December 2013

2014 Outlook: Energy

John Dowd, Sector Portfolio Manager

Fidelity sector portfolio manager John Dowd provides his view on the most attractive investment opportunities and the major risks in the energy sector in 2014.

INVESTMENT OPPORTUNITIES IN 2014

U.S. crude oil producers with strategic land positioning and low cost structures

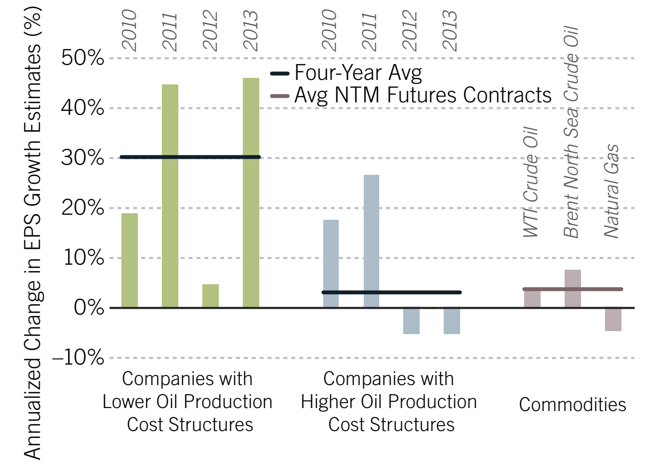
With natural gas prices at historically low levels given an abundant supply in the U.S., many energy companies have been spending the bulk of their capital to produce crude oil because it is far more economical to do so. The prospect of increased crude oil production is being driven in large part by relatively new drilling techniques to more effectively extract crude oil and natural gas from previously impenetrable shale rock formations. This drilling technology, known as fracturing (or "fracking"), has been heavily deployed in both the U.S. and abroad, and is a primary reason the outlook for increased global oil production growth remains promising.

My expectation is that crude oil prices will remain range-bound over the near to intermediate term, barring an unexpected acceleration or deceleration of the global economy. The upside to oil prices is limited by elasticity of demand and negative repercussions for the global economy. The downside to the price of crude oil is limited by high development costs via innovative shale-drilling technologies to produce the commodity. Companies are going to invest capital to produce a commodity only if it is profitable to do so. It is unlikely for the price of crude oil to fall and remain below the cost of production for an extended period of time.

In a backdrop of range-bound oil prices, owning the stocks of oil producers with operations in strategic commodity-rich regions where production costs are expected to decline the fastest may be a rewarding strategy. Today, there are several small- and mid-sized exploration and production companies that have the following competitive advantages relative to many larger, global integrated companies:

- **Strategic drilling locations.** The prospect of U.S. energy independence is being driven by production growth in four specific shale oil and natural gas field regions—Eagle Ford (Texas), Permian (Texas), Bakken (North Dakota), and the Marcellus (Appalachians). Within each of these four areas, a small group of companies owns the majority of the prime acreage and have the financial ability, scale, and innovative fracking technology to produce crude oil. These companies have made smart capital investments in the latest drilling technology, and by developing the infrastructure and acquiring the drilling rights in these regions. In my view, companies without exposure to these particular regions do not have the scale necessary to drive down production costs going forward.

EXHIBIT 1: In an environment of flat commodity prices, exploration and production companies with low cost structures and superior drilling operations in newly discovered shale oil fields have seen expectations for their profit growth increase significantly during the past three years.



EPS: earnings per share. Companies with Lower Oil Production Cost Structures are based on the view of the author as of Oct. 31, 2013, and may be subject to change. These include: Anadarko Petroleum Corp.; Continental Resources, Inc.; Cabot Oil & Gas; Concho Resources; EOG Resources, Inc.; Noble Energy Inc.; Oasis Petroleum; Pioneer Natural Resources Company; Range Resources Corp.; Southwestern Energy Company; and EQT Corp. Companies with Higher Oil Production Cost Structures are based on the view of the author as of Oct. 31, 2013, and may be subject to change. These include: Chevron Corp.; Exxon Mobil Corp.; BP p.l.c.; Total S.A.; Royal Dutch Shell plc. EPS growth is based on annualized change calculated using data from the end of October each year, through FactSet. Commodity price growth reflects an average of the futures contracts over the next 12 months. WTI Crude Oil: Price represented by West Texas Intermediate (WTI) crude oil at Cushing, Oklahoma. Brent North Sea Crude Oil: Price represented by Brent North Sea-sold crude. Natural Gas: U.S. Henry Hub natural gas spot price. Source: Bloomberg Finance, L.P., Fidelity Investments, as of Oct. 31, 2013.

- **Superior cost control and declining production costs.** Companies with prime drilling locations within the aforementioned top-producing land basins have lower exploration budgets relative to other companies (less need to seek new locations for drilling) because they already have land-drilling leases and infrastructure (e.g., drilling pads and access roads) set up in the most fertile areas. For some of these companies, total production costs have plummeted and they have already optimized drilling pads in prime locations, which is contributing to more favorable profit growth. Other companies have higher production costs because they do not have leased acreage in these four prime locations, and thus are forced to explore more vigorously to search for and identify other promising drilling regions to stay competitive.

Many of the smaller U.S. exploration and production companies that have these key attributes are growing production faster than most of their peers and, as a result, are experiencing improving returns on capital. The future oil production output of these companies continues to look promising based on improving cost structures and continued development and application of new technology. If a flat oil price environment unfolds in the coming year, stock selection within the sector is likely to be more of a differentiating performance factor than perhaps it was during prior energy cycles, when commodity price inflation provided a tailwind for the entire sector (see Exhibit 1, page 1).

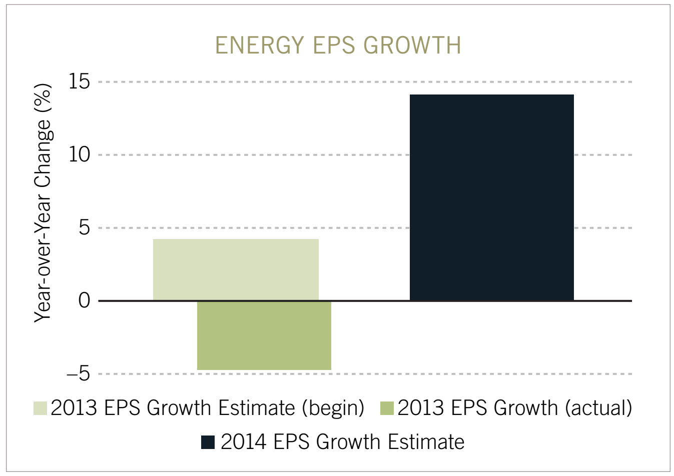
RISKS: WHAT TO WATCH IN 2014

Faster-than-expected crude oil production

Although onshore U.S. production of crude oil has increased and there is good visibility into further domestic production growth going forward, foreign production of oil has not materially accelerated, leaving global production levels more or less unchanged from the output in recent years. Going forward, one of the risks to the investment strategy I outlined earlier is faster-than-expected production growth, either in the U.S. or in other parts of the world. Such a dynamic would likely put pressure on per-barrel oil prices, as well as profits for U.S. companies engaged in oil production. It is possible that a new U.S. region will be discovered in the near term by a company or group of companies, which will lead to production levels that eclipse existing oil basins, allowing the companies involved to experience even faster earnings growth. Foreign-based oil producers also could experience the same upside in terms of higher production and lower costs should future land-basin discoveries emerge abroad.

One way to insulate the energy exposure in a portfolio from the risk of unexpectedly strong oil production growth and falling oil prices is to own the higher-quality companies with declining cost structures and strategic land resources in the most fertile shale regions. If the supply-demand fundamentals within the oil industry become unfavorable, companies with these attributes are likely to outperform their peers.

EXHIBIT 2: Earnings growth in the energy sector has fallen short of expectations in 2013, and analysts are forecasting faster growth in 2014.



EPS Growth Estimate for 2013 was as of Dec. 31, 2012. Actual 2013 data include estimates for Q4 2013. EPS: earnings per share. Source: FactSet, Fidelity Investments, as of Oct. 31, 2013.

The roadmap for this approach was produced in previous years as the U.S. developed the abundant supply of natural gas that exists today due to fracking. While U.S. natural gas prices have been in a bear market for five years due to the application of new technologies (e.g., fracking) and a subsequent decrease in costs, lower natural gas prices have not influenced all exploration and production companies to the same degree. The stocks of companies that have high cost structures have floundered as natural gas prices have retreated. Conversely, companies that have reduced their cost structure have profited in the current low natural gas price environment. For example, some natural gas producers operating in the Marcellus region have grown production volumes 20% annually, and their stocks have outperformed the broader equity market—despite the overall pressure on the price of the commodity.[1]

Going forward, I believe the same scenario is likely to play out for crude oil producers. The oil exploration companies that cannot grow U.S. production in a flat-to-falling commodity price environment are likely to be disappointing investments. In contrast, the stocks of companies with strategic advantages—ideal drilling locations and declining costs—are likely to be the catalysts of future growth in the energy sector, and I believe they could be the leaders of tomorrow, regardless of the supply backdrop.

Author

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John Dowd is a research analyst and portfolio manager for Fidelity Investments. Mr. Dowd currently manages energy sector portfolios and subportfolios, and serves as co-manager of diversified equity portfolios.

Fidelity Thought Leadership Vice President and Associate Editor Kevin Lavelle provided editorial direction for this article.

Endnote

[1] Source: Company reports, Fidelity Investments, and stock performance vs. S&P 500 index over past three years.

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