2020 Integrated Oil & Gas Outlook

The credit outlook for the integrated oil & gas sector in 2020 is stable. Companies will retain financial headroom gained from recent restructuring despite weaker commodity prices. Pressure to return cash to shareholders and tougher environmental regulation are potential threats to credit quality.

Corporates, Scope Ratings GmbH

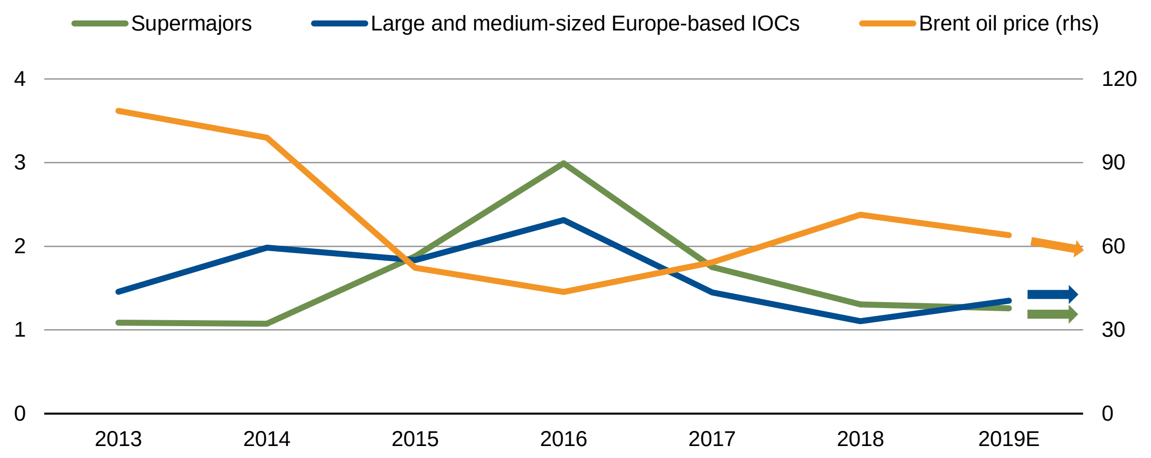
Executive summary

The credit outlook for the integrated oil & gas sector in 2020 is stable. Integrated oil and gas companies (IOCs)[1] will retain financial headroom gained from recent restructuring despite weaker commodity prices. Pressure to boost shareholder remuneration and toughening environmental regulation are potential threats to credit quality.

The main trends we expect for 2020 are:

- Brent crude prices will be weaker at around USD 60 a barrel; downward pressure on natural gas prices around the globe (with UK NBP at 30-35 pence/therm); and stable to improving refining and petrochemical margins.
- Companies should show solid operating resilience though those companies with higher break-even levels in their upstream business and weaker exposure to downstream will be more sensitive to any steep declines in oil and gas prices.
- Some divergence in financial discipline will emerge. Growing shareholder remuneration is a general trend, while the appetite for investment spending varies across the sector.
- The industry faces accelerating investor and regulatory pressures. Repsol SA is the first IOC to pledge to reduce net carbon emissions from its operations and *most products* to zero by 2050. We expect more IOCs to set ambitious targets, leading to faster and deeper transformations of their operations. The impact on credit quality will depend on the individual business and its financial strategies.
- Balance sheets will weaken in the short-to-medium term, as IOCs keep capital expenditure on legacy activities at recent levels while simultaneously investing significant amounts in new energy businesses.

Figure 1: Sector leverage (median Scope-adjusted debt/Scope-adjusted EBITDA multiples among IOCs analysed by Scope; Brent oil price (USD/bbl)



Source: Company reports, Bloomberg, Scope Ratings

Scope Corporate Ratings

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[1] Scope analysed the five supermajors – BP plc, Chevron Corp, Exxon Mobil Corp, Royal Dutch Shell plc, TOTAL SA – and the large and medium-sized Europe-based integrated producers: Eni SpA, Equinor ASA, Galp Energia SGPS SA, MOL Hungarian Oil and Gas plc, OMV AG, and Repsol SA.

Key themes for 2020

Commodity price assumptions

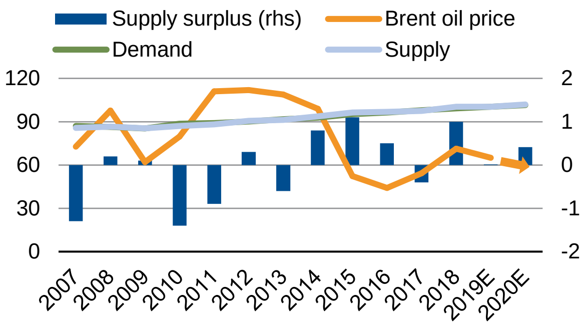
Scope's main forecasts for 2020 are:

- Moderately lower oil prices than in 2019 with Brent averaging around USD 60/bbl
- Depressed gas prices in key regions; UK NBP at 30-35 pence/therm
- On average stable to moderate increase in refining and petrochemical margins
- High volatility in prices and margins

Volatility remains the norm in oil and gas markets. This is due to a variety of geopolitical factors – conflict in the Middle East and North Africa, the US-China trade dispute, variations in OPEC+ countries' oil output – to which we can now add the growing health scare from China's coronavirus outbreak even if the full impact may prove limited. These difficult-to-predict factors will determine the supply-demand balance in the oil market and oil prices in the medium term.

The International Energy Agency estimates growth in global oil demand at around 1.2 mb/d in 2020, mainly driven by non-OECD countries. Global oil supplies are expected to outpace the growth in demand, with strong output from non-OPEC countries (mainly the US, Norway and Brazil) partly offset by an expected extension of production cuts from OPEC+ countries (mainly Saudi Arabia). The oil market is therefore projected to be somewhat oversupplied, even assuming OPEC+ countries stick to the oil supply cuts.

Figure 2. Global oil demand-supply balance (million barrels/day) and Brent oil price (USD/bbl)



Source: International Energy Agency, Bloomberg, Scope Ratings

We expect gas prices to remain depressed in 2020, mainly driven by ample supply in key markets worldwide, high inventory levels and muted demand due to the unusually mild winter.

We assume that refining margins will increase moderately, mainly driven by MARPOL 2020 low-sulphur emissions regulation. High-complexity refineries are among the beneficiaries of the new, stricter regulations. Low-complexity refineries will face more difficult times because of the widening spreads for oil products. We expect stable petrochemical margins, supported by solid demand and lower input prices.

Improving operational resilience

Most IOCs' operations are more resilient than before the last downturn in oil prices and have even improved in the past year. Companies should be able to sustain oil prices in the lower USD 50/bbl range without a material deterioration in their credit metrics, provided they adopt flexible shareholder remuneration and investment plans (follow this link for our 2019 Outlook). However, some IOCs are more vulnerable to lower prices than others. Those companies with higher break-even levels in their upstream business and weaker exposure to downstream, especially low-complexity refineries, will be more sensitive to oil and gas prices, such as Italy's Eni SpA. Other IOCs, such as Spain's Repsol SA, are more diversified and have businesses less correlated with each other, for instance, energy retailing and renewable power generation.

Cost discipline will remain crucial for the sector in 2020. Expect capex to be kept at recent levels and IOCs to closely monitor operating expenses after major improvements in recent years due to efficiency gains, streamlined processes and pressure on suppliers to reduce prices for equipment and services. Monitoring opex improvements has become less easy because new accounting standards have moved operating leases to the balance sheet. This has lowered operating expenses because operating lease costs are reported under depreciation and interest instead. For now, management at the IOCs doesn't see any significant increase in prices for services and equipment provided by suppliers.

Financial framework

In addition to operational resilience, overall credit quality depends on a company's investment appetite and the scale of its shareholder remuneration.

The IOCs that we follow are increasing shareholder remuneration through dividends and/or share buybacks. Nevertheless, remuneration is not overly aggressive, mainly because of its counter-cyclical nature, as seen during the industry downturn of 2014-2016, when many IOCs reduced ordinary dividends and/or introduced scrip dividends.

Many IOCs are maintaining capex at the recently optimised levels, while focusing on "portfolio high-grading" by securing:

- Low-cost upstream assets that generate free cash flows even at low prices,
- Assets expected to be more resilient to changes in demand (also driven by the energy transition) and to generate higher value, e.g. natural gas/LNG vs oil, more petrochemicals vs refining, shifting refining and petrochemical capacities to Asia (increasing demand) or the US (cheaper feedstock).

Some IOCs, such as ExxonMobil Corp, are increasing investments in existing business. Others are venturing more aggressively into low-carbon technologies, such as Repsol. Royal Dutch Shell PLC and France's Total SA are cautiously targeting the electricity sector as part of long-term plans for diversification away from fossil fuels.

Similar to the last year's outlook, we expect only modest deleveraging at best. Debt ratios remain close to or within the targets set by management.

Sustainability and regulatory pressure

IOCs are facing a growing investor focus on sustainability and renewed regulatory concern in Europe and some other regions – bringing forward the potential impact on credit quality from the long term to the medium term.

- Growing numbers of investors are demanding detailed climate-impact disclosures and specific actions to combat climate change or are avoiding fossil fuel related investments. Notably, in January 2020, BlackRock, the world's largest asset manager, joined Climate Action 100+, an investor initiative to ensure the world's largest corporate greenhouse gas emitters take action on climate change. The initiative involves some 370 investors with more than USD 35trn in assets under management.
- One of the reasons why IOCs increase shareholder remuneration is the attempt to make investments in O&G companies more attractive amid growing investor concern about long-term value creation/resilience in the low-carbon world. Another reason is the lack of attractive investment opportunities due to weaker long-term energy price forecasts and growing regulatory challenges.
- Regulatory changes not only imply long-term objectives (e.g. the EU targets carbon neutrality by 2050, Austria has an even more ambitious deadline of 2040) but also *short- and medium-term* policies and commitments to address climate change (please refer to Scope's 2020 Sovereign Outlook)
- As one of the world's main oil consumers, the auto sector is adapting to the new environment by accelerating spending on the development of electric vehicles. While the number of electric vehicles sold remains small, it is growing rapidly (e.g. EV ramp-up – Scope research)
- IOCs have started to address these challenges, though to differing degrees. Repsol recently pledged to reduce net carbon emissions from its operations and most of its products (so-called scope 1, 2 and 3 emissions) to zero by 2050. We expect more IOCs to set ambitious targets, leading to faster and deeper transformations of their operations. The impact on credit quality will depend on the individual business and its financial strategies. However, we expect balance sheets to weaken in the short-to-medium term as IOCs keep capital expenditure in legacy activities at recent levels while simultaneously investing significant amounts in new energy businesses.
- The acquisition of low-carbon technologies will be one of the main driving forces for the M&A activity in the industry (e.g. e-mobility – Scope research)

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