A new president, a new approach?

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Mergers, supermajors and capital

January is traditionally a time for reflection at the year just gone, and anticipation for the year ahead. This was certainly the mood at the Cripps Leadership Advisors' energy transition in Houston at the end of 2024, where we were delighted to welcome guest speaker Doug Terreson, board member of Phillips 66 and, in his executive career, one of Wall Street's most influential analysts. Here, he shared some of the lessons history has taught us in the energy story so far.

Doug discussed the 'era of the supermajor', highlighting the turbocharged value creation driven by the mega-mergers of industry giants: BP and Amoco in 1998, Exxon and Mobil in 1999, Elf and Total in 2000, Chevron and Texaco in 2001, and Conoco and Phillips in 2002. These combinations ushered in the adoption of the value-based model, prioritizing growth in shareholder value over production expansion, which propelled energy to outperform all other market sectors through 2008.

Doug also examined key lessons from some of the world's most significant energy restructurings and privatizations, including those in China, Norway, Venezuela, and beyond. Referring to chapter, 'Golden Age of Refining,' in his book, "Can't Deny It", Doug shared how the R&M sector experienced extraordinary gains, with stock values surging by 1,700 percent between 2003 and 2007, underscoring the consequences of prolonged underinvestment in commodity market capacity.

As the shale boom took off in 2010, Doug shared the concerns he raised in his book about the shift away from the value-based model. Energy sector spending relative to shareholder distributions ballooned from 2:1 to 10:1—an indicator of potential value destruction and poor shareholder outcomes. By mid-decade, widespread E&P bankruptcies highlighted the risks of such a departure. However, the industry's adoption of the 'pledge' for greater capital discipline and enhanced corporate governance marked a turning point, driving exceptional performance in traditional energy in recent years. This underscored a crucial lesson: investors prioritize value creation through higher returns on investment over mere size or production growth, regardless of the industry.

While Doug expressed optimism about the energy transition, he suggested the pace may have been overestimated. The initial hype surrounding ESG and alternative energy led to P/E ratios of 50 in the sector near the 2021 peak, compared to just eight for traditional energy—valuations that were unsustainable without exceptional returns on investment. When these returns failed to materialize, the market's message became clear: while the world desires an energy transition, alternative energy valuations will likely be governed by the same criteria as other industries—future profitability and ROI. Expectations for 'green premiums', he noted, may increasingly become a thing of the past.

"We all want to fast-track the switch to green energy, but access to capital and shareholders need for higher returns sooner, continues to slow progress.

Murray Fox | Director, Cripps Leadership Advisors

How does the energy transition sector attract capital?

The good news is that clean energy technologies attracted two-thirds of 2024's total energy investment worldwide. According to the IEA's annual World Energy Investment report, world energy investment is expected to exceed $3 trillion in 2024, with some $2 trillion set to go toward clean technologies. This includes renewables, electric vehicles, nuclear power, grids, storage, low-emissions fuels, efficiency improvements and heat pumps, with the remainder going to coal, gas and oil[1].

The IEA, however, pointed out that there are still major imbalances and shortfalls in energy investment flows in many parts of the world, with levels of clean energy spending in emerging and developing economies far below what is required to meet growing energy demand in many of these countries, where the high cost of capital is holding back the development of new projects.

As part of this imbalance, the demand for fossil fuels of all kinds, even polluting coal, continues. Spending on global upstream oil and gas continues to grow, up by an expected seven percent this year to $570 billion, following a similar rise in 2023. Worryingly, the lower cost of inflation means that the headline rise in spending is buying an even larger rise in activity. What's more, the world continues to invest in new coal capacity, with more than 50 GW of unabated coal-fired power approved in 2023, the highest since 2015, and thermal coal company stock valuations are soaring.

Of the oil and gas spend, around 40 percent is targeting existing fields, with 33 percent opening up new fields and exploration to keep future pipelines filled. Much of the spend is by the national oil companies in the Middle East and Asia, but international oil companies are still investing in new and existing reserves. Oil majors certainly like to talk about their investments in clean energy projects, but the numbers show that fossil fuels remain their key business and will for many years to come. Their investment in clean energy was $30 billion in 2023, but this was only four percent of the industry's overall capital spending, according to the IEA, while investment in low-emissions fuels is only 1.4 percent of the amount spent on fossil fuels. One thing is clear: these levels are far too high if the world is to meet its climate goals.

[1] www.iea.org/news/investment-in-clean-energy-this-year-is-set-to-be-twice-the-amount-going-to-fossil-fuels

AI data centers turbo charge demand

All this investment in new production is driven by consumption. Growing populations, industrialization in developing nations and, of course, the energy demands of electric vehicles and AI data centers mean spending on fossil fuels remain a sure bet for investors.

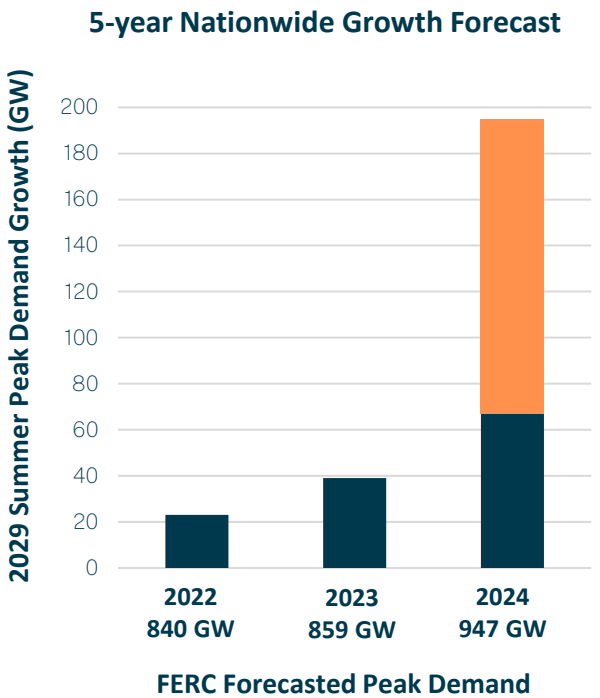
In the US, for example, the forecast of cumulative electricity growth over the next five years appears to have increased by a factor of five, from 2.8 percent to 15.8 percent, largely due to the energy demands of strategic industries such as semiconductor chip manufacturing, AI, and battery manufacturing[2]. In Texas (ERCOT), load growth forecasts for 2029 have surged by 37 GW to 43 GW due to data centers and manufacturing. Overall, ERCOT says it has received 103 GW of new load requests, including 82 GW from new data centers along with demands for hydrogen plants and other industrial projects.

Large data centers in particular present new, unique challenges to grid reliability. Large, rapid changes in load during crypto mining operations, for example, can increase or decrease load by almost 100 percent due to price response while AI data center training models can vary load significantly within seconds. At large scale, these load drops can cause severe reliability problems.

If the updated national forecasts are correct, annual electricity demand growth will jump from the norm of around one percent a year to an average of three percent per year over the next five years – this means six times the planning and construction of new generation and transmission capacity.

This is a big ask. According to FERC data, the US only built 55 miles of high-capacity transmission (greater than 345 kV and up) in 2023, a level of expansion that if sustained would fall far short of demand. Across the country there are large backlogs of slow-moving generation projects, with nearly half of project delays occurring during the construction phase due to supply chain bottlenecks, lack of prioritization by transmission owners, and delays by interconnection customers who may lack contracts with power customers or necessary permits.

The rate of build out is set to increase, however, with planned transmission expansion investments having increased from $9.2 billion two years ago to $15.1 billion for 2024. Much more will be needed to meet the demands of a digital, AI-powered and low carbon future.



Over 2022-2024 the 5-year load growth forecast has increased to 128 GW

Graph reference: Grid Strategies LLC

[2] https://gridstrategiesllc.com/wp-content/uploads/National-Load-Growth-Report-2024.pdf

Carbon pricing: bridging the financing gap?

This is where carbon markets could prove pivotal, by creating the premium required to support the development of the net zero agenda. As stated in the most recent World Bank report into carbon pricing[3], carbon pricing revenues reached a record $104 billion in 2023, with 75 carbon pricing instruments in operation worldwide. Over half of the collected revenue was used to fund climate and nature-related programs and carbon pricing is, according to the World Bank, 'one of the most powerful tools to help countries reduce emissions'.

The bank has been tracking carbon markets for around two decades, over which time carbon taxes and Emission Trading Systems (ETS) have expanded from covering only seven percent of the world's emissions to almost 24 percent. While traditional sectors like power and industry continue to dominate, carbon pricing is increasingly being considered in new sectors such as aviation, shipping and waste.

There's a lot of fragmentation, with schemes operating at different levels of government, from the supranational, such as the EU, to the city level, such as Beijing. Pricing varies wildly but is generally considered too low – around $50 per ton CO_2 or less - to deliver on climate goals[4].

Some industries are taking a lead: in shipping, the International Maritime Organization (IMO) is inching closer to a global carbon tax, with a final decision on carbon pricing due in 2025, which could act as a catalyst for further global carbon pricing. Encouragingly, the IMO has a track record of successful mandating cuts in emissions from the global fleet, as evidenced by its introduction of a strict sulphur cap.

[3] https://carbonpricingdashboard.worldbank.org/compliance/price
[4] https://www.visualcapitalist.com/sp/visualized-the-price-of-carbon-around-the-world-in-2024/#:~:text=Carbon%20pricing%20varies%20significantly%20across,with%2016%20initiatives%20in%20place

A new administration

There can be no look ahead at 2025 without considering that there's a new administration heading to Washington. It's hard to say what changes President Trump may oversee during his second term in office. What of the Biden-era IRA, which proved so instrumental in releasing investment for clean energy projects?

With an optimist's lens, we observe that most of these funds, 88 percent, went to companies and projects in so-called Red states, which could protect the legislation. If President Trump version one is anything to go by, we can expect permit and regulatory requirements to be eased, which will support all types of energy projects with a particular focus on new power generation and critical transmission infrastructure. Could this further boost clean energy projects, not just oil and gas? What of trade tariffs - what changes might we see and how might these impact LNG trade flows? With tech billionaires staying close to the president-elect, what support might there be for power projects that can feed the vast energy demands of AI data centers? Could this hunger for power be the shot in the arm that new nuclear, particularly SMRs, need?

Time will tell.

Cripps Leadership Advisors Viewpoint

A lot has happened over the first quarter of the 21st century. When it comes to the climate crisis, there have been huge gains in renewable energy but also a dawning realization of how much more there is to do and just how much it is going to cost.

As for trends, we have observed that the green hydrogen hype is certainly in an ebb phase, blue hydrogen as a concept and carbon capture still have opportunities and there is tangible progress in low carbon molecules supported by government or industry mandates, particularly aviation fuel, gas and hope in marine fuels. Nuclear is an interesting debate, for many, an obvious solution, particularly if SMR technology and cost can be achieved, but will continue to be hamstrung by regulation and planning, public safety concerns potentially easing. Finally, with wind and solar creating growing intermittency, battery storage is attracting investment.

The role of private equity and energy investment banking will be pivotal in shaping a sustainable and profitable energy future. Embracing the energy transition is not just about compliance or risk management; it is about seizing the opportunity to lead in a new era of energy.

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