

Industry Agenda

Energy for Economic Growth

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The Importance of Energy Investment for a Sustained US Economic Recovery

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The United States is now in its fourth year of substandard economic performance, and observers are wondering if the recovery from a “credit bubble” recession is going to be slower than one from a normal “business cycle” recession. Although many analysts believe that a long, slow recovery is unavoidable, those who more fully understand the nature of the slow recovery are reaching a different conclusion. Real consumer spending has been growing since mid-2009 and is now greater than it was at the beginning of the recession. Total non-residential investment, which fell by nearly 22% during the recession, has increased by nearly 20% in the past year and is now less than 10% below its peak. Residential investment, however, declined by more than 30% and is not recovering. Importantly, because every dollar of construction GDP requires the purchase of one dollar of intermediate goods and services, total investment cannot recover until housing does.

Unfortunately, the US housing industry is unlikely to fully recover to its pre-recession activity level. Most markets were so overbuilt at the peak of the bubble that a best case recovery scenario would be 65% to 75% of peak housing starts.

About one-third of the 7.5 million jobs lost during the recession were in construction. In addition, we estimate job losses in supporting activities may have equalled 75% to 100% of the direct jobs lost. Even if the housing market returns to 75% of its peak level, we will still need to replace over 1 million construction-related jobs with other activities.

Fortunately, the domestic oil industry may provide the antidote to our housing-related employment blues. A confluence of high real oil prices and new technologies creates the opportunity for the United States to boost domestic production by 2 million to 3 million barrels per day within five years by increasing its horizontal rig count by 10% to 15% per year. Based on industry rules of thumb, this additional production would create at least 500,000 new jobs plus many new indirect jobs.

For example, new or upgraded roads will be needed for drilling and production crews. Many new resource technologies require significant investments in water handling. Pipelines or other transportation solutions will be needed to move supplies to markets. In short, this industry will create jobs for workers with construction skills. In addition, we may see downstream benefits such as a possible resurgence in the US petrochemical industry resulting from increased production of natural gas liquids in “wet gas” shale plays, or an increase in manufacturing jobs to provide steel pipe and other oil and gas field supplies. Finally, because today’s oil prices are set in the global marketplace at prices that reflect the revenue needs of oil exporting countries, profit margins will allow industry players to mitigate environmental issues associated with the development of these resources.

What public policies are needed to make this happen? First, the industry needs both clarity and certainty in its tax, environmental and regulatory environments. Clarity regarding costs allows firms to make investment decisions that reflect society’s priorities. If there are issues, they should be quantified. For example, if the public is concerned about well-bore integrity in shale drilling, solutions should be developed with dollar amounts attached to them. The costs will not be large relative to today’s margins and will properly flow through to consumers in the form of higher prices. Certainty allows firms to lengthen their investment horizons and lower the required returns – two actions that will increase the level of exploratory activity and expand the potential resource base. More importantly, investment decisions can be made based on the economic life of the activity, rather than on the political cycle. Together, clarity and certainty can dramatically increase industrial activity without requiring higher prices.

Second, the industry needs to know that infrastructure will be available on a timely and cost effective basis. Again, this is primarily an issue of clarity and certainty. The transportation charge associated with new infrastructure is directly related to the time period over which costs can be amortized. Today’s high differentials reflect both the uncertainty in the timing for permitting new pipelines and an expectation that new infrastructure costs will be recovered over a shorter time period than the productive life of the new basins.

Finally, the United States needs to address its financial system. Washington still treats the credit bubble as a liquidity issue, not a debt-to-income one, and has not resolved the underlying regulatory problems that led to excessive leveraging in the first place. Excessive leveraging allows investors to achieve higher returns in financial assets than in the capital goods that they finance. This unnatural situation restricts the flow of capital to industry, resulting in too little investment. Because “capital deepening” is needed to increase both per capita and national income, addressing this issue is perhaps the most important challenge facing the country. Recognizing that a solution to the leverage issue can also help the United States dramatically improve its energy balance may be the catalyst needed to finally make progress in this area.