Four trends driving the oil and gas industry in 2022 and beyond

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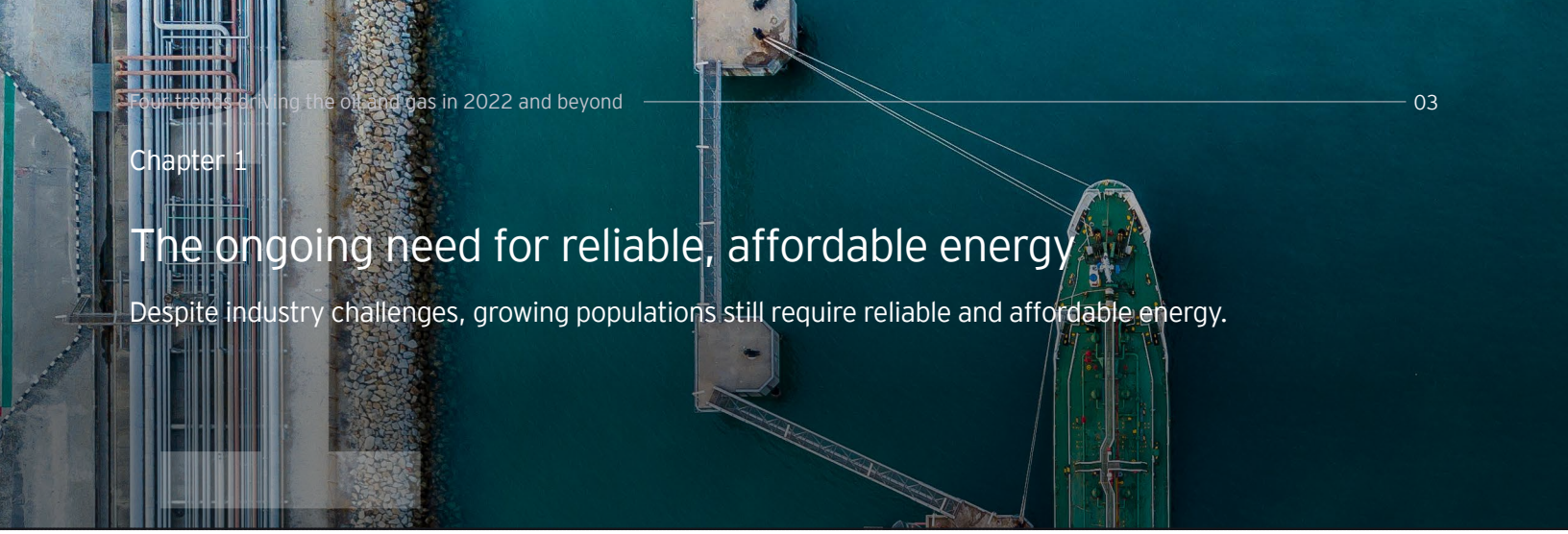
An increasing risk of tight markets and opportunities for companies to invest in the oil and gas industry are on the horizon

As we approach 2022, it is increasingly clear that next year - and potentially the next five - in the oil and gas industry will be defined by capital markets' reluctance to invest in oil and gas and the dissonance among government, consumer and investor perceptions about the speed with which oil and gas should or can be replaced and the very real inertias that will slow that transition.

Market developments in 2021 make structural undersupply of oil and gas commodities self-evident. In prior times, that would mean high returns and a rush to invest, but we are not in prior times. As a result, expected tensions between higher energy costs and emission reduction will reinvigorate a discussion around energy reliability and affordability.

Pressure to decarbonize and the reaction of capital markets may result in continued structural underinvestment. But 2021 has shown us that the laws of supply and demand haven't changed. When gas demand in Europe and Asia surged, the spread between natural gas at the Henry Hub and LNG delivered into Asia went from US$3/mmBtu to US$30/mmBtu. Moving into next year, EY teams see an increasing risk of tight markets and opportunities for companies willing to make investments in what is increasingly perceived as a sunset industry.

In 2022 and beyond, four trends will shape the sector.



Chapter 1

The ongoing need for reliable, affordable energy

Despite industry challenges, growing populations still require reliable and affordable energy.

The oil and gas industry is under relentless pressure. It's traditionally been perceived as a villain when fuel prices were high, ignored when fuel prices were low, and the threat of climate change has reinforced that image. Government action to decarbonize the energy complex is increasingly certain and whatever the destination, the journey will take time and cost trillions.

Renewable penetration and electric vehicle adoption are growing, but the impact on oil and gas demand remains imperceptible. Populations and economies will grow and will require and demand reliable, affordable energy. Until fossil fuels are displaced at scale, oil and gas demand will grow alongside.

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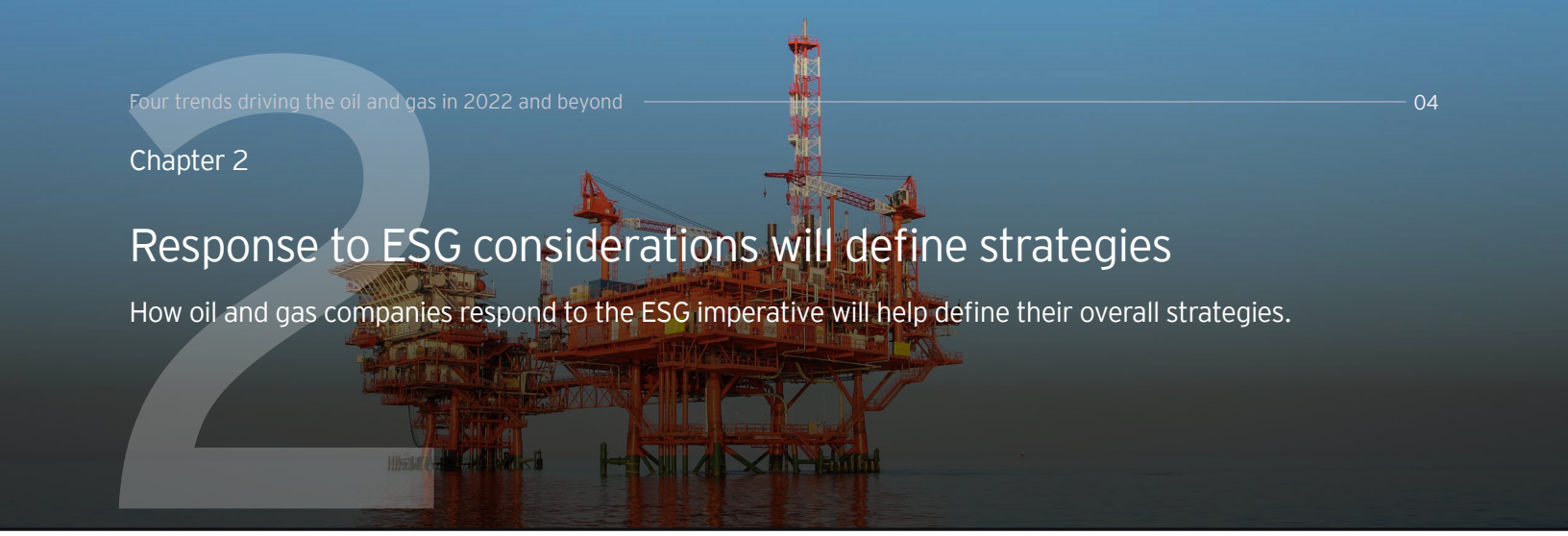
This presents an opportunity for certain companies to create scale and earn superior returns if they're willing to take the risk and can engineer their companies for success. Integration makes a more valuable collection of assets by connecting them {perhaps virtually) and removing or avoiding obstacles to optimize operation - this will be a pivotal differentiating factor for energy companies. Energy value chains are complex, and at each link, there are leakages when buyers and sellers take time and lose opportunities finding each other. Many industries have struggled with which parts of the value chain belong together and which parts are best left separate. Oil and gas companies are no exception. Information has proven to be the biggest obstacle to integration; the digital age has created a new dynamic where we see great opportunity.



Chapter 2

Response to ESG considerations will define strategies

How oil and gas companies respond to the ESG imperative will help define their overall strategies.

From our perspective, response to the rising environmental, social and governance (ESG) imperative will take one of three forms and the choices that companies make will, to a large extent, define their overall strategies. Returns and valuations in the near term and beyond will hang on the decisions these companies make.

Certain oil and gas companies view ESG excellence as a competitive advantage and will invest proactively to create value based on that business strategy. While many oil and gas companies are digitalizing their operations, digitalization is taking on a whole new lens around ESG. As an example, a company might identify a business unit, gather and collate the carbon emissions data from that unit, monetize those emissions, and trade them via blockchain. Oil and gas companies are increasingly looking to digital twins, data platforms and other technologies to move beyond simply monitoring to emission controls. Simultaneously, companies are evaluating opportunities to invest in decarbonized energy: hydrogen; wind; solar; carbon capture, utilization and storage; geothermal; energy storage; and others. Those with command of the technologies will be at an advantage.

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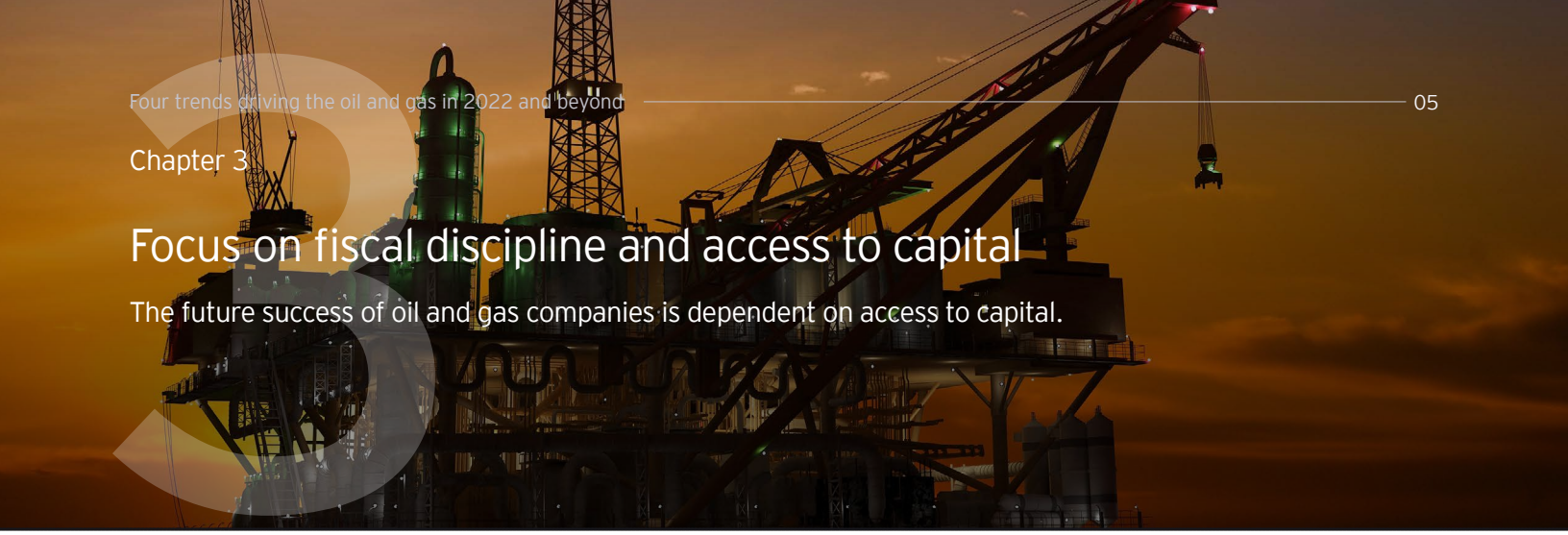
Others will act now out of a sense of inevitability. ESG won't necessarily be seen by this group as a source of competitive advantage now or ever, but these companies will recognize that transparency is essential. Those companies will be proactively buttoning up their systems, data and ESG reporting processes to keep up.

A third subset of companies carry on as usual. Branding and access to capital can be compartmentalized to some extent in commodity industries that can sustain oil production with little or no outside investment. This group is waiting for action around ESG to become a requirement and for SEC disclosure mandates to be mandated. Regulation may eventually take over, but until it does, competitive advantage will be difficult to see. While there will be some, those firms will be few and far between in our view.



Chapter 3

Focus on fiscal discipline and access to capital

The future success of oil and gas companies is dependent on access to capital.

The oil and gas industry must walk a very fine line, balancing fiscal discipline and progress on ESG issues, while meeting growing demand and shareholder expectations on the heels of the COVID-19 pandemic as commodity prices increases. No matter the ESG strategy that companies choose to take, access to capital will be a critical factor in oil and gas companies' future success.

Capital providers are increasingly aware of sustainability risk. They are calculating their exposure and analyzing their clients' emissions both on an absolute and intensity basis to understand how that rolls into an aggregated view from a portfolio perspective. They are also aware of the capital investments needed to truly fund the energy transition, but many are struggling to determine the realistic measure of funding required to meet mid-century and interim emission targets. Balancing the need for that capital with the realistic expectations for decarbonization outcomes will set the financial and regulatory context for the coming decade.

Further, some investors are concerned that a rush to low-carbon technology will cause overvaluation. As a result, capital access for those organizations that actually need to make this transition will be delayed and bumpy.

Amid less third-party investment, capital discipline and operational excellence will remain a high priority for all oil and gas companies. Profitability in legacy businesses will need to fund energy transition investments and keep returns at the corporate level competitive while alternative energy projects find their footing. Digital transformation will lead the way, unlocking efficiencies, cutting costs and enabling new business models. With better data analysis, companies will make better M&A decisions and optimize portfolio risk and returns.

Chapter 4

Oil and Gas M&A opportunities emerging

The 2022 oil and gas M&A outlook appears strong.

The combination of a positive return outlook, upward pressure on valuations and the need to decarbonize will have oil companies taking a hard look at their portfolios. That analysis will no doubt lead to portfolio rebalancing and a surge in transaction activity, keeping in mind how access to capital impacts deals. Forecasts of falling oil demand, targets that would force oil companies to be accountable for not just oil production but the use of oil products (Scope 3 emissions) and questionable economics have led international oil companies (IOCs) to pivot away from US shale properties.

Eventually, the appetite for those assets from publicly traded companies will be exhausted, leaving room for private players, who are large and financially healthy, to step up. Rig counts are well above where they were last year but are less than half of their pre-pandemic peak, which was less than half of the peak they reached before the 2014-15 downturn, begging the question of what it will take to get more capital into the oilfield. Private ownership of US shale properties may turn out to be the answer, though moving the ownership of carbon-emitting assets from company to company will not actually result in less emissions.

Investment in the Energy Transition

US$10b

How much oil companies have invested in renewable energy projects in each of the last three years

Meanwhile, oil and gas companies will seek to placate activist investors, diversify their portfolios and in some cases divest fossil fuel assets. They also are increasingly investing in the energy transition. Oil companies put over US$10 billion into renewable energy projects in each of the last three years. Time will tell if those investments will pay off. Competition among fossil fuel companies to put down a footprint in clean energy is fierce, projects are selling at a premium and there's a lot of downward pressure on returns. At the same time, there are good questions about the fit between oil company competencies and success factors in the electricity business generally and the renewable energy sector specifically.

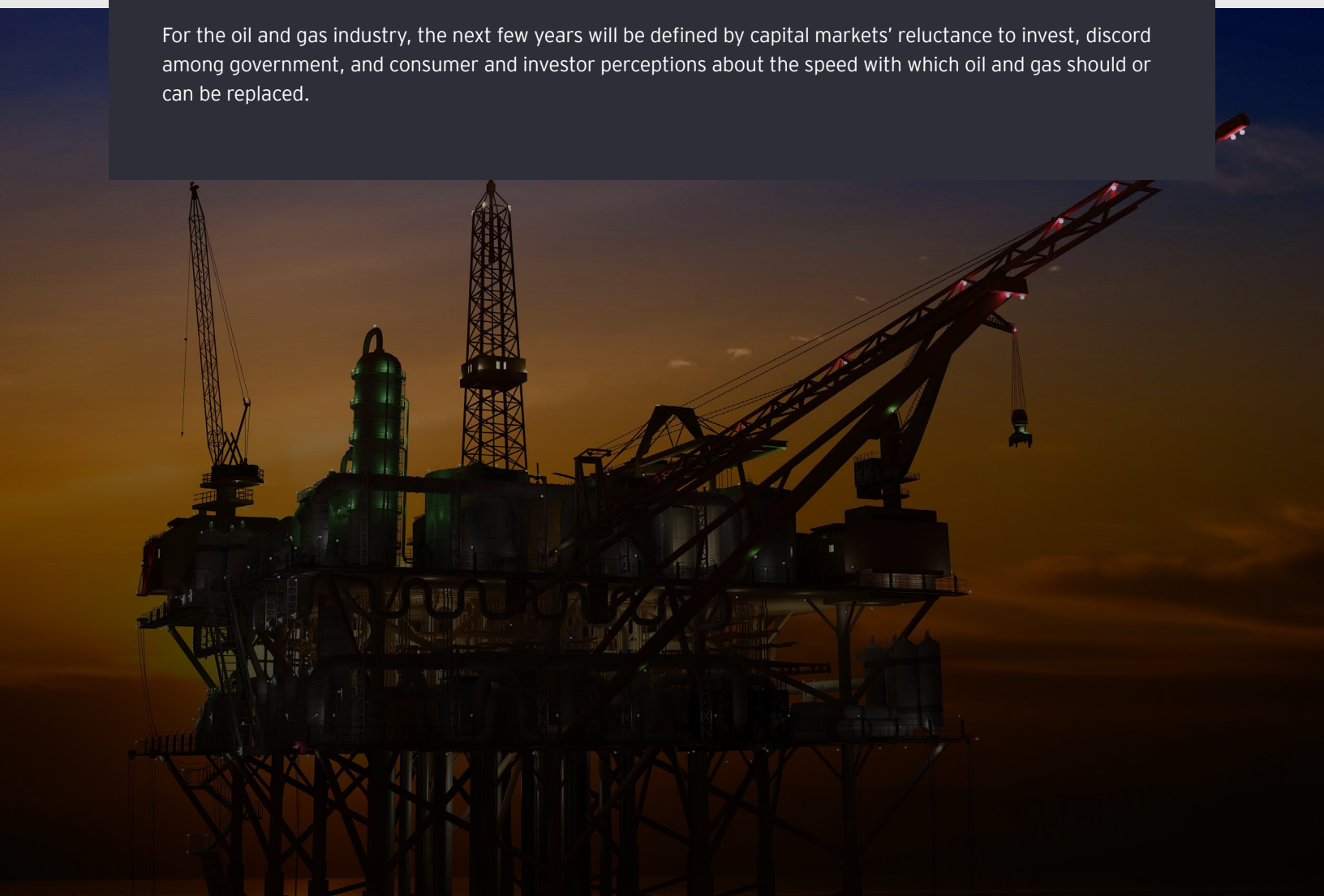
The outlook for M&A in 2022 looks strong. Market disruption begets portfolio rebalancing which begets transaction volumes. Companies will need to cash out on fossil fuels as they cash into renewables. After that comes the drive to meet shareholder expectations of profits, returns and cash flow.

Oil and gas majors focus on renewable energy, hydrogen, and carbon capture"

https://www.powermag.com/oil-and-gas-maJors-focus-on-renewable-energy-hydrogen-andcarbon-capture

Summary

For the oil and gas industry, the next few years will be defined by capital markets' reluctance to invest, discord among government, and consumer and investor perceptions about the speed with which oil and gas should or can be replaced.



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