

Letter 37

The rise in oil prices, an opportunity for producers and for energy transition

“Thirty years from now there will be a huge amount of oil – and no buyers. Oil will be left in the ground... The Oil Age will come to an end not because we have a lack of oil.”

Sheikh Ahmed Zaki Yamani in the year 2000.

Sheikh Ahmed Zaki Yamani, in the year 2000, predicted a collapse in oil demand by 2030 and this visionary, long-serving oil minister in Saudi Arabia and secretary general of OPEC, who is renowned for his moderate positions, should be right in his predictions. His premonitions are now more than twenty years old while so many other experts allow themselves to be deceived by their certainties and by their blindness.

The energy transition is necessary because, as **Bill Gates** writes in his interesting book, *“How to avoid a disaster?”*, the global demand for energy is expected to increase by 50% by 2050 and, if nothing changes, greenhouse gas emissions will grow by almost as much.

This transition is costly because it requires expensive investments, and it is clear that it is not facilitated by the low price of oil. At \$70/barrel, a liter of oil costs \$0.44, which is cheaper than a soft drink.

What are the trends in oil supply? What is the outlook for demand? What are the expectations for crude oil producing countries? What are the expectations for prices? These are some of the issues addressed in this Letter 37.

What is the outlook for supply?

Investment spending on exploration and production peaked in 2014 at over \$850 billion but fell to \$400 billion last year. It will increase but will not return to pre-crisis levels because, as everyone knows, ¾ of greenhouse gases come from fossil fuels and the follow-up to the Paris Agreement presupposes a rapid development of renewable energy.

To reflect on the evolution of supply is to dissociate the problem of companies listed on the stock exchange from those of producing countries and national companies, while at the same time showing that even the latter themselves cannot ignore the issues related to climate change.

- Oil companies have no choice but to invest in renewable energy :

Recently, the pressure on companies and their banks has increased and development strategies have had to be adapted to the requirements of renewable energy development.

In Europe, as in the United States, the oil industry and the banks that finance them, cannot ignore the action taken by investment funds, NGOs, such as Amazon Watch and Stand.earth, and minority shareholders to divest oil assets and invest in renewable energy.

According to industry specialist, Wood Mackenzie, the "Majors" alone have disposed of \$28 billion in assets since 2018 and could sell another \$30 billion. And globally, according to the firm, there has been or will be \$140 billion of disinvestments in this sector. There is certainly a strategic turnaround for these "Majors", but it could also be an opportunity for unlisted companies, investment funds and other players that are off the radar of climate change watchdogs.

In Europe, Total, renamed TotalEnergies, and BP have carried out this revision. The former is devoting \$2.5 billion of its \$13 billion in annual investments to renewable energy. BP is also investing in solar and wind power. Royal Dutch, which was ordered by a Dutch court to reduce its CO2 emissions by 45% by 2030, will stop exploring for new oil and gas fields as early as 2025, and will then simply maintain existing fields. It has also promised to achieve carbon neutrality by 2050. Other companies could be affected by similar lawsuits. Banks, even when they finance oil trading, are also being singled out by NGOs, as we have seen recently with Credit Suisse and UBS.

In the United States, Exxon, which lags behind European groups in energy transition, has had to resolve to write down \$20 billion in non-strategic assets, under the pressure from BlackRock and other shareholders, and publish a loss of \$22 billion after a profit of \$14 billion in 2019. The group is refusing to invest in clean electricity generation but is instead focusing on research in hydrogen and carbon capture. Chevron, the other US "Major," is being urged by investors to reduce downstream emissions.

These are all examples, not surprisingly, of an oil industry targeted by activist funds, as well as examples, also, of pressure against shale oil exploration, and the scarcity and increase in the cost of bank loans. This is why, despite the recent sharp appreciation in oil prices, US production is still 15% below its peak of 13Mb/day in 2019. This is why the number of drilling wells, 376, as measured by Baker Hughes, is far from pre-Covid levels of 683, compatible with a goal of reducing current debt, estimated by Wood Mackenzie at nearly \$150 billion, but insufficient to maintain the production rate. This is why listed companies, worried about legal action taken by shareholders, are playing it safe and are using their cash flow to improve their balance sheets.

In the United States, opponents of climate change see it as a sacrifice of American assets, a loss of hard-won energy independence, for the benefit of authoritarian regimes and without benefit for the decarbonization of the planet because the demand for oil is still there.

- ***The stakes for producing countries and national companies :***

A priori, the producing countries and national companies of these states have little to worry about NGOs, but they cannot ignore the pressure in favor of renewable energy.

Nearly \$2,000 billion of investments are envisaged by 2030 (according to the Natural Resource Governance Institute) by these national companies that are not dependent on private shareholders and the stock market. The Emirates (UAE) has increased its production capacity from 3.1Mb/d to 3.8Mb/d and aims to produce 5Mb/d by 2030 in order to finance energy transition. Russia, favored by low production costs and a weak currency, is not thinking of depriving itself of hydrocarbons, which accounts for 40% of its budgetary revenues, even if the economy is diversified. It is investing \$10 billion in railways to facilitate the export of coal, building pipelines to sell its gas, and letting Rosneft announce a \$170 billion investment project in northern Russia in gas and oil.

But we can examine 4 challenges for the producing countries :

On the one hand, they remain too dependent on oil revenue : slow development and weak diversification of economies. This has not always been the case. Although oil has been known since antiquity, in 1900, 90% of oil production was carried out in the United States or Russia and, in the Middle East, only Iraq

had a marginal production under Ottoman rule. It was not until 1945 that there was a rapid boom in production in the Arab countries.

Today, as much as the Gulf countries have a high GDP/capita, the majority of other producing countries (Dutch disease?) are lagging behind and have not experienced the development as in South-East Asia : *Amin Maalouf* recalls in *“Disordered World”* that in 1966, income/capita was \$130 in South Korea against \$160 for Egypt; today, it is \$31,000 in South Korea but less than \$2,500 in Egypt, less rich in oil than its neighbors but more diversified!

In the producing countries, the oil rent has been monopolized by small groups and has not allowed the take-off.

According to *Pétriart* in his book *“In the countries of black gold”*, Hydrocarbons, in 2018, represented 65% of the GDP in Iraq, 60% in Libya, 42% in Saudi Arabia, 40% in Kuwait, 30% in the Emirates and Algeria. In all these countries, hydrocarbons provided at least 80% of export revenue and, except for Algeria, more than 80% of the revenue of the states mentioned.

Iraq, like Iran, has invested little in diversifying its revenue. In Libya and Nigeria, oil accounts for half of the revenue and the electricity grid is inadequate.

Saudi Arabia offers some diversification of its economy, but it is facing rapid population growth. The problem in Saudi Arabia, as in Algeria, is the low job creation offered by the development of hydrocarbons that is between 1.5% and 2.5% of the working population. In recent years, Saudi Arabia and Kuwait have sent many Asians and Africans out of their borders, but that has not been enough. In 2020, more than 60% of Saudis between the age of 20 and 29 are unemployed and the middle class is affected by the current crisis. Moreover, in many States, the illiteracy rate is still high.

Iran faces a worse situation – it is confronted with an inflation rate of 40%, an official unemployment rate of more than 12%, a deep crisis and crude oil production under US embargo, at less than 2Mb/d today. If an agreement with the Americans is reached, production could reach 3Mb/d at the end of the year and even more next year, and this could bring down the price of crude oil.

The second challenge, the growth of oil consumption by these countries is poorly controlled : in the 90s, the Gulf countries consumed 13% of their oil production, in 2010, 25%, and today, even more. Between 2010 and 2017, domestic oil consumption increased by 7.6% each year in Qatar and 4.5% in Saudi Arabia and, as noted by the Saudi Oil Minister at the time, *Al Naimi*, "At this rate, the country could become a net importer in 2038." Starting in the 2010s, producing countries began to reduce price subsidies in order to reduce consumption growth and eventually prepare for price liberalization. But the Arab Spring has slowed this movement. At most, countries are taking advantage of moments when crude oil prices fall, not to adjust prices at the pump downwards.

Third, according to a *recent study* by the *IEA* (International Energy Agency), *the ambition to achieve zero greenhouse gas emissions by 2050 could lower the revenue of producing countries by 75% by the 2030s*, even if OPEC's share of global production increases to more than half. As noted by the authors of the *CIA report, “The World in 2040”*, oil producers, accounting for 8% of the planet's GDP and 900 million people, could face significant revenue losses in an aggressive decarbonization scenario.

This transition will also limit the ability of these countries to use energy as a tool for coercion or political action as energy systems become more decentralized.

Fourth, we must invest in renewable energy : countries as diverse as Canada, the Emirates, Norway, and Australia are engaged in the transition. The producing countries in the Middle East are not necessarily

the biggest polluters, but they cannot neglect global warming and the difficulties in developing agricultural production, because the impact on desertification, food and water insecurity and the risk of rising water levels are concrete problems for everyone. It is impossible for them to ignore the warming in the Arctic, which is three times faster than in the rest of the world, because the melting of the ice has already caused a rise in sea level of 20 to 23 centimeters since the end of the nineteenth century. Over the next twenty years, it could lead to a further increase of 7 to 36 centimeters that would not spare the Gulf countries.

To mitigate the risks and to diversify their exports, several States have set up powerful sovereign wealth funds. Saudi Arabia and Algeria repaid debts incurred during the 1980s and 1990s in the 2000s, but military spending is rising sharply, and sovereign wealth funds are often used to invest in foreign companies rather than in local industries.

The promotion of the post-oil era was inaugurated as early as 1996, together with Oman. In 2008, it was Bahrain and Qatar with 2030 plans. In 2010, Kuwait launched a 2035 plan, and in 2016, Saudi Arabia announced a 2030 plan. National oil companies such as Aramco or Sonatrach are keen to play a pioneering role in the development of renewable energy and, to achieve this, Aramco wants to increase its production capacity from 12 to 13Mb/d. The Emirates, in the same spirit, wants to invest \$120 billion to increase its crude oil production capacity from 3.1Mb/d to 5Mb/d by 2030 to generate revenue to finance the transition.

In most of the plans, the aim is to attract foreign investors, but this is not always obvious. Given the importance of the Asian market, contributing about 70% of Saudi crude oil exports and more than 90% of Emirates' exports, Chinese, Japanese and Korean companies have become privileged interlocutors in renewable energy development projects, and they are multiplying investments in consortiums with local companies.

However, in these countries where gas and oil are abundant and inexpensive, alternative energy remains uncompetitive and thus, more than 60% of electricity production is carried out with natural gas, while the rest mainly with oil.

Due to the Covid crisis, sovereign wealth funds have been depleted to cover deficits and investment projects have had to be postponed.

Demand and oil prices :

The demand, in many uses presents an incompressible character :

In the short term, we are seeing a strong recovery in demand in OECD countries. In the United States alone, consumption increased by 1.5 million barrels per day, to the great benefit of refiners. For the developed countries as a whole, OPEC estimates the recent increase in demand at 2.7mb/d and the year-end increase at 3.1mb/d. Thus, in the 3rd quarter, global demand could, according to **BIS Markit**, reach 99Mb/d, not far from the 102Mb/d recorded before the crisis. In the medium term, demand from emerging Asian countries will remain strong.

Another obstacle to the decline in demand is transport : nearly 60% of global consumption is in transport, and even if car manufacturers are investing \$330 billion in electric cars in the coming years, even if Stellantis, for example, promises 70% of electric car sales in Europe by 2030, the renewal of the fleet, a billion vehicles worldwide, will be slow, and converting planes and trucks to electric poses problems. The last major consumer is industry, which represents a third of demand, and here too, the recovery is strong and substitution slow.

From a medium-term perspective, the IEA urges emerging countries to make efforts because, with 2/3 of the world's population, they will account for 90% of new emissions. But the annual investments needed in clean energy are estimated by the IEA at \$1,000 billion/year compared to \$150 billion today. Emerging countries are defending themselves by citing their lack of capital and it is hard to see how 800 million people without access to electricity today can be prevented from producing carbon emissions tomorrow. Among the developed countries, Japan, which imports 90% of its energy needs, is investing heavily in hydrogen and it is not the only one, but the capital available is greater.

A sustained price per barrel suits both crude oil producers and renewable energy investors :

The price has always been volatile : it was \$20/b in 1998, \$150 in 2008 before falling to \$40 at the end of the year and rising again to \$100 at the end of 2010, during the first Arab spring protests in Tunisia, then \$120 in 2013 thanks to the recovery of demand and the interruption of production in countries, such as Libya, that were shaken by the Arab Spring. This price level, higher than that recorded during the 2 oil shocks, was explained by the strong growth of Chinese demand and the paralysis of the Iraqi oil industry after the American invasion in 2003.

Saudi Arabia has often played the role of a "swing producer", the best example being in the aftermath of the 2nd oil shock when production fell from 10 million barrels a day in 1981 to 2.2 million barrels per day in August 1985. Worried about the drying up of demand, the Saudi Kingdom had adopted a strategy of moderate prices to encourage consumption and slow down the adoption of new energy.

In 2014, the fall in oil prices was the result of slowing economic growth in China and the decision by Saudi Arabia to break the profitability and development dynamics of US shale oil and gas producers through low prices. The cost of this policy was high for all producers and thus, Algeria's foreign exchange reserves fell from \$200 billion in 2013 to half in 2017, and that of Saudi Arabia decreased from \$745 billion to \$510 billion. Saudi Arabia's budget deficit increased to \$100 billion in 2015.

In 2016, prices recovered thanks to a production limitation agreement between OPEC countries and Russia.

The supply restrictions of 9.7Mb/d last year are still at 5./Mb/d. Brent crude is trading at \$75/barrel and the appreciation since the beginning of the year exceeds 45%. The price has surpassed the pre-Covid level but Biden, determined not to tolerate a recovery in US production in areas like Alaska, is pressuring OPEC to increase supply and ease upward pressure on prices.

The rise in prices could continue : on the one hand, the OPEC countries, aware that they are regaining control of production, are slow to open the floodgates of production; on the other hand, high prices serve both the needs of producing countries and the objective of developing renewable energy. Costly to develop, they are thus more competitive. It remains to be seen whether Iran will return to the market, as it could potentially add 1.5% to 2% to global supply.

Conclusion : *“Act so that the effects of your action are not destructive of the future possibility of such life.” Hans Jonas* in The Imperative of Responsibility.

- **From the perspective of transition, Hans Jonas'** exhortation must be heard because while greenhouse gas emissions have decreased by 6% in 2020, a figure close to that set in the Paris Agreement, the year has been exceptional. **BP's annual study** shows that in 2020, global solar energy production capacity increased by 22% and that of wind turbines by 18% but overall, renewable energy represents only 6% of the energy balance sheet compared to 31% for oil, 27% for gas, 25% for gas and the remaining for nuclear and hydroelectric. The road to carbon neutrality is therefore a long one.

- **From a sectoral point of view**, the **IEA**, International Energy Agency, is urging companies and producing countries to stop oil exploration by 2050 in order to achieve the goal of zero greenhouse gas emissions, but the demand is still there, and substitutes are more expensive.
- **From the demand point of view**, according to **BP**, global energy consumption has decreased by 4.5% in 2020, a record low, but dependence on oil persists in transport, which accounts for 60% of world consumption, and this will persist even if the number of electric cars increases. While there certainly are energy savings in developed countries and lower population growth, rising standards of living in emerging countries imply an increase in the consumption of hydrocarbons, and trucks and planes are not ready to use electric batteries.
- **From the perspective of listed companies**, investors' expectations are high. In the eyes of many, companies can and should do more than governments for the climate. Admittedly, active communication on disinvestments cannot hide the fact that production continues in the context of unconsolidated joint ventures. However, the oil companies are victims of their image and of rejection by many investors and are therefore undervalued on the stock market. Advantageous because of their high cash generation and low debt, they are nevertheless financing massive investments in renewable energy. The "Majors" are often the largest investors in the energy transition and, as such, should increasingly be included in ESG funds. These "Majors" would benefit from a revaluation, more justified than that of the 25 largest American production companies whose capitalization doubled this year when the S&P500 index is up by only 16%.
- **From the perspective of environmentalists and activists**, the focus on large-listed companies is excessive because, according to the IEA, they hold only 12% of the world's hydrocarbon reserves and carry out only 15% of production. The spotlight and pressure should be on the national companies of the producing countries, which are sometimes less concerned with reducing gas emissions.
- **From the point of view of countries**, for a long period of time the United States was the leading polluter of the planet. Today, China has taken this place and is responsible for 29% of greenhouse gas emissions ahead of the Americans, 16%, and the European Union 12%. India is also a major polluter, but all countries are obviously concerned. Emissions per capita in the United States is double that of the Chinese. As the leading polluter, China is also the leading producer for investments in renewable energy : China controls the solar sector and the electricity sector with 50% of lithium production capacity, and soon 50% of cobalt production capacity and significant nickel production capacity.
- **From an economic point of view**, the recent surge in prices will strengthen oil-producing countries such as Russia and the Gulf states but will weaken the growth of emerging countries (which are underweight in our investment strategy), worsen their current account deficit, and increase inflation. However, it will not break the recovery of developed countries because services, accounting for more than 70% of GDP, consume much less oil than industry, which accounts for only 10 to 20% of GDP, and since in the energy balance sheet, renewable energy, in Europe for example, represent 20% of the total. Thus, at current prices, the oil bill is less than 3% of GDP and households will be able to rely on their additional savings to absorb a rise in the price of gasoline.

Geneva, 12th July 2021

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