FINANCE

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A landscape in transition

The global oil and gas investment landscape is a varied one – but while there are some jurisdictional and sub-sector-specific trends, there have always been a number of macro trends in which the industry sits that affect investment decisions across the sector value chain. Ashurst's *Michael Burns*, Partner, and *Justyna Bremen*, Senior Expertise Lawyer, report.

In recent years, there is no doubt that the ups and downs of the oil price have been the dominant macro trend affecting investment discourse. But now a new macro trend, perhaps better described as a 'macro presence', has emerged – the pressure to reduce carbon emissions.

For a long time, this was seen as a 'nice to have' as part of a market participant's investment strategy or formed part of a 'tick-box requirement' to have an environmental and social responsibility policy. This has changed.

The US' withdrawal from the Paris Accord notwithstanding, investors (ranging from individuals to fund managers, to banks to corporates) have 'drawn a line in the sand' – carbon reduction is no longer simply a 'green label' that can be patched on a corporate strategy. Incorporating carbon reduction into the multifaceted investment decision-making process is a requirement and companies that do not recognise that requirement will be shunned by Western investors.

A new investment era

The drive for carbon reduction and its impact on investment decisions has led to the creation of a new era – the energy transition era which, when paraphrased, is the era of the transition from the production of energy by carbon intensive means to less carbon intensive processes.

What does that mean for corporates operating in the oil and gas industry? It means a change in the parameters to be applied by many boards or investment committees when answering the question 'Is this a sensible investment to commit to?'.

It does not mean saying 'Is this an investment related to fossil fuel-based energy production? If yes, we should not invest.'

For many participants, investment decisions will now need to be taken with the objective of overall production of energy in less carbon intensive ways than was previously the case.

Upstream action

Nowhere in the energy value chain is the energy transition being seen more in action than the upstream sector.

The shift in decision making by the energy majors to take into

account the energy transition in their corporate strategies has been stark. Investments by BP in BP Chargemaster and Lightsource BP; Total in battery storage; and Shell's increased capital allocated to the power supply market were almost unthinkable five years ago.

But there are others in the upstream sector who have narrower business models. They are steering a path that recognises that their core business necessarily involves carbon intensive processes, but they embrace it as part of their existence – often citing themselves as being a key part of facilitating the transition to a lower carbon intensive energy supply mix – working with suppliers to reduce the carbon footprint of their operations.

The classic example of this would be the growth of the North Sea independent operators over recent years. These operators will provide a vital source of energy as part of the energy transition.

Decisions of boards and investment committees are also not taken in a vacuum. Investors want a return on their investment. No board will be thanked by their investors if the Chairman reports at the end of the year: 'It's been a great year everyone. We are helping to move the energy transition forward, but please note that our profits fell by 50%.'

The balance between maintaining and, indeed, increasing, dividend levels (in which many individuals are exposed either directly or through funds invested by them, or through funds invested by asset managers in which their pension is invested) and meeting the requirement to help drive a lower carbon future is a tough one.

The answer is two-fold – 'balance' and 'investment impact'. It is clearly not sensible from an investor return perspective for a company like BP or Shell to simply stop investing in energy produced from hydrocarbons. Indeed, according to a June 2018 report from the International Gas Union (*The Role of Natural Gas in the Energy Transition*), due to the predicted demand growth, gas will become the major fossil fuel in use by 2040. It is widely recognised that gas, a hydrocarbon, is the transition fuel of choice to facilitate the energy transition to lower carbon-intensive energy production on a scale sufficient enough (and supported by the necessary infrastructure, such as battery storage) to operate on a standalone basis.

What is key is to look at investments in energy transition promoting businesses and assess their returns – in particular, whether they are either sensible investments that will help retain the 'baseload dividend' or investments that could have a high impact return on investment, such as a new technology which develops and has mass market application across the sector.

Midstream pressures

Traditionally, the midstream sector, from offshore pipelines to LNG liquefaction and gasification facilities, have, to a large extent, been owned by the same oil and gas companies that have dominated the upstream sector.

However, this has been changing in recent years. The concept of 'right assets, right hands' driven by a desire from upstream companies to recycle capital and/or improve balance sheet positions has led to the rise of infrastructure funds owning midstream infrastructure assets.

But what of the energy transition? Like the upstream sector, these companies are under pressure from funders to demonstrate the requirement that investments are made on the basis of the reduction of carbon production.

Over time, if one assumes that there will be a long-term reduction in demand for oil, it is possible that oil-related midstream assets will become less utilised or will find new business models; but, at the same time, new facilities will be created. For example, after a lull in the last few years, there is a significant rise in the number of new LNG liquefaction projects being taken to final investment decision (FID).

These projects are hugely capex intensive and clearly, just like in the upstream sector, the decision to invest needs to be taken on the basis of economic as well as environmental returns (think of our hypothetical Chairman referred to above).

The projects are also very carbon intensive to build. One of the key elements of business planning now is to ensure that the quantum of carbon produced as part of the construction phase is reduced as much as reasonably possible. This puts pressure on budgets as well as suppliers.

The obvious attractiveness of gas is that it is seen as the clean member of the hydrocarbon family and therefore investment in this fuel is consistent with the credentials adopted by many investment funds.

Downstream developments

So, if it is clear that hydrocarbons will continue to play a key role in meeting world energy demand for the foreseeable future, it naturally follows that companies will continue to invest in getting the energy produced from those hydrocarbons to the end user.

Indeed, Shell's investment in the downstream sector in the UK has been cited as the company looking at the business from 'the other end of the telescope' and focusing more on the end user.

This is fine in concept, but investments need to be profitable – and profitable at acceptable levels. The downstream market has historically been the lowest margin part of the value chain. Companies that look to expand into (or re-expand into) those markets need to have a business model either of scale or of diversity of product (eg Shell cross-selling its retail station customers to domestic energy supply by way of rewards schemes).

Furthermore, there are some clear geographical distinctions in the nature of the downstream infrastructure being required today. Europe may be focusing large capex on downstream gas-related infrastructure but, in contrast, parts of Africa and other emerging markets are in need of significant investment in downstream oil infrastructure as well as gas, to meet growing domestic demand. Myanmar, for instance, is severely lacking in energy infrastructure and seeking to deliver it through foreign investment. Recently, the retail arm of Thailand's state-controlled PTT announced a joint venture with Myanmar private investment giant Kanbawza to build an oil product and LPG storage terminal in Thilawa, near Yangon.

Here to stay

What is clear is that the energy transition is here to stay. Market players cannot ignore it and it is very unlikely that their business models will be left untouched by it. But for decision makers it is about balance – if it is a requirement to consider the energy transition in every investment decision that is made, the energy policy frameworks of regulators must not lose sight of the fact that investors will want returns.

Whether corporates can meet those demands and at levels of current returns (or greater) will be fascinating to watch as the energy transition moves forward. ●