RESPONSIBLE INVESTING

Energy in 2021: An ESG-informed outlook

By: John Miller | & Cheryl Wilson | January 13, 2021

Washington - It is difficult to underscore how challenging 2020 was for companies in the energy sector. The sudden collapse in transportation demand resulting from the global spread of COVID-19 and a transition to more widespread remote working sapped commodity prices. While benchmark equity indexes rallied from March lows (and clean energy valuations surged), the energy sector reported a full year 2020 total return of -34%.

With this backdrop as prologue, what follows are some factors likely to impact performance in 2021, and how environmental, social and governance (ESG) principles can help investors position themselves for risk avoidance and opportunity maximization.

Demand

Average daily oil demand in 2020 fell by 8.8 million barrels per day (MMbbl/d) when compared to 2019, down to 91.2 MMbbl/d.[1] While a demand bounce in 2021 seems likely, the challenges to a full recovery in 2021 are enormous and widespread. Key industry forecasts continue to point toward an ongoing 2.5-3 MMbbl/d demand shortfall in 2021 when benchmarked to 2019, primarily driven by ongoing weakness in aviation fuel.

In this demand environment, the performance of alternative low-carbon fuels (such as renewable diesel) - supported by tax incentives, fuel standards or outright mandates - are likely to continue displaying strength and attracting capital investments.

Long term, as personal and commercial vehicles continue to transition toward electric drivetrains, the core thesis arguing for oil demand growth declines. It is estimated that battery-electric vehicles (EVs) and hybrids will tick up to 4% of total passenger vehicle sales in 2021, with a range of new models hitting global markets. While sales growth is accelerating, electrified passenger cars will make up less than 1% of the global auto fleet in 2021, with significant penetration - and oil displacement - ramping later this decade.[2]

Supply

The supply outlook is equally unsettled. Into January 2021, OPEC+ continues to hold more than 7 MMbbl/d of production capacity off the market to support prices.[3] In 2020, its production declined for the fourth straight year as the cartel sought to balance an oversupplied market.[4] How long this balance can be maintained is a growing questions, particularly if the "+" states, led by Russia, again push for aggressive supply increases.

Change also is likely in the world's largest oil producer, the U.S. With the Biden administration set to take office, regulatory scrutiny and costs surrounding land access, water treatment and operational emissions are likely to increase. The burden of proof required for infrastructure approval - including a consideration of lifecycle emissions - is also (rightfully) likely to rise. How this step-up in operational costs will affect producers is yet to be fully understood.

Energy transition positioning

In many ways, 2020 was a breakthrough year for discussion and strategic consideration given to the energy transition. Topics that have been core to financially material ESG investment research for many years rapidly transformed into mainstream financial and strategic dialogue.In 2020, integrated majors and E&P companies announced groupwide emissions targets inclusive of full Scope 1, 2 and 3 emissions (value chain emissions) - with varying levels of believability. Timelines for "peak oil demand" were drawn forward, or even more remarkably identified as in the past, in oil producer reported outlooks. On the back of $145B in oil and gas asset valuation write-downs,[5] industry-led discussions of renewables, hydrogen, carbon capture and energy "services" thrived.

Through 2021, we are most interested in observing trends in the following topics:

- **Scope 1 Emissions:** The energy industry has a widespread flaring and methane leakage problem. Will these wasteful practices be curtailed by the industry or forced through regulatory action?
- **Scope 3 Emissions:** 2020 pierced the veil on emissions targets inclusive of Scope 3. To date, this trend has remained primarily confined to European-domiciled integrated majors. Will U.S. majors, E&Ps or refiners make similar announcements - or be further left behind?
- **Gas or oil:** With oil-based transportation demand stymied in 2020, energy companies highlighted natural gas, a lower-carbon, longer-lived fossil fuel. Will this trend hold if oil prices recover?
- **Renewable development:** Oil majors announced significant solar and wind capacity targets and paid up for large offshore wind leases in 2020. Will energy companies be able to compete against established utility and clean energy developers? Will renewable businesses achieve the returns that have been communicated to the market?
- **EV/CCUS/Hydrogen:** Outside of well-established solar and wind technologies, energy sector "off ramps" such as EV-charging infrastructure, carbon capture and hydrogen were highlighted in 2020. Will talk turn to capital allocation and project execution?
- **Corporate structure and reporting:** Representing tiny contributions to total revenue, reporting and financial details related to renewable units within energy companies has historically been opaque or totally nonexistent. Will renewable arms earn dedicated carve-outs in corporate reporting? Will this drive a "green premium" and encourage farm-downs or IPOs?

Bottom line: The combined public health and economic consequences of COVID-19 should gradually recover through 2021. As energy companies manage the various supply and demand pressures inherent in oil and gas markets, 2021 will be a key year for action on climate and energy transition-related commitments. ESG investors like Calvert will remain watchful for leaders in the sector willing to commit capital toward low- and zero-carbon energy transition solutions.

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1. *IEA Oil Market Report, December 2020*

2. *BloombergNEF, Long-Term Electric Vehicle Outlook 2020, May 2020.*

3. *CNBC, "OPEC+ reportedly nearing compromise on holding oil output steady," January 5, 2020.*

4. *OPEC, Monthly Oil Market Report.*

5. *Collin Eaton and Sarah McFarlane, "2020 Was One of the Worst-Ever Years for Oil Write-Downs," The Wall Street Journal, Dec. 27, 2020.*

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