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2017: Making American Crude Again

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Higher prices, deregulation, infrastructure – and tariffs – make US frackers takeover targets.

With just two days to go, we're not going to hit our $65 year-end price target for global crude. That said, we got to $56 on the Brent benchmark, a better than 50% gain over 2016, in a year when many major investible assets just made a big round-trip. It's better than a double from when we called the bottom in January (see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016).

- We're delighted to have used our $65 target to express our conviction. And as we head into 2017, that conviction is stronger than ever.
- *With global demand certain to outstrip supply growth in 2017, and especially with OPEC members and non-members having agreed to cut production to draw down global inventories* (see "While the World Cuts, the US Pumps" December 12, 2016), *$65 is easily reachable in the first quarter of the new year.*
- We think that December's OPEC deal is an acknowledgement that the US fracker is now the swing global producer. *Higher prices, coupled with the Trump administration's focus on deregulating energy, building infrastructure and bolstering American jobs, mean that 2017 could see US operators as takeover targets for the majors that haven't yet acquired enough US oil reserves.*

President-elect Donald Trump's America First Energy Plan speech, which was delivered at a Bakken conference in May 2016, provides some insight into what he may do after assuming office. In that speech, Trump mentioned the word "job" 21 times, and made it abudantly clear that he sees domestic production of oil and natural gas as a job creator.

- In the same speech, Trump pledged to approve the Keystone XL pipeline. He since publicly stated that he supports completion on the Dakota Access pipeline, and would resolve the impasse with protestors "very quickly" once in office. Pipe transport is critical to lowering full-cycle breakeven costs, especially for Bakken oil (see "Keystone is Key to Low Oil Prices" February 2, 2015 and "On OPEC's Production Target" September 29, 2016).
- Trump's cabinet and regulatory nominations – Oklahoma Attorney General Scott Pruitt for Environmental Protection Agency

Update to strategic view

OIL, US RESOURCE STOCKS: Crude is going to miss our year-end target of $65, but it has been among the very best-performing investible assets in 2016 – up more than 50% on the year and more than 100% since we called the bottom in January. With a looming mismatch of demand over supply and new OPEC cuts designed to reduce stockpiles, $65 is easily attainable in 2017-Q1. Higher prices, the Trump administration's focus on deregulation and infrastructure, and possible tax changes that would disfavor imported oil and favor exports, all point to the US integrated majors looking at frackers as takeover targets. ExxonMobil is especially in need of more domestic production.

[Strategy dashboard]

Administrator, former Texas Governor Rick Perry for Secretary of Energy, and Representative Ryan Zinke (R MT) for Secretary of the Interior, indeed even former ExxonMobil Chair Rex Tillerson for Secretary of State – all signal an administration eager to carry out Trump's pro-energy agenda.

- And despite President Obama's parting shots at the energy industry – a putatively "permanent" ban on oil and natural gas exploration and production in broad regions of the Artic and the Atlantic seaboard, and the designation of various western lands as "national monuments" in order to block exploration there – the industry has already begun to enjoy the fruits of the one deregulatory initiative that he signed. In a political *quid pro quo* last year for the Iran nuclear deal, Obama agreed to a GOP initiative to permit US exports of crude oil for the first time in more than 40 years.

Trump also has a protectionist agenda (see "Kudlow, Navarro, Uh Oh: Trump's First False Move" December 23, 2016), which brings us to some interesting possibilities that could arise as he works with Congress next year to implement tax reform.

- Trump's tax reform proposals, as articulated during the campaign, centered on simply lowering the top corporate tax rate to 15%. Separately, Trump has floated various forms of protectionist tariffs.
- House Republicans, led by Speaker Paul Ryan (R WI-01) and Ways and Means Committee Chair Kevin Brady (R TX-08), have a more complex tax reform "blueprint," with its own protectionist edge. It is a wide-ranging proposal that would result in a comprehensive revision of the US tax code, dramatically impacting the upstream and downstream operations for the oil and gas industry – and for that matter, the entire US business sector.
- Under the House plan, the corporate tax rate would fall to 20%. A firm's export revenues would not be taxed at all. But its expenditures on imported components of goods sold domestically could not be excluded from taxable revenue. In fancy policy-speak, this is a "destination-based cash flow tax" – alternatively, taxation is "border adjusted." This appears to be similar to the Value Added Tax concept in place in much of the developed world, in relation to which the present US corporate tax system is believed to discourage exports. *But when domestically-sourced inputs can be expensed and foreign-sourced inputs cannot, that amounts to an import tariff at the mark-up of marginal tax rate* (that is, at a 20% tax rate, a $1 imported input that is not deductible from revenues bears an implied 25% tariff versus its domestically sourced equivalent that costs only $0.80 after taxes).
- The concept's advocates in the House argue that this new system of taxation would cause the dollar to strengthen, offsetting the windfall to exporters and the punishment to importers. But if those offsets do in fact occur – highly dubious in the first place – then why bother changing the tax code?
- *But for most US participants in the global energy supply chain, the dollar debate is beside the point. Oil is traded in dollars world-wide,*

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so no matter what happens in FX markets, any tax code change that is effectively a tariff on imported product would really bite – and the freedom from taxation on exports would really help.

- Now with the ban on crude exports lifted, more than 6% of US production is already being shipped overseas, up from virtually zero just a few years ago. When those exports become effectively tax-subsidized, they are likely to increase substantially.
- The subsidy makes exports of refined products more attractive, too. But the US has little scope to expand refinery capacity to increase exports, while still serving the domestic market – unless Trump's deregulatory initiatives extend all the way to permitting new refineries, surely one of the most environmentally contentious forms of infrastructure.
- *So for US refiners, as the tax reform is currently envisioned, there would be no escape from the arithmetic that, all else equal it would be better to source feedstocks domestically so that their cost would be tax deductible. Indeed, all else equal, the difference in after-tax profits for a US refiner would be on the close order of $10 per barrel.*
- There is some scope for US refiners to immediately swap about 640,000 barrels per day of imported light oil for domestic. But after that, US frackers can't supply the medium and heavy crude that would substitute for the bulk of imports. Eventually, under the pressure of the implied tariff, refineries would gradually adapt to use lighter crude inputs.
- Looking together at the tariff pressure on imported refinery inputs and the opportunity for tax-exempt crude exports, US integrated energy majors would likely realize that they aren't sufficiently invested in US production. ExxonMobil (XOM) may be especially vulnerable – and its stock is a high-powered currency. It derives only 22% of its production from the US. For Chevron (CVX), that's 30% and for Occidental Petroleum it's 48%.
- XOM made a big move in 2009 to gain a massive natural gas foothold in the US, buying XTO for $41 billion. Its 2015 purchase of 200,000 acres in the Wolfcamp from LINN Energy was small potatoes, but demonstrates its interest in the Permian Basin – a world class oil asset with multiple formations.
- XOM is already one of the largest acreage holders in the Permian Basin. But this multiple-basin play is geographically huge, still with a great deal of room for development by horizontal drilling and hydraulic fracturing, and conventional means as well. Of the main acreage-holders, Apache Corporation (APA), Pioneer Natural Resources (PXD), Concho Resources (CXO) and EOG Resources (EOG) could be takeover targets. All of them, except EOG, have market capitalizations lower than that of XTO when XOM acquired it in 2009.
- We have no idea whether Speaker Ryan's tax reform "blueprint" will become law, or whether or not some other form of protectionism might arise that would motivate the majors to want to control more US production. But surely such things now get some probability-weight in their plans.

- Even without such factors, the far more certain deregulation and improved infrastructure that will flourish under the Trump administration, America's new position as the world's swing producer – and the ongoing productivity gains acquired as frackers move down the learning curve – make them attractive targets.

Bottom line

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