Oil Companies at the Crossroads

Stockholm (HedgeNordic) – Most large oil and gas companies around of the world are at the crossroads. These companies are facing the choice between doubling down on extracting fossil fuels or substantially diversifying away from fossil fuel production towards renewable energy and power generation, simultaneously relabelling themselves as energy companies rather than oil companies.

According to Hans Berglund *(pictured)*, CIO at Stockholm-based asset manager Proxy P Management, "oil and natural gas companies are now in the process of figuring out what to do in the future, and some companies are going to use their existing revenue streams to transform themselves for a new world." Companies that do not address the uncertainties associated with the future of oil and do not show a willingness to change might put their existing business models and valuations at risk.

Referring to Warren Buffett's transformation of Berkshire Hathaway from a textile manufacturing company to a conglomerate with a multitude of businesses, Berglund reckons that some oil companies will choose the same path of transformation. Just as Buffett used the textile company's cash flow stream to acquire and expand into other business areas without reinvesting a penny into the weakening textile business, some oil companies will embark on multi-year transformation journeys embracing renewable energy.


Dan Lindström, CEO at Proxy P Management.

Dan Lindström, CEO at Proxy P Management, believes that "many companies will be early adopters of the energy transition and will use existing cash flow streams to change," but others will keep generating and distributing cash to shareholders as long as possible by doubling down on fossil fuels and then say "goodbye" at the end. "It is a fact that oil companies will have to adapt, but will they?" asks Lindström. However, the future of oil is not yet written, according to the Proxy P team.

The Future of Oil: Two Possible Paths

As Berglund explains, "the overarching one thing that one has to remember is that the need for energy will grow; the demand for energy will expand geographically, will grow volume-wise, and intensity of request for energy will just expand." There is an expansion from the customer side, argues Berglund. "But if you talk about the supply side, there will be change ahead; everyone knows there is a big change ahead."

In the debate on energy transition, there are broadly two camps, according to Proxy P's CIO. One

camp “wants to go totally green” and the other one, mainly comprised of individuals from an older generation, “wants the security of supply, ease of use, instant access and a good price.” Berglund, who held a gasoline coupon as a young boy here in Stockholm in early 1970s because of gasoline rationing, represents the latter camp. Yet, he acknowledges that “the industry is going to have to adapt to new needs,” a transition process partially fuelled by climate change, as well as a disruptive change in energy technology that is on the verge of changing the playing field. Renewable energy sources and electrification are getting more cost- and production-efficient.

Speaking about the future, there are two distinct views on the future of oil, according to Berglund. One view is that the commodity is not going to be needed in the future, in which case most oil companies will just decide to sell their oil reserves as quickly as possible. “You don’t care if the price falls, you just get rid of the stuff,” says Berglund. “After all, in 25 years, no one wants oil anymore.” The base case, however, is that although demand is expected to show stagnation, plenty of oil will be in used in the future and, somewhat counterintuitively, the price of oil will most likely increase during this demand-stagnating phase. Berglund places himself on the “valuable asset side” and bets on higher prices in the future.

The reasoning behind a higher price for oil stems from the depletion ratios of oil production and lack of investment in the sector. As Lindström explains, “the depletion ratio of existing oil production is roughly 5 percent annually on a global scale and will be accelerating if new fields are not developed.” He emphasizes that “although there is plenty of oil available for the time being, this could quickly change.” More importantly, however, “there is too little capital being invested in developing oil fields at the moment because of limited availability of financing for long-term projects,” according to Proxy P’s CEO. “The spare capacity is going to shrink,” reckons Berglund, “because companies are not supplementing the production.”

In either scenario, the energy transition will keep accelerating going forward. “Higher prices for oil will increase the transition to alternatives,” believes Lindström, who emphasizes that the speed of transition “is very dependent on policy and regulations.” Climate change is a catalyst for the energy transition, according to the CEO, but “we believe the change is inevitable as the combustion technology is already inferior to electric engines.” An accelerating energy transition does not necessarily mean that oil will not be used in the future (most likely plenty of oil will be used for a long time) or that oil prices will not be high, argues Lindström. However, the energy transition highlights the fact that the oil industry is a stagnating (and soon, most likely declining) industry with financing challenges and technology successors.

Thoughts on Aramco

Saudi Aramco is preparing for its initial public offering and could become the world’s most valuable company with a valuation north of $1 trillion. However, because of the fast-accelerating energy transition and the sheer size of the company, Lindström reckons that “it is almost impossible for Aramco to be as valuable in the future as they are now, adjusted for the oil price.” Aramco produces more than ten percent of the world’s oil production, which corresponds to around five percent of the energy used globally. “Aramco can start to take big chunks of other industries, but they are not going to catch five percent of the world’s entire energy production in the future, and renewable energy production margins will not be anywhere close to the margins provided by oil for Aramco,” says Lindström.

According to Berglund, “Aramco is based on a few fields that will provide them with a good revenue stream for more than 50 years.” If the company were a public corporation, “all the metrics would be fantastic here and now.” But the problem for Aramco is that “despite these fantastic numbers, the money the company generates is not enough for the Saudi budget.” Aramco may want to expand into

other areas, believes the CIO, but “they really want to have an oil price north of $80 per barrel to survive.” And investing in low-carbon energy solutions will not help the income short term.

The article was originally published on Ekonamik.com