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OPINION

Oil companies must come clean about their price estimates

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With the price of Brent crude oil having risen from roughly $50 a barrel over the past three years to more than $73 today, oil and gas companies are reporting profits not seen since 2014. Shareholders are optimistic that dividends will grow.

This picture contrasts with arguments that oil and gas companies are facing a mountain of writedowns as the world weans itself off fossil fuels in line with the Paris climate accord. Both cannot be right. And knowing which is correct matters enormously.

A review by Sarasin & Partners of the financial statements of eight European oil and gas companies (Royal Dutch Shell, BP, Total, Equinor, Eni, Repsol, Cairn Energy and Soco International) shows that there may be systemic over-statement of capital and performance due to the use of overly optimistic long-term energy price assumptions.

Of course no one knows for sure what the long-term oil price will be. But oil and gas companies must identify a long-term price to use in their accounts that reflects structural trends in demand and supply. This underpins reported capital, profit and dividends.

For the eight companies reviewed, the accounts are drawn up using long-term oil price assumptions of $70 to $80 a barrel from 2020/21, rising by 2 per cent a year thereafter. This translates into a nominal price of between $127 and $145 a barrel by 2050.

The same oil and gas companies, however, now routinely point to the risk posed by global decarbonisation as governments seek to combat climate change by eliminating net carbon emissions by roughly 2070. Moreover, in response to growing uncertainty, they have been adopting lower price thresholds for new project approval. New investments will not get funded unless they can be shown to cover internal rates of return at $60, $50 or even $40 a barrel. These prices are comparable with those that third parties are suggesting would be consistent with accelerating decarbonisation linked to the Paris climate accord.

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Unfortunately, companies provide hardly any visibility on their sensitivity to lower long-term energy price assumptions.

For example, in 2017, Total reported that a 10 per cent reduction in its oil and gas price assumptions would halve its reported profit due to asset impairments worth over $4bn. While manageable for a company with approximately $114bn of reported equity, this is not small beer. Would a $60 a barrel oil price assumption wipe out all Total's profit? What about $40? While oil and gas companies look vulnerable to lower fossil fuel prices, investors do not have information on how vulnerable. And shareholders need to know what headroom companies have to absorb lower prices.

In the case of US energy companies, shareholders are even more in the dark, lacking any sense of the long-term prices used in financial statements. This makes it impossible to interpret their reported numbers properly or compare to other oil and gas companies.

Investors, creditors and regulators should seek more transparency. The low-carbon world promised by global leaders will mean weak demand for fossil fuels, and this should be reflected in company financial statements. Where information is not forthcoming, shareholders should vote against directors and auditors.

The importance of ensuring reliable and prudent accounting extends beyond the need to protect capital and ensure financial market stability. Over-statement also works against efforts to combat climate change, since higher reported capital and returns enables more investment in fossil fuels than is wise.

The longer we delay adjustment to the accounts, the greater the risk of disruption for society at large.

The writer is head of stewardship at asset manager Sarasin & Partners