Oil and Gas

Hydrocarbon prices to remain supportive of credit quality

January 23, 2023
This report does not constitute a rating action

What's changed?

Russia-Ukraine War. Disruption to Russian oil and natural gas supplies and swings in government policies, raised energy supply concerns and led to inventory, logistics, and trade flow disruptions.

Record European gas prices. Europe saw record spot and average market prices.

Refiners benefit from cyclical peak margins. 2022 was a complete reversal from 2020 as demand for oil products led to healthy crack margins.

What are the key assumptions for 2023?

Energy security will be paramount. The Russia-Ukraine war has raised concerns about energy supply.

Oil prices and refining margins should remain supportive of credit quality. Despite global recession risks, we see supply factors supporting oil prices in 2023.

Gas price also supported. European gas benchmarks are likely to remain elevated.

What are the key risks around the baseline?

A deep or prolonged recession. A global recession that is more severe than our base case assumptions could lead to lower prices.

Government actions. We see risks from regulation, taxation, and policies given the confluence of high prices, producers' strong profits, energy affordability and security, and decarbonization.

Escalation of the Russia-Ukraine war could result in a supply shock and sharp price spikes, likely followed by demand impacts.
Ratings Trends: Oil and Gas

Chart 1
Ratings distribution

Chart 2
Ratings distribution by region

Chart 3
Ratings outlooks

Chart 4
Ratings outlooks by subsector

Chart 5
Ratings outlook net bias

Chart 6
Ratings net outlook bias by subsector

Source: S&P Global Ratings. Ratings data measured at quarter-end.
Industry Outlook

Ratings trends and outlook

In 2022, positive ratings trends continued as healthy hydrocarbon prices allowed oil and gas companies to reduce debt while balancing shareholder rewards. For investment-grade issuers to warrant an upgrade, we wanted to see permanent debt reduction and not just improvement in credit metrics through higher hydrocarbon prices and cash flows. Typically for the investment-grade independent and integrated oil and gas companies, we evaluate producers at our long-term price deck to ensure credit metrics are sustainable even in downturns. For speculative-grade issuers, we expect ratings to be more volatile relative to their investment-grade peers, and improved credit metrics are the reason for the majority of upgrades.

Despite the strong hydrocarbon prices in 2022, positive rating actions in the oil field service (OFS) space were muted in comparison to the E&P sector. This was the result of public exploration and production (E&P) producers continuing to limit capital expenditures (capex) and not outspend. OFS companies had limited ability to offset material and labor inflationary pressures; however, we are beginning to see pricing power return to OFS companies and, as a result, we expect margin improvement, some debt reduction, and credit metrics to improve in the sector. We expect E&P capex budgets to increase by 15%-20% in 2023 including cost inflation.

Shale producers are bumping against productivity issues as producers drill up their Tier I acreage. They will need to spend more to improve efficiencies and maintain at least similar production levels. Moreover, we do not expect more capacity to enter the market and much of the equipment to remain mothballed or used for spare parts.

With the outlook largely stable, we do not expect the overall pace of positive rating actions exhibited in 2022 to continue in 2023. We believe oil and gas companies will be allocating a greater share of cash flow to shareholder rewards in 2023. We also believe the industry debt maturity schedule does not allow the same level of debt reduction opportunities afforded over the previous two years.

Over the longer term, we believe smaller producers will have to either merge or be acquired to effectively offset the impact of climate regulations and the costs and restrictions associated with that as well as declining productivity as prime acreage becomes depleted and wells mature. In this case, being bigger and having diversity and flexibility will not only allow companies to manage during the downturns but will also afford the company access to capital markets that smaller producers may not have in the future.
**Main assumptions about 2023 and beyond**

1. **Energy security and affordability is the focus**
   
   The Russia-Ukraine war and the subsequent energy crisis have brought the subject of energy security to the forefront and deprioritized climate change initiatives. Many countries, having shuttered coal plants to comply with carbon emission standards, reactivated plants, or delayed closings given fuel shortages. We expect this yin and yang dynamic to continue for the foreseeable future. It is likely that high energy costs will promote continued investment in renewables or electric cars. However, given inflationary pressures and the likelihood of many global economies heading for a recession, budgets will be stretched and renewables investments delayed.

2. **Oil prices remain supportive of credit quality**
   
   We expect oil prices to remain supportive of credit quality. In a mild recession scenario, it is unlikely oil prices will stay below $75 for an extended period. Supporting this thesis are China’s reversal of Covid shutdown policies and the supply side of the equation. Global inventory levels remain relatively low and OPEC has remained supportive on the production side and even if it wanted to increase production--is unlikely to be able to as some OPEC countries are having difficulty maintaining current production targets. Moreover, there is limited OPEC spare capacity. We also expect shale producers to eschew the "drill baby drill" mantra they were previously known for. Lastly, Russia will continue to be challenged to find takers for its production.

3. **Natural gas prices to remain elevated**
   
   Natural gas prices will remain elevated well into next year as Europe will look to replenish its gas inventories beginning in April for the winter heating season, this time with markedly lower Russian supply expected. This will continue to have a knock-on effect on gas and liquid natural gas (LNG) price levels and volatility globally. With limited new build LNG capacity, global gas prices will respond in kind. This scenario could play out for the next several years before additional LNG capacity comes online.

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**Recessionary concerns aside, we expect the current strong cycle for hydrocarbon prices will continue next year driven by the supply side of the equation.** Nevertheless, the industry faces medium to longer term headwinds driven by climate change and rising operating costs due to maturing and less productive wells. Climate change regulation will raise the cost of doing business and the cost to access capital markets as investors continue to focus on environmental, social, and governance issues (ESG) and to reassess the allocation and exposure of their portfolios to polluting industries. Also, barring the introduction of new technologies, productivity for some U.S. shale regions is peaking, which will increase costs to maintain production and increase capital budgets. We expect rising capital intensity and climate change regulation over time will drive increased mergers and acquisitions (M&A) as scale, scope, and diversity of operations prove to be a paramount offsetting factor.

**OFS companies should perform better in 2023.** Pricing power is shifting to oil field service providers which should result in improved margins and cash flow. Continued depletion of Tier I reserves and increasing capital intensity from U.S. shale should lead to increased demand for OFS goods and services. Although utilization and rig rates have improved, we remain less sanguine on deepwater versus land based providers given long lead times of development and the high breakeven prices needed to justify expenditures.

**Refining margins in most regions will remain healthy.** If not at the historically lofty levels refiners experienced in 2022. Demand for refined products has remained resilient, and inventory levels,
particularly for diesel, should keep middle-distillate cracks high. A tight diesel market should support good refinery runtimes and keep utilization in the low- to mid-80% area globally:

- **The U.S. market is set to follow up one of the strongest years on record,** with margins that are slightly lower but well above pre-pandemic levels, supported by strong distillate prices, low product stocks for jet fuel and diesel, and a robust export market, particularly given the European ban on Russian crude in December 2022 and refined products beginning February 2023. We believe North American refining utilization will stay at historic highs, averaging in the low-90% area for most of 2023. We expect U.S. refineries' credit quality to remain strong as companies continue to repay debt and build cash. We expect most U.S. companies to return more cash to shareholders without sacrificing credit quality or balance sheet strength that was built up during the previous 12-18 months.

- **Latin America will see crude runs remain at historically high levels** of about 4.6 million barrels per day.

- **The outlook for European refineries is mixed,** with the EU embargo on Russian crude leaving refiners in Europe fewer alternatives and likely buying more from Kazakhstan, Norway, the U.S., and Guyana. Unplanned downtime could also be a risk given recent labor strikes in the United Kingdom and parts of France and the Netherlands. That said, margins should be solid if European operators can solve their feedstock and operational challenges.

- **China continues to manage domestic capacity,** closing smaller refiners in favor of large ones, and managing utilization in response to rising product stocks stemming mainly from government COVID controls. China will likely look to reduce surplus inventory through increased exports. Overall, will believe Chinese and other Asian refineries will see improvement in operations during the next 12 months as COVID controls relax and countries manage utilization and product stock.

Credit metrics and financial policy

**With the benefit of stronger hydrocarbon prices, E&P producers are raking in record cash flows** and are balancing these cash flows between reducing debt and returning value to shareholders. The conversation on earnings calls has changed from one of production growth to one of improving the balance sheet. Many companies, particularly in the investment-grade space, are now publicly stating leverage targets such as a debt/EBITDA of 1.0x-1.5x in what they deem to be midcycle oil and gas prices of around $50/barrel of West Texas Intermediate (WTI) and $2.75 or so natural gas. Investors continue to influence producer’s financial policy than in recent years.

**Refiners globally will continue to see credit improvement in 2023, aided by strong margins and limited spare capacity.** Refiners continued to focus on strengthening their balance sheets in 2022 while also rewarding shareholders, mainly through share repurchase programs. Liquidity is strong across many of our rated refiners, which provides them with ample financial flexibility in the event of a global recession and weakening demand or other shocks like labor strikes or unplanned downtime that could affect utilization and runtimes. We believe credit metrics will remain strong in 2023 but may not see much improvement from 2022, when we stabilized much of the North American refining portfolio and upgraded several speculative-grade refiners and one investment-grade company because of significant EBITDA growth coupled with debt reduction, which in our view improved the companies’ permanent capital structures. Credit measures for North American refiners exhibited marked improvement in 2022, with debt to EBITDA averaging about 1.75x, or two turns better than the prior year.

**Credit ratios may soften as refining margins come down from historically high levels.** Nevertheless, most companies have built up a substantial cushion in their credit ratios and
Industry Top Trends 2023: Oil and Gas

should be able to withstand moderate credit pressure and economic headwinds without having these factors affect ratings. Investment-grade refiners have substantial cash balances even after returning money to shareholders and should maintain leverage close to 1x. Speculative-grade refiners also have strong credit measures but are more exposed to regional demand patterns and crude prices given their smaller size and scale. That said, we believe their credit positions during the next 12-18 months are secure.

Key risks or opportunities around the baseline

1. A deep or prolonged recession

Risks of a severe global recession remain. Lower prices could follow a view that oil demand is flattening or could decline for a period. An escalation in the Russia-Ukraine war could potentially result in a supply shock and sharp price spikes, likely followed by demand impacts.

2. Government actions

We see increased risks of less-favorable regulation, taxation, and policies for the industry given the confluence of high prices, producers’ strong profits, energy affordability, and security, and imperatives to decarbonize.

3. Stronger financial standing allows strategic flexibility

With continuing strong cash generation and deleveraging, companies can do more to prepare for the uncertainties of the future. This can involve mergers and acquisitions but also making investments in the resilience of current and future assets and businesses.

The upward trend in oil prices from the lockdown lows of second quarter 2020 reflected recovering demand supported by some OPEC+ supply management. The Russia-Ukraine conflict turbocharged prices as supply concerns, especially for gas, came to the fore. Although the majority of Russian oil supply has continued to reach markets so far, and Chinese oil demand growth is likely to rebound, we can’t discount the possibility of a harsher or longer recession in major economies. Interest rate rises and the price increases may be more impactful for consumers and businesses than we assume in our base-case forecasts. Worse, an escalation or spread of the Russia-Ukraine war might sap confidence further. This would likely dampen oil consumption growth—which remained on a positive trend in 2022, with demand now close to 2019 levels. Further supply restraint from OPEC+ might not be achievable or sufficient to balance markets and support prices materially.

Governments and regulators have been increasingly active in oil and gas markets since 2020. The coordinated production cuts of 2020 have been replaced by demands for more supply and investment to meet the immediate consumption and affordability needs of society. Companies in Europe are facing higher tax payments, albeit on the back of much higher profits. Our key concern is that regulation and polices rapidly become more restrictive for fossil fuel companies. We recognize that globally coordinated taxation or bans are not likely in the next year, but note a confluence of adverse trends that might lead to more impactful measures for the industry in certain states. For example, energy companies are increasingly seen as contributing to climate change as consumers and voters bear the brunt of higher energy prices and other costs of living, while producers report exceptional profits. At the same time, consumer behavior is responding to both increasing concerns about climate change and policies that subsidize or promote low-carbon activities.

Stronger financial standing allows strategic flexibility. The 2023 likelihood is that hydrocarbon prices and refining margins are likely to continue supporting strong cash generation and
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potentially deleveraging for oil and gas companies. Notably, even given the opportunity, public companies have not increased capex dramatically; our estimated average 15%-20% increase in 2023 relates to some inflation, particular in North America, and short-payback activities rather than mega-projects, as well as prioritization of low-carbon investments for some European majors. Rather, excess cash flows have mostly gone to shareholders. These uses are likely to continue in 2023, potentially with less cash being directed to debt reduction, especially for companies with already low reported debt levels.

**We anticipate prudence continuing as companies heed investors’ calls for returns today, not production tomorrow.** Also, companies recognize the uncertainties and evolution of the energy transition are more likely to be a negative factor over time--contrary to 2022. Consequently, we see a focus on investments in low-cost and low-emission assets for both the next turn of the cycle and the future decades.

**Related Research**

- S&P Global Ratings Revises Its Oil And Gas Price Assumptions On Supply/Demand Fundamentals, Nov. 18, 2022
- S&P Global Ratings Lowers 2022 Canadian AECO Natural Gas Price Assumption Due To Pipeline Maintenance, Sept. 15, 2022
- U.S. Gas-Focused E&P Companies Continue Steady Production And Financial Discipline As Gas Prices Rise, July 28, 2022
Industry Forecasts: Oil and Gas

Chart 7
Revenue growth (local currency)

Chart 8
Capex Growth (USD, adjusted)

Chart 9
Debt / EBITDA (median, adjusted)

Chart 10
FFO / Debt (median, adjusted)

Source: S&P Global Ratings. f = Forecast.
Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.
Cash, Debt, And Returns: Oil and Gas

Chart 11
Cash flow and primary uses

- Capex
- Net Acquisitions
- Operating CF
- Dividends
- Share Buybacks

Chart 12
Return on capital employed

- Global Oil & Gas - Return On Capital (%)

Chart 13
Fixed- versus variable-rate exposure

- Variable Rate Debt (% of Identifiable Total)
- Fixed Rate Debt (% of Identifiable Total)

Chart 14
Long-term debt term structure

- LT Debt Due 1 Yr
- LT Debt Due 2 Yr
- LT Debt Due 3 Yr
- LT Debt Due 4 Yr
- LT Debt Due 5 Yr
- LT Debt Due 5+ Yr
- Val. Due In 1 Yr [RHS]

Chart 15
Cash and equivalents / Total assets

- Global Oil & Gas - Cash & Equivalents/Total Assets (%)

Chart 16
Total debt / Total assets

- Global Oil & Gas - Total Debt / Total Assets (%)

Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2022) figures use the last 12 months’ data.