that now may be one of the best times ever for the oil and gas industry to proceed with new pipeline construction. Permitting and ROW costs and challenges will only increase in the future while both political and public support for new infrastructure that can help lead to energy independence may never be higher.

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