Strategy, Free Cash Flow, and Climate Uncertainty: Where Now for the Integrated Oil Sector?

Building on ShareAction’s work on disclosure and remuneration in the oil sector, this report analyses the implications for investors in integrated oil companies of the rising technological and regulatory trends that will disrupt global oil demand.
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Executive Summary

This report analyses how structural trends may disrupt future oil demand and explains possible implications for publicly-listed oil companies and their investors. These structural trends are producing an environment of heightened uncertainty where investors’ interests would be better served with more of their capital returned for asset allocation elsewhere. This report concludes with three actions that investors should consider to adapt to this new environment: 1. Ask management teams to commit to returning shareholder capital in lieu of investing in new hydrocarbon growth; 2. Vote against scrip dividend options in 2018 to increase capital returns to shareholders and; 3. Adapt executive remuneration to prioritise returns and profitability over hydrocarbon production growth.

Since the oil price collapse in 2014, the integrated oil and gas sector has undergone a significant period of change. Management teams have struggled to adjust capex and business plans, dividend policies and balance sheets in a new oil price environment where the cost of a barrel for the last 3 years was approximately 50% lower than the average over the previous decade. Asset impairments, disposals and emergency rights issue have been a feature of the industry. Furthermore, structural changes to the global energy system, driven by new disruptive technologies in the supply and consumption of oil and changes in climate-related regulation, have increasingly been challenging investors’ thinking and oil companies’ decision-making. In this report we outline why these structural trends mean the sector is at a critical juncture, with significant implications for investment managers, asset allocation teams and sector management.

Historically the industry has been dominated by cycles of capital expenditure and production growth. Recent improved financial results across the sector suggest that management teams are once again able to start increasing the allocation of organic free cash flow (FCF) to growing oil and gas production through the development of new projects. Indeed, 2017 has seen oil companies ramping up investments in new projects compared to 2016, representing an increase in net new production to the oil majors of 6% of total production by 2024. After a period of cost reductions, the integrated oil and gas sector looks to be on the verge of a new growth cycle.

These new projects will have economic life spans in a very different technological and regulatory environment to previous industry cycles. Although demand growth will still increase in the short-term, medium-term demand growth is likely to be more muted and unpredictable than in previous cycles due to the emergence of different transportation services (such as automated vehicles) and technologies (such as electric vehicles), pressures on end markets (such as plastics recycling), increasingly fuel efficient vehicles, and slowing energy demand growth in China. These disruptive trends are introducing uncertainty around future oil demand growth, making long-term demand forecasting increasingly difficult. With technology opening up new sources such as shale oil, industry debate has moved onto peak oil demand and the development of shorter cycles. ShareAction believes that the relevant point for investors is the increased uncertainty in forecasting demand patterns and subsequent implications for capital investment decisions based on historic relationships between population growth, emerging market demand and oil demand.

For example, these changes have meant some energy analysts are starting to forecast that global oil demand will peak in the mid 2020’s, considerably earlier than currently forecast by OPEC or most of the international integrated oil and gas majors. There are huge bands of uncertainty around these forecasts – but that fact alone has significant implications for how investors should view the sector and differentiate between its constituents.

The European utility sector provides a potentially worrying precedent for investors. A combination of slowing energy demand, changes in technology and regulation and management teams unprepared for the scale and pace of change in their industry resulted in significant value destruction. On a market capitalisation basis, Europe’s largest five power generators lost 37% of their value between 2008
and 2013. Equity valuations in the sector were moved by directional rather than absolute levels of change in demand for coal-based electricity generation. Though present oil demand growth is still strong, in the medium term, increasing uncertainty around demand should challenge and change the way investors view and value the oil and gas sector.

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Changing regulation, technology, demand growth and a medium-term ‘excess’ of resources mean that new capital-intensive projects delivering production growth that are currently undergoing final investment decisions should be assessed through a different lens by investors and by management teams. To compensate for higher levels of uncertainty, investors should demand higher returns from capital expenditure to grow hydrocarbon production and robustly challenge management teams’ production growth ambitions. Investors should encourage corporate boards to prioritise the return of capital through improved distributions in lieu of investment in assets set to deliver oil and gas production growth. In an environment where forecasting demand is likely to be increasingly difficult these projects may produce returns that fall significantly below current expectations based on historic cycles. We recognise

that many businesses have started investing heavily in natural gas as an attempt to decarbonise their portfolios. However, like oil, many natural gas assets require high capital commitments with >20 year economic lifespans, and could suffer from many of the disruptive factors identified above in the medium-term. Furthermore, the climate benefits of natural gas, when methane leakage is included, need to be carefully assessed.

Our proposition is that shareholders’ interests would, in many cases, be better served with more of their capital returned for asset allocation elsewhere. This could be achieved through increased dividends or other mechanisms.

ShareAction has consulted widely on the contents of this paper and will continue to consult with institutional investors on:

1. A strategy of highly restricted capital allocation to new organic growth projects (pg 17);
2. The cancellation of scrip dividend programmes to increase capital returns to shareholders (pg 19); and
3. A wholesale review of remuneration targets and executive performance metrics to achieve better alignment with the risks now facing investors’ capital (pg 19).

This debate is also relevant for investment consultants and passive fund managers. The MSCI World Index and the FTSE 100 both have significant weightings in the integrated oil sector with extensive further indirect exposure to the industrials and finance sectors. Investment consultants and passive fund managers need to respond to the emerging systematic risk across material sections of their clients’ portfolios.

As the integrated oil sector starts a new cycle, there is a window of opportunity for investors to refocus these businesses on capital return and capital discipline. For shareholders of the global integrated oil sector, 2018 is a critical juncture.
This report outlines the broad ranging changes that have influenced investor thinking since the top of the previous cycle in 2014. The collapse in the oil price, the Paris Climate Agreement, changes in economic prospects and energy demand forecasts in emerging markets, and the emergence of US shale oil as a marginal producer have had far reaching implications for the business models of integrated oil and gas companies.

Management teams across the sector have struggled to adjust capital expenditure (capex) and business plans, sustain dividend policies and repair balance sheets. Asset impairments, disposals and emergency rights issues have been a feature of the industry. All participants, whether large or small, have been impacted by these changes.

Since 2014, blue chip institutional investors have also become increasingly vocal about how climate-related risks impact the business models of the integrated oil sector. Institutional investors are increasingly participating in and supporting initiatives such as Climate Action 100+ and the Taskforce for Climate-related Financial Disclosures but also voting in support of climate-focused shareholder resolutions. These initiatives are no longer solely the remit of specialist socially responsible investors but accepted by global blue chip investors.

Blackrock and Vanguard voted for climate-focused shareholder resolutions for the first time in 2017 and the Norwegian Sovereign Wealth fund is considering a proposal to reduce its exposure to the sector. However, industry analysts might point to the complex relationship between oil price, industry capex and production levels. Based around historic relationships, analysts would describe the current point as at or close to a cyclical low, where improving or at least stabilising free cash flow (FCF) should now flow through to increased growth capex, growing production levels and improved sector profitability through a new cycle.

This paper points to the growing evidence that low carbon technology and regulatory changes will impact on oil demand patterns over the length of the next commodity cycle. This has implications for the way investors and executive management teams consider portfolio construction and capital allocation in and to the sector.

The coming disruption of the historical cyclical pattern in the oil sector has been recognised by some sector leaders. At BP’s 2017 Strategy day, BP’s CEO Bob Dudley acknowledged the need to develop business models that would work across the commodity cycle..."to compete in today’s world we need a business model for the Group that is not driven by price cycles."
Excess Supply & Peak Demand

Historically, finding, producing and refining crude oil has been a cyclical growth industry with oil demand correlated with GDP. Hence management teams have focused on growing production and increasing reserves. One of the many diverse drivers for the peak of the last cycle (Summer 2008: $147 boe) was market concerns about hitting ‘maximum’ production. Under 10 years later, industry debate has moved on and is focusing instead on peak oil demand and its implications for the health of the sector.

One source of disruption to future sector cycles is innovation in exploration technology. Current identified resources have grown significantly over the last 40 years and now exceed ‘consumption’ forecasts to 2050 (see Figure 1). Resource shortage is no longer an industry issue over any medium-term timeline or certainly before many commentators forecast global oil demand starts to decline. The issue is not about resource shortage but the rate at which recoverable resources can be extracted at commercial returns in a changing political and technological environment.

As illustrated in Figure 1, excess recoverable resources should be considered in the context of a forecast decline in the percentage of the global energy mix from oil and, in the medium-term, a slow decline in demand. The next 30 years will see renewables rapidly increase global market share whilst energy efficiency dampens overall energy demand.

Figure 1: BP Strategy Day 2017 (Slide 50)
Source: BP (2017)
It is broadly accepted that the global primary energy mix is undergoing fragmentation as government policies and, more importantly, new technologies become commercially and technically viable. The commercial and widespread adoption of electric vehicles (EVs), significant fuel efficiency improvements in other transport modes (HGVs and marine) and high efficiency solar/wind technologies are the energy technologies competing with any new growth projects seeking capital allocation today in the oil and gas sector.

Fossil fuels will remain a key element of the global energy mix over the coming decades but marginal growth is already coming from an increasing array of renewable technologies. As illustrated by Figure 2, DNV-GL forecasts that oil and gas will account for 44% of the world’s primary energy supply in 2050 (down from 53% today). Installed solar capacity has been doubling every two years for decades and is still growing at 30% per year. In 2016, taking BP data, solar, wind and other non-fossil fuels made up 62% of the increase in global energy supply.

Forecasting the future energy mix will always involve a series of estimates and results in a number of different forecasts. For example, Wood Mackenzie’s analysis of the IEA New Policies scenario, and BP, Exxon Mobil and Wood Mackenzie’s outlooks reveals a wide variation in estimates of future global energy demand within the industry. All forecasts expect energy demand to grow through 2035, although disagreements exist around future growth rates and market size of primary fuels, especially around oil, renewable energy sources and hydropower.

Oil demand growth is still set to grow in the near term but it is the change in marginal growth rates that is a key determinant of company and sector valuations and potentially a trigger for significant disruption across the sector. The European Utilities sector was recently transformed when demand stagnated and marginal growth came from the renewables sector leaving incumbents with uneconomic assets in an environment of low prices. Financial markets are influenced by directional change not absolute change.
Oil Demand & Patterns Becoming Increasingly Uncertain

Although the ‘market share’ of oil as a primary energy source is set to gradually decline in the next 10 years, absolute global oil demand is still forecast to grow, supported by a series of assumptions around Chinese and Indian demographic and economic growth and historic correlations between economic growth, population growth and oil demand.

Forecasts differ regarding the likely date at which absolute global demand for oil will peak. Many oil and gas industry ‘insiders’ believe the tipping point (peak global demand) is beyond 2040. OPEC’s most recent annual oil market review had a central forecast that outlined growth in demand extending beyond 2040. Many of the IOCs have forecasts based around peak oil demand in >20 years but forecasts differ significantly. The Wall Street Journal reported that the IEA forecasts the peak before 2040 broadly in line with BP, Total and many US IOCs. Shell and Statoil both forecast peak oil demand between 2025 and 2030. The primary cause of this variance seems to derive from different scenarios surrounding emerging market demand, technology and policy choices at a national and global level. Despite the wide range of forecasts, the length of capital investment programs in the oil industry means these timescales are well within the lifespan of many projects currently undergoing consideration and financial approval. Importantly these timescales are significantly longer horizon than the remuneration targets and KPIs of the current executive teams making capex decisions.

China has been the most significant source of growth in global energy and oil demand for the last 15 years. However, China is now undergoing an adjustment in expansion of energy demand, which is set to slow from 6% pa over the last 20 years to 2-3% over the coming decade. J.P. Morgan has reported that Chinese oil demand growth may peak by 2030. Slowing energy demand growth in China reflects a maturing in the pace of economic growth, lower energy intensity per unit of economic growth, regulatory change and improved energy efficiency. Alongside China, India will likely dominate the global incremental demand for oil over the next 25 years. The IEA predicts India will be responsible for 56% of all growth in global oil demand over that period.

The Chinese and Indian economies are largely dependent on imported hydrocarbons. This provides a strong economic and strategic impetus for their...
governments to encourage the rapid growth of alternative, domestically produced fuels. Public health concerns reinforce this motivation. This makes investment in infrastructure to support consumer choices such as EVs politically and economically more attractive than in hydrocarbon exporting economies.30
Technological Changes & Oil Demand Disruption

Technological changes are also introducing levels of uncertainty around demand growth. In developed nations, new drive train and electric vehicle technology are becoming more economically feasible and widespread. Regulators are also more open to mandating the use of lower emission and higher efficiency vehicles.32

Though EVs currently lack accessible charging infrastructure, McKinsey reports that new battery technology and improved investment in infrastructure could result in EVs representing 27-37% new vehicles sales by 2035.33

DNV-GL’s analysis indicates that uptake of EVs will follow an S-shaped curve with 50% of new European cars being electric just after 2025; with North America, OECD Pacific, China and the Indian subcontinent reaching this threshold in 2030; and the rest of the world by 2035 (see Figure 4). The IEA reported that China was the largest global market for EVs in 2017 with 40% total sales into the Chinese market. Even if forecasts about EV uptake prove to be wrong by a significant margin, they are set to influence fuel oil demand patterns within the economic lifespan of oil projects currently undergoing financial investment decisions at integrated oil companies. That impact may be most marked in regions where the IOCs are forecasting the greatest demand growth – China and India.

Adoption rates of EVs will be dependent on variables such as policy, technology improvements, consumer choices and infrastructure investment. These are difficult to forecast so the potential impact on light vehicle fuel demand is difficult to forecast. Edison has forecast a wide range of potential impacts on fuel oil demand (see Figure 5).

McKinsey also attempts to quantify the impact that EVs, improving fuel efficiency and social changes will have on the global demand for liquid transportation fuels. They forecast a combined demand drop of 8-25% by 2035.36 The adaption of light EVs and improved efficiency is unlikely to alter demand patterns materially in the near term however this is not the only technological development with implications for transport oil demand.

Increasing fuel efficiency and technological developments in heavy goods vehicles also have the potential to negatively impact transport fuel demand. In his recent piece, Sanjeev Bhaal (from Edison Research Commodity team) highlighted that, despite representing only 5% of the global vehicle fleet, the global truck fleet consumes c.20% of road transport fuel.37 Truck fleet purchasing decisions are heavily influenced by life time costs and regulation. They can change quickly without being influenced by consumer lifestyle choices. EV trucks may have a greater impact on fuel demand than light vehicles over the next 10-20 years.38 Technology is also changing the demand for petrochemicals in the plastics market. Mckinsey has outlined a scenario where global plastic recycling improves 8% (2016) to 20% (2035) and plastic packaging use falls 5%. In this scenario, demand for liquid hydrocarbons driven by chemicals could be approximately 2.5m bopd below their business-as-usual case.39
The relevant point for investors is not the absolute level of demand destruction (which is open to a wide range of variables) but the increased uncertainty in forecasting demand and subsequent implications for capital investment decisions.

Figure 4: Market share of EVs in new light vehicle sales
Source: DNV-GL (2017)34

Figure 5: Oil use impact - Edison forecast range to 2035
Source: Bhaal (2017)35
Reduction in Production Costs

The global oil and gas industry has reduced offshore development and production costs by between 30-40% in the past 3 years due to new technology adoption, project redesign and supply chain cost control. Onshore production costs have also declined significantly through technology and cost savings. The decline in development costs since 2014 has flattened the supply cost curve suggesting that the marginal development barrel is economic at approximately $60/bbl.\(^{40}\)

Combined with other changes such as the introduction of the scrip dividend and slowing new capex, these changes have meant margins have improved as the industry has adapted to a new lower oil price environment. However, these trends are unlikely to persist as management start to re-invest to grow production and as a smaller, consolidated supply chain starts to try to pass through cost increases. Current projects undergoing final investment decisions should be assessed using a range of scenarios including lower long-term oil prices, slowing demand and the possibility of rising costs from a smaller supply chain.

Figure 6: Forward cost curves since 2002
Source: Edison Investment Research\(^9\)
Implications for Industry Capital Allocation

Since 2014, the industry has successfully undertaken steps to reduce new growth capex and maintenance capex. Sections of the integrated oil sector have also reduced cash dividends through the use of a scrip dividend option.42

Recent financial results have highlighted an improvement in actual and/or forecast FCF across the sector, driven by projects from the previous cycle coming on-stream, cost reductions and the introduction of measures such as the scrip dividend. Indeed, Bloomberg reports that most oil companies can now cover dividends with crude oil prices as low as $50 a barrel and even allocate proceeds from higher prices to reinvestment or debt reduction.44 Some majors have forecast even lower breakeven points. For example BP has forecast that “based on (their) current planning assumptions….(they) would expect (their) cash balance point to reduce to around $35-40 per barrel over the next five years”.45

Although the pattern is similar across many IOCs, different quoted businesses have moved at difference speeds. JP Morgan46 reported that Shell and BP have led their European peers in terms of growth in Cash Flow from Operations, gearing and FCF dividend coverage (Figures 7 and 8 show the improvement in FCF at BP and Shell).

With growing FCF across the sector, executive boards are in a position, for the first time in several years, to make real choices about the future direction of their business. Some of these decisions are already being made.

A review of recent strategy day presentations and quarterly results suggest that oil are planning to step up production growth in the next decade, mainly through mergers and acquisitions or production start-ups. For example, BP expects its upstream production to grow by average of 5% a year from 2016 to 202149 and Total SpA will extend production growth of 5% per year until 2022.50

Wood Mackenzie reports51 that 2017 was a turning point for new capital investments in the sector with H1 2017 already seeing more final investment decisions than 2016.

Figure 7: BP’s Free Cash Flow forecasts to 2021
Source: BP plc47

Growing sustainable free cash flow to 2021

- Delivering growth in operating cash flow
  - Upstream ramp-up of major projects
  - Downstream marketing growth and increased resilience
  - Continued modernisation and efficiency improvements
  - Portfolio enhancements
- Group organic capital expenditure maintained at $15-17bn
- Gearing within 20-30% band

Organic free cash flow per share

Brent price

$55-60/bbl

Current cash DPS

100% current DPS

2018

2021
Figure 8: Shell’s free cash flow to 2021
Source: Shell (2016)48

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<tr>
<th></th>
<th>2013-15 average</th>
<th>17Q3 4Q rolling</th>
<th>2019-21 average</th>
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<tr>
<td>ROACE</td>
<td>8%</td>
<td>4.6%</td>
<td>~10%</td>
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<tr>
<td>Gearing</td>
<td>14%</td>
<td>25.4%</td>
<td>&lt;20% end ‘20</td>
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<tr>
<td>Buybacks</td>
<td>$8.7 billion cumulative ‘13-‘15</td>
<td>-</td>
<td>at least $25 billion* in period 2017-2020</td>
</tr>
<tr>
<td>Brent</td>
<td>~$90</td>
<td>~$51</td>
<td>~$60**</td>
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Figure 9: Shell’s forecast production growth to 2020
Source: Shell (2016)53
Most of these projects are either brownfield expansions, satellite developments or subsea tiebacks. These tend to have a lower risk profile than greenfield projects. They also have better return profiles due to some of the trends identified earlier in this report. Wood Mackenzie estimates on aggregate, project capex is lower than 2015 with higher Internal Rate of Returns (IRR).\textsuperscript{52}

If management teams’ base assumptions on historic relationships between demand growth, oil price and the industry capital cycle, we would expect the allocation of capital to new production growth to accelerate across the sector over the next 24 months. Indeed, this trend is already reflected in forecast net production growth across the sector.

As has also been the pattern in previous cycles, investors might also expect costs to rise and returns to fall as industry investment levels increase.
Recommendations for Investors

For holders of the integrated oil sector, this is a critical juncture. As outlined above, changing technology, regulation and demand patterns mean that the industry should not assume the conditions exist for a profitable new cycle of production growth and organic capital investment.

In this new environment, boards should prioritise the return of shareholder capital through improved distributions in lieu of investing in new production growth or investing to meet ambitious production growth targets.

To navigate a new environment of heightened uncertainty shareholders should consider the actions outlined below:

1. Ask management teams to commit to capital returns in lieu of investing in new production growth or publish a detailed business transformation plan

   Investors should recalibrate return expectations on projects forecast to deliver new production growth. In this new environment, boards should prioritise the return of shareholder capital through improved distributions in lieu of investing in new hydrocarbon production growth or investing to meet ambitious production growth targets.

This might take the form of a commitment to return a growing percentage of FCF to investors. We think this step would be supported by a range of institutional investors.

Some investors might argue that "mandating" capex restrictions limits the ability of management teams to invest in and grow downstream, renewables or natural gas operations.

This report does not focus on, or provide a separate discussion on natural gas or downstream/midstream capital investment programmes. New natural gas investments will be required under different energy demand scenarios and have already become an important part of the global energy mix. To varying degrees, LNG and natural gas now represent important parts of integrated oil sector portfolios. However, like oil, many gas assets require high capital commitments with >20 year expected economic lifespans where, as highlighted, the economics will become increasingly unclear in the medium-term. Natural gas is not immune to many of the disruptive factors identified above and often requires higher initial development costs.

Traditionally downstream developments are often the FCF engines for many IOCs. They are therefore crucial sections of the business in supporting dividend payments. Investors might find it valuable to compare the capital discipline shown in downstream businesses with the historic profligacy of upstream capex.

We are not arguing here for no investment in new production growth but for sustained capital discipline and a clearer commitment to capital returns.

Management teams in the integrated oil sector are energy experts, able to adapt to new environments and respond to new energy scenarios and demand patterns. In response to the changes outlined in this report some businesses within the sector have allocated capital to renewable energy investments and technology.

In most cases, however, management teams have not taken the opportunity to meaningfully grow or
invest in alternative business models based on the supply of renewable energy as a transport fuel. Across the sector, capital plans and production targets are still largely focused on new hydrocarbon production growth.

We would also question whether a move to renewables by firms in this sector is in the interest of shareholders. There are few examples of mature incumbents successfully reinventing themselves through gradual change. Where this is completed by acquisition, there is extensive evidence that mergers and acquisitions result in value destruction.58

Any significant transition to renewables would inevitably result in an extended phase of ‘conglomerate’ structure with different business models and drivers co-existing under the same corporate structure. This type of organisational structure is often ascribed a valuation discount. Investors may want to consider this when supporting diversification by firms in the integrated oil sector.

Though various transition pathways are possible for each company, and some firms my succeed by evolving their business models, technology disruptions often happen too quickly for incumbents to respond effectively. We believe this is particularly true for an industry with long and expensive capital cycles.

Another criticism of our proposal might be that restricting the allocation to investments in new production growth inevitably commits these businesses to slower or negative production growth and will eventually results in corporate decline - undermining a sustainable dividend yield. Our argument is indeed based around slowing and then declining demand growth for liquid fuels over a 10 to 15year period. We would argue that some of the trends outlined in this paper will result in structural changes in the integrated oil industry that will inevitably undermine the long-term sustainability of the dividend yield. Our intention is to safeguard capital as that process develops.

As outlined earlier in this paper, the global economy will require new investment in some production growth to replace natural production declines. However, unlike the iron ore industry,59 it is more difficult for equity investors to have direct exposure to the lowest cost producers at some of the National Oil Companies.60, 61 At this stage, it is entirely sensible that IOCs allocate capital to projects at the bottom of the marginal cost curve where they can achieve high returns over the full economic life of these projects under a series of possible scenarios. Our proposition does not restrict management from maintenance or brownfield capex to slow production decline but calls for management decisions to recognise increasingly uncertain economic returns from investments in new production growth. We propose instead more capital be returned to investors for alternative allocation – including into the renewable sector.

In an increasingly uncertainty environment for the sector and commodity demand, we believe improving the consistency in capital returns throughout the cycle would be supported by shareholders. We think that IOC management teams should be discussing this option with institutional shareholders. We think that IOC management teams should be discussing this option with institutional shareholders. Studies have shown a clear connection between dividend growers and shareholder returns.62

2. Vote against scrip dividend options in 2018

Scrip dividend programmes give shareholders the right to receive new shares instead of cash dividends. Boards normally introduce scrip dividends as a mechanism for conserving cash from a position of balance sheet weakness. They are often popular for tax reasons. For example, BP introduced the scrip dividend at its 2015 AGM and shareholders will vote on the scrip again at the 2018 AGM. In the Q3 2017 results, BP announced the intention to buy back shares to offset dilution from the scrip. Shell has also recently announced plans to scrap its scrip dividend programme.63 Repsol has had a scrip dividend programme since 2012, as part of its “Flexible Dividend Policy”. Total SA recently
stated it would remove the scrip dividend scheme though some analysts have suggested this will be delayed due to the recent Maersk Oil acquisition. With most IOCs in stronger financial position than in 2015 there is no longer a robust case for the scrip dividend even with a buy-back programme to offset the share dilution. We believe scrip dividends are no longer in the interests of long-term shareholders in the sector and should be phased out completely. It is in investors’ best interests to vote against the scrip dividend at all but the financially weakest IOCs in 2018, especially if the companies propose a multi-year extension.

Removal of the scrip would be one mechanism to ensure management teams focus on capital returns rather than investing in new production growth.

3. Adapt executive remuneration to prioritise returns and profitability over hydrocarbon production growth

As outlined above, oil demand levels are likely to undergo significant change over the next 10 years due to technological and regulatory changes, with widespread implications for the profitability of new capital intensive projects with long lead-times. Remuneration committees should recognise this new reality and introduce long-term incentive schemes (LTIPs) that reflect increasing uncertainty and the need to focus on capital preservation in an industry a structurally new demand environment.

Yet a majority of IOCs are still using remuneration metrics that reward hydrocarbon production growth. For example, executives at Repsol, Shell and Statoil are incentivized to maintain high reserve replacement ratios (RRR), a measure which is not linked to returns on production, nor the delivery of long-term value. In the face of declining access to conventional fields, RRRs encourage executives to turn to non-conventional and frontier projects that tend to be higher cost and higher risk, such as tar sands and deep water projects. These projects often rely on high break even prices and long lead times, which put them at risk of stranding in a low-price environment. Following the shareholder resolution by the ‘Aiming for A’ investor coalition which questioned the role of the RRR in remuneration targets, BP recently removed the RRR and any other volume-based metrics from its remuneration policy. However, BP continues to include RRR, production (mbbl/d) and major project delivery in senior management KPIs.

Furthermore, the performance and vesting timelines of long-term incentive schemes at IOCs currently fail to reflect the long-term risk horizons associated with hydrocarbon projects. Shell recently recognised the limitations of 3-year horizons for its LTIP, but suggested that by requiring executives to hold large shareholdings, executives’ interests are aligned with those of investors. While there is a good case for using equity-based rewards, this is only true if the holding periods are meaningfully extended. For example, before filing for Chapter 11 bankruptcy, Peabody Energy executives cashed in stock options worth a combined $47 million between 2008 and 2011. In July 2015, Peabody stock closed at $1.20 per share, compared to $63.98 at the end of 2010. Extending performance timelines far beyond the tenure of executives is not without problems either. Remuneration committees should thus identify steps needed to protect shareholder value over 20+ years, then to translate these factors into measures that support the delivery of a long-term strategy on a year-by-year basis.
We believe executive remuneration should decouple remuneration metrics from hydrocarbon volumes, such as by doing the following:

• Reward ongoing capital discipline (e.g. increasing weighting of multi-year Return on Capital Employed targets); or
• Reward capital returns (e.g. targets for % free cash flow returned to shareholders); or
• Focus executives on per share measures (e.g. not production growth but production per share growth; FCF per share, dividend per share)

ShareAction undertook an extensive review of executive remuneration at BP and Shell in 2017\textsuperscript{71}\textsuperscript{,}72 which resulted in advice to vote against the resolutions on executive pay policy in 2017.

4. Recommendations for asset owners and investment consultants

As highlighted earlier in this report, integrated oil and gas companies are important segments of most benchmark indices. Benchmarks still provide the basis for asset management compensation, performance measurement and a range of new equity products. For many asset managers, deviation from the benchmark returns are key to determining relative performance or allocating risk budgets. The systematic challenges to the oil and gas sector over the next 10-20 years should also raise questions for asset owners and allocators about their reliance on market capitalisation indices as important benchmarks for performance measurement, asset manager compensation and risk management.
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54. World Economic Forum (2017). Game Changers in the energy systems: Emerging themes reshaping the energy landscape.


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