PERSPECTIVE

Upstream financing: viruses, oil prices and climate change

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Casting one's mind back to the days before COVID-19 and the recent collapse of the oil price (at the time of writing the price of Brent crude is 60% of its price at the start of the year), the most pressing challenge facing upstream oil and gas companies was the growing emphasis by investors on ESG (environmental, social and governance) and, associated with that, the 'energy transition' (a term with no precise definition but which broadly is taken to mean the shift in the energy industry away from fossil fuels to renewable sources of energy, to respond to the challenge of climate change).

With the immediate COVID-19 crisis and the collapse in oil price, ESG and the energy transition are, albeit temporarily, no longer the top talking points of those in the oil and gas sector. However, when people return from isolation, economies start to repair and increased demand and production cuts result in an oil price recovery, the primacy of ESG and the energy transition as the biggest challenge for the industry will undoubtedly return.

Longer term impact

But what longer term impact will COVID-19 and the 2020 oil price collapse have on the financing of oil and gas projects and the subjects of ESG and the energy transition for E&P companies?

To answer this question, it is worth examining how the challenges of climate change and the broader ESG agenda have already been impacting E&P companies. ESG has many facets, in particular the impact of oil and gas activities on local communities and the local environment – factors high on the agenda for most oil and gas companies and their lenders for some time. The high standards that lenders expect on project financing and related techniques such as reserve based lending (RBL) were first embodied into a risk management framework known as the Equator Principles, which apply on a voluntary basis but have been adopted by over 100 financial institutions including all the leading lenders to the sector. However, we focus here on the climate change aspect of the ESG umbrella and how that has been and, looking forward, may impact the upstream oil and gas industry and its funding.

Whilst the science of the impact of fossil fuels on climate change is now well accepted, the challenges of reducing demand by society for hydrocarbons and the carbon impact of the oil and gas industry are great. In 2019 oil demand increased by 1.2mn b/d and the International Energy Agency forecasts that if governments continue with current policies, global demand will reach 121mn b/d by 2040.

While the current crisis has abated that growth, even leading to a drop in demand currently, as the global economy recovers continued population and energy consumption growth will revert to this trend – and continue to do so for decades to come. Hydrocarbons are also used for a great variety of purposes aside from energy; the chemical precursors to the plastics in the computers this article was written on were themselves formed in an oil field reservoir millions of years ago.

Although it is a widely held view that alternative sources of energy such as renewables will continually increase, the 'event horizon' of their total displacement of fossil fuels is a long way off. In the near term they will perhaps fill the growth in energy consumption rather than replace fossil fuels all together. In the meantime, gas as the cleanest of the fossil fuels is likely to become increasingly important as a 'bridge' fuel to the full transition.

Notwithstanding the impossibility of alternatives replacing all oil and gas for the foreseeable future, growing negative sentiment towards the oil and gas industry is a reality and E&P companies are embarking of a range of plans to respond and reduce their carbon impact. These range from reducing flaring to the use of renewable energy on offshore platforms, to carbon capture and storage. Innovations in the funding of E&P companies such as the margin reductions linked to environmental targets can be expected to encourage and reward E&P companies in making these changes.

While the cost and efficiency of renewable sources of energy is continuously improving, it has been widely espoused that the recent fall in oil prices making renewables less economic compared to now cheaper fossil fuels, may slow the transition. Equally the opposite has been postulated; that investors going forward will shy away from the volatility of the oil and gas sector and look for lower but more stable returns of renewable projects.

A complex picture

Both positions seem an oversimplification of a complex picture. Neither the impact of COVID-19 nor the recent oil price crash will change the fundamental reality of the world's current need for hydrocarbons, and in turn the industry's need for funding.

What can be said with confidence, however, is not only will investors focus ever more stringently on the economic resilience of oil and gas companies to withstand periods of low prices (their 'credit quality') but increasingly will focus more on ESG standards. ESG will become the new 'credit' parameter and available capital will flow only to those companies with the highest standards, which themselves are expected to increase to ever higher benchmarks. ●

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