Oil Market Report: May 2022

The death knell of the oil majors (BP, Shell, Exxon etc) has been sounded many times. In the 70's, it was all about being eclipsed by OPEC (Organisation of Oil Exporting Countries). The 90's brought "Peak Oil" and the exhaustion of oil stocks. Since 2000, focus has switched to the incompatibility of oil exploration with pressing environmental needs, whilst 2020 brought Covid and oil prices plunging into negative territory. Yet the majors have always survived and invariably bounced back to post enormous profits and thus face extra-ordinary levels of taxation (windfall taxes) as a punishment for being so successful (and resilient)!

The "post-pandemic, pre-renewable" major oil companies of 2022 are at a crossroads, with two very different routes to the future ahead of them. The first road sticks with – and possibly increases - oil and gas exploration. It looks likely that this path will largely be followed by the American majors (Exxon, Chevron), faced with significant shareholder scepticism as to the merits of "going green" and also, having traditionally been the most efficient operators in the exploration sector. In their mindset, the Russian invasion of Ukraine has highlighted the fact that oil and gas still dominates the global economy. Moreover, it has sent western governments into apoplexy over boosting domestic production of oil and gas, to avoid dependence on imports from unfriendly nations. These companies are also more than aware that whilst transport looks likely to rapidly decarbonise (thus reducing oil demand), that still leaves up to 50% of oil demand wrapped up in everything from concrete to contact lenses and clothes that have colour. In these sectors, demand for oil will stay robust and consistent.

Taking a very different approach are the European oil majors (BP, Shell, Total) who have to deal with a very different public and a more environmentally conscious shareholder base. These companies are now falling over themselves to show their alignment with decarbonisation and both BP and Shell have announced their intention to achieve "Net-Zero" by 2050. There have been a slew of acquisitions of everything from wind, solar and hydrogen power companies, through to battery manufacture and roadside electrical charging. The CEO of BP has even called on the UK Government to speed up the proposed ban on petrol and diesel cars (2030), a hitherto inconceivable public statement from the head of on oil company.

It should be recognised that the European oil majors are not obliged to take this progressive path. There is no legal mandate to do what they are doing and they have plenty of shareholders who may conclude that going green will not generate sufficient returns. Traditional oil companies have generated between 15-20% returns in upstream (oil and gas) exploration, whereas to date, large scale renewable projects have only generated around 5-10%. Most shareholders are keen on dividends from immediate profits and this "profitability gap" may drive more mercenary investors back to the more traditional modus operandi of the US sector (which they understand), thus leaving European majors with insufficient funds for the huge capital investments required for renewable energy projects.

There are however, two major arguments that support the "European" approach. The first is that historical returns of 15-20% on oil and gas do not guarantee the same level of profits in the future. In fact, traditional energy projects seem unlikely to perform at these high levels in the face of tightened regulation and competition from ubiquitous renewable energy plays. The second more cynical point is that the European oil companies are clearly hedging their bets in the short-term. No-one is shutting down hydrocarbon production, so revenues from oil and gas will continue for at least another 10 years. The logic given for this is that only the handsome returns from traditional energy projects can generate the kind of money required for massive re-investment in renewable energy. Plus of course, it helps pacify nervous investors...

So which approach will win the day? Both approaches represent quite a gamble. If the world is still consuming massive amounts of oil and gas in 10 years, then the European operators will have disposed of their "crown jewels" unnecessarily. Equally, American producers are banking on the value of their oil reserves, which may never see the light of day in a cleaner and greener future. Needless to say, there will probably be no binary winners and losers in this particular battle. "Old-school" fossil fuel extraction will undoubtedly bear fruit for at least another 10 years, whilst the European oil majors are in a perfect position to profit from the clear long-term growth opportunities that clean energy represents. One thing is for sure though, the dire predictions for the future of the oil majors are as misplaced now, as they always have been.