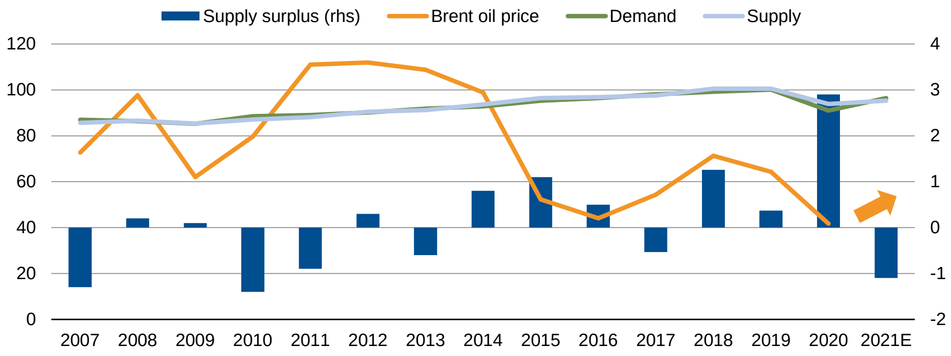
Integrated oil & gas: credit outlook remains stable amid rising prices, environmental pressures

The integrated oil & gas sector's credit outlook remains stable. Higher-than-expected energy prices are helping short term. Longer term, government, shareholder and public pressure is bringing forward the sector's reckoning with its environmental impact.

Integrated oil and gas companies (IOCs) should turn in a strong financial performance in 2021 as oil and gas prices have rebounded strongly as the economic recovery from the Covid-19 crisis last year has gathered pace[1].

Brent oil price averaged USD 63/barrel in Jan-May 2021, far above our medium-term expectation of USD 50/barrel. Natural gas prices have also exceeded our expectations. Strong demand growth from economies emerging from pandemic related lockdowns is one factor but so is the discipline in sticking to production cuts shown by the OPEC+ countries so far.

Figure 1: Global oil demand-supply balance (million barrels/day) and Brent oil price (USD/barrel)



Source: International Energy Agency, Bloomberg, Scope Ratings

Short-term view: IOCs focused on cost control despite higher crude prices

High energy prices coupled with the optimised cost structures translated into strong financial performance in Q1 2021, which topped Q1 2020 – a quarter only moderately affected by the pandemic-related economic disruption.

If oil and gas prices remain above USD 60/barrel, we will see strong free cashflow generation even after dividends, exceeding levels of 2019 when Brent averaged USD 64/barrel.

IOCs are sticking to the strict spending discipline despite windfall profits. We expect capex this year to remain well below already optimised 2019 levels. The shareholder remuneration remains contained, with moderate increases in dividends and only selective share buybacks. Royal Dutch Shell's quarterly dividend increased for the second time after a historic cut by 66% in 2020 and remains 63% below pre-pandemic level. BP plans to return to shareholders only part of the surplus cash via share buybacks after reaching its net debt target a year earlier than expected.

The cautious approach to investment spending and shareholder remuneration reflects uncertainty regarding duration of the current upcycle and rapidly growing regulatory and investor pressure to achieve goals set by the Paris Agreement.

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

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Medium-term to long-term view: strategic challenges intensify

IOCs face deeper transformation of business models

As we said in our Integrated Oil & Gas Outlook published in January 2021, "regulatory and investor pressure, as well as the prospect of peak oil demand, are combining to transform the oil & gas sector" and that we expect "more IOCs will set ambitious targets, leading to faster and deeper transformations of their operations". If there were any doubts about these trends, events last week will have removed them.

Shareholders in US-based companies ExxonMobil Corp and Chevron Corp, laggards in addressing the environmental issues among IOCs, made it clear to executives that they are not doing enough to address the risks related to climate change. In landmark vote shareholders of ExxonMobil replaced at least two board members with outsiders in an attempt for climate strategy change. On the same day investors in Chevron voted for the company to reduce emissions from the company's customers (so-called "scope 3 emissions"), a proposal opposed by the company's management.

There is still a significant gap between US and Europe-based IOCs in terms of climate policies. The gap is even larger when it comes to alignment with the goals of the Paris Agreement, also in the light of the big change in climate policy brought by the Biden administration. Therefore, we expect to see more pressure on IOCs based or operating in the US.

Dutch court ruling, Exxon shareholder vote show change

In Europe, a Dutch court ordered Shell to speed up its plans to cut emissions with respect to Shell's global operations. Specifically, the court ordered to cut its absolute carbon emissions by 45% by 2030 compared to 2019 levels. Shell's current strategy assumes a reduction of carbon intensity of products it sells by 20% over the same period compared to 2016. While Shell's intensity-based targets could imply growing absolute emissions when the overall operations grow, the court ruling focusing on absolute levels is more strict and implies that the legacy business has to shrink considering the low development level of CCUS technologies that could offset GHG-emissions. Shell plans to appeal the decision and it could take years before the case is settled.

Regardless of the outcome of this specific case, the ruling is important because it could trigger legal action against energy companies around the world. This decision is also remarkable considering that Shell's energy transition plan is quite ambitious by oil and gas industry standards. Nevertheless, it fell short of meeting the goals of the Paris Agreement, according to the recent report published by Carbon Tracker. The report highlights that Italy's Eni SpA is the only large oil and gas company to tick all the boxes for the so-called Paris compliance:

- Climate goals need to reflect end use emissions, be on an absolute basis, and cover the breadth of company activities.
- Climate goals need to have interim absolute reductions to 2030
- Company targets are not overly reliant on unproven technologies, such as CCUS.

Eni, TotalEnergies show better Paris accord compliance

TotatEnergies SE – the just-rebranded French IOC Total - and BP PLC also score highly in that ranking, but Shell is placed in the intermediate group, mainly because of missing interim targets in absolute terms.

We also expect additional pressure will be triggered by the recent report published by the IEA outlining a roadmap for the energy sector to net zero world by 2050.

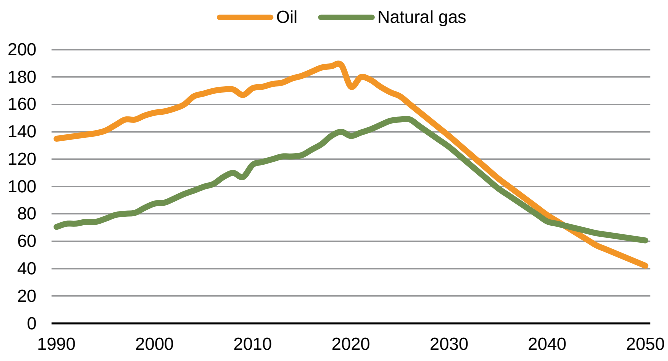
One of the key conclusions of the report is that there is no need for new oil and gas discoveries. It is important because IEA forecasts and recommendations are widely used by policy makers.

IEA report likely to prove influential

If IOCs plan to maintain their role as important energy players while meeting the goals of the Paris Agreement, they need to transform their business models more aggressively, primarily through heavy investments in low carbon technologies.

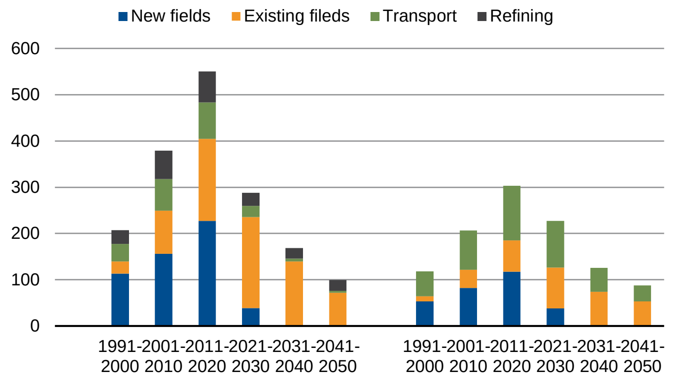
The current commodity boom provides a good opportunity to fund this transition. The impact on credit quality will depend on the individual business and financial strategies.

Figure 2: Oil and natural gas production in Net Zero Emissions by 2050 scenario (exajoules)



Source: International Energy Agency, Scope Ratings

Figure 3: Investment in oil (left graph) and natural gas (right graph) supply in Net Zero Emissions by 2050 scenario (USD bn, real 2019)



Source: International Energy Agency, Scope Ratings

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