MORNINGSTAR®

Climate and ESG narrative choking the life out of the oil and gas industry

10 June 2021

By Peter Warnes

Peter Warnes is Head of Equities Research, Morningstar Australasia. Contribution by Mark Taylor, Senior Equity Analyst, Energy and Mining Servies. This is a financial news article to be used for non-commercial purposes and is not intended to provide financial advice of any kind.

Market action suggests the end of the global oil and gas industry is in sight. No longer should discounted cash flow forecasts exist in perpetuity. Under the weight of climate change and ESG narrative, investors are shunning the sector with increasing belief that oil and gas will not have a future beyond 2040. Is that a realistic conclusion or could there be an opportunity?

Recently, the District Court of The Hague ruled Royal Dutch Shell should cut its greenhouse (CO2) gas emissions by 45% by 2030 against 2019 levels. The ruling means Shell is liable for its contributions to climate change after finding its fossil-fuel operations violated basic guaranteed human rights. The climate-change industry is a mega-billion-dollar industry, and more cases are certain to follow.

The judgement reads, "*The court acknowledges that Royal Dutch Shell cannot solve this global problem on its own, however, this does not absolve RDS of its individual partial responsibility to do its part regarding the emissions of the Shell group, which it can control and influence.*" It adds, "*RDS does bear an individual responsibility, which it can and must effectuate through its corporate policy for the Shell group.*"

The ruling followed on the heels of a report *Net Zero by 2050: A Roadmap for the Global Energy Sector* from the International Energy Agency (IEA) which espouses over 400 milestones to guide the global journey to net zero by 2050. They include the immediate cessation of investment in new fossil-fuel supply projects and no further final investment decisions for new unabated coal plants; no sales of internal combustion engine passenger cars by 2035; and the global electricity sector reaching net-zero emissions by 2040.

With passenger cars having at least a 10-year life, petrol and diesel will still be required as we approach 2050. How much is the question, as to the quantum of electricity required to energise the global electric vehicle fleet as well as industry and households. It is a massive job for more unreliable, non-baseload renewables, but not an insurmountable one.

The IEA's pathway requires annual additions of solar PV to reach 630 gigawatts by 2030, and wind power additions to reach 390 gigawatts. Together, this is four times the record level set in 2020. For solar PV, it is equivalent to installing the world's current largest solar facility almost every day. The discussion in the democratic open forum of thoughtful disagreement is becoming increasingly intense with all parties emotionally engaged.

© 2021 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'regulated financial advice' under New Zealand law has been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. For more information refer to our Financial Services Guide (AU) and Financial Advice Provider Disclosure Statement (NZ) at www.morningstar.com.au/s/fsg.pdf and www.morningstar.com.au/s/fapds.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Morningstar's full research reports are the source of any Morningstar Ratings and are available from Morningstar or your adviser. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.

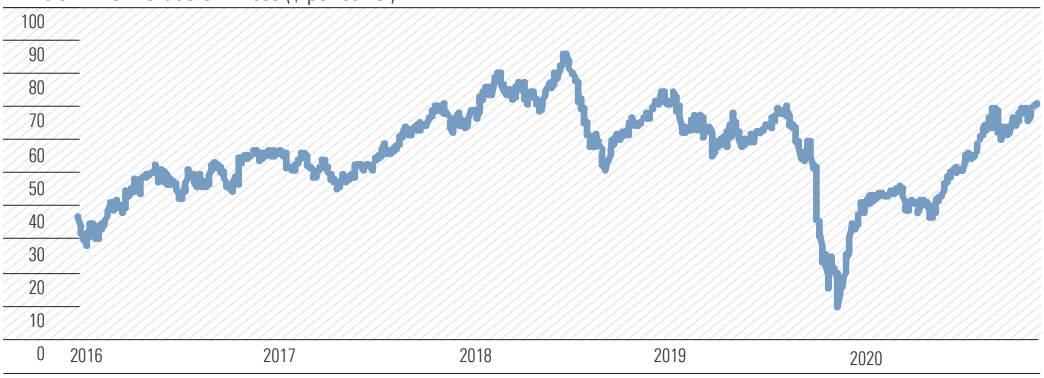
Currently oil and gas stocks are under the whip despite the two global oil price markers, West Texas Intermediate (WTI) and Brent, reaching two-year highs. Australia's Woodside Petroleum is one of the most affected. The table below reveals the last two times the oil price benchmarks were at present levels of US$70 per barrel, Woodside's share price was at least 50% higher.

Exhibit 1: Does Woodside provide an opportunity?

	17/5/19	6/1/20	9/6/21
West Texas Intermediate	US$63.15	US$63.27	US$69.76
Brent	US$72.20	US$68.90	US$72.06
Woodside Petroleum	A$37.20	A$35.40	A$23.76
Santos	A$7.29	A$8.60	A$7.67

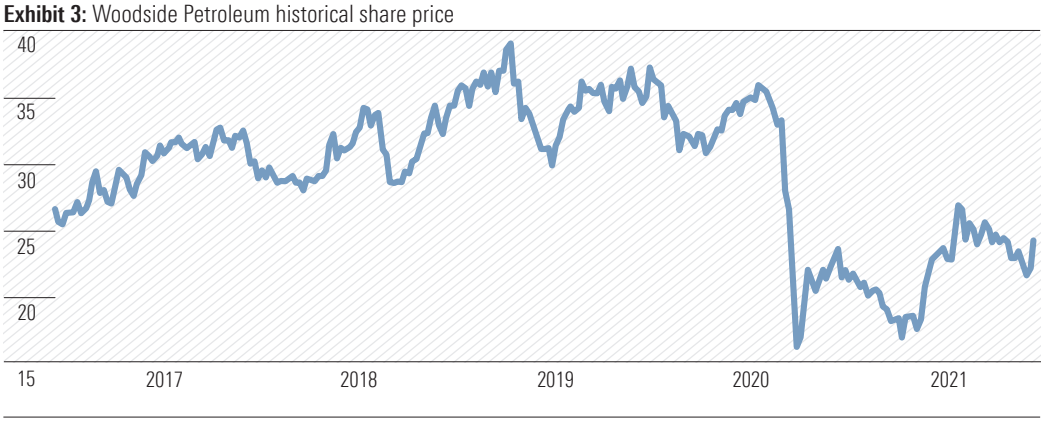
Source: Morningstar

Exhibit 2: Brent Crude Oil Prices ($ per barrel)



Source: www.macrotrends.net

Exhibit 3: Woodside Petroleum historical share price



Source: www.google.com

© 2021 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'regulated financial advice' under New Zealand law has been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. For more information refer to our Financial Services Guide (AU) and Financial Advice Provider Disclosure Statement (NZ) at www.morningstar.com.au/s/fsg.pdf and www.morningstar.com.au/s/fapds.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Morningstar's full research reports are the source of any Morningstar Ratings and are available from Morningstar or your adviser. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.

Acting CEO Meg O'Neill has tried to allay fears of a "watershed moment" for the industry, as pressure mounts from climate change activists, while outlining Woodside's decarbonisation plans. D-day is fast approaching for the decision on the expansion plans of Pluto and Scarborough which could determine the direction of the company's share price.

If the oil and gas industry cuts capital expenditure, as the IEA recommends, a greater portion of the free cash flow generated over the next 20 years should be directed toward shareholders. Dividend yields could be quite appealing, but not risk free. The ultimate reduction in global supply from non-OPEC countries with the US heading the list should widen the imbalance between demand and supply, driving prices higher. Will OPEC+ bow to the IEA's requests?

US payrolls miss again, but 'hit the sweet spot'!

For the second consecutive month US nonfarm payrolls disappointed. After April's big miss, when 266,000 was nowhere near estimates of around one million, explanations or excuses came from left, right and centre. The Dow and the S&P 500 surged to new peaks as dovish Treasury Secretary Janet Yellen reminded investors the US economy faces a "somewhat bumpy" recovery. The big miss eased concerns over rising interest rates propelling equities higher. Fund managers cooed "the Fed's loose monetary policy isn't going anywhere soon."

May's consensus guess was 670,00, the actual 559,000 and yes you guessed it, the Dow and the S&P 500 pushed to new highs as bond yields fell. April's number was revised up to 278,000. The underwhelming report relieved investor's concerns the fed would rein in monetary stimulus any time soon". Again, fund managers joined in "it's just a risk-on trade because the market believes rates are going to stay lower for longer" and "the opportunity to keep rates low is good news for risk takers." Headlines trumpeted, "US job numbers hit the sweet spot." This sounds like a game of Cry Wolf as investors keep asking for help when they do not need it.

For April and May, 837,000 nonfarm payrolls were added against forecasts of 1.67 million, a 50% miss. There are some budding weather forecasters about! Leisure and hospitality added 292,000 or 52% of May's payrolls, with 186,000 coming from restaurants and bars. Public and private education benefited from re-openings adding 144,000. Construction lost 20,000 and retail 6,000. Unemployment fell to 5.8% from April's 6.1% as the participation rate eased to 61.1% with generous unemployment benefits from the recent stimulus package still available. Total jobs are still about 7.6 million below pre-pandemic levels. At the monthly rate of the average of April and May (418,500) it would take 18 months to recover all COVID-related jobs lost—November 2022. At May's 559,000 clip, some 13 months to June 2022.

The US recovery is not smooth and while the markets are riding high on optimism and incoming data is keeping the Fed's taper at bay there will be a day of reckoning. The stalemate is getting long in the tooth and frustration will ultimately come to the fore. There is unlikely to be a warning. MI

© 2021 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'regulated financial advice' under New Zealand law has been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. For more information refer to our Financial Services Guide (AU) and Financial Advice Provider Disclosure Statement (NZ) at www.morningstar.com.au/s/fsg.pdf and www.morningstar.com.au/s/fapds.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Morningstar's full research reports are the source of any Morningstar Ratings and are available from Morningstar or your adviser. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.