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Energy Transition: Developing Markets Are Still Fueling Demand For Oil

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Editor's Note: This report is one in a five-part series providing insights on developments in the energy transition.

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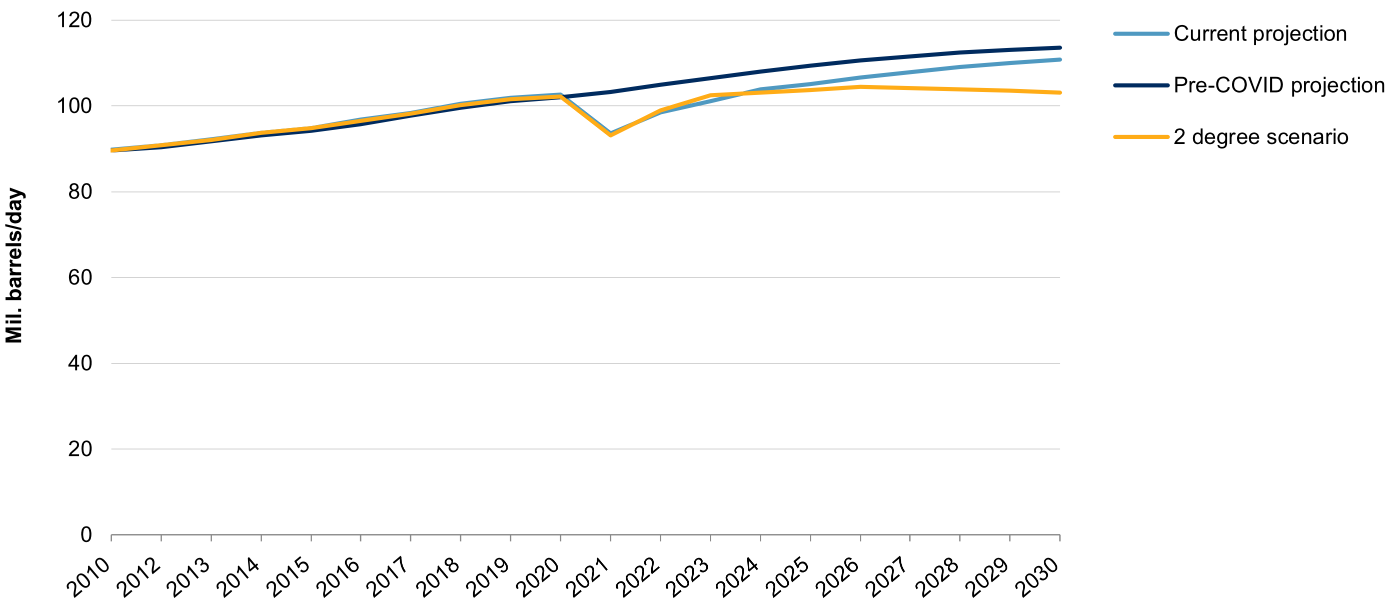
Key Takeaways

- We expect global oil demand growth to continue into the next decade, peaking at 112 million barrels per day (mbpd), up from 101 mbpd this year as developing markets keep expanding.
- In a scenario where the world is on track toward limiting global warming by 2 degrees, the likelihood of which we consider low, oil demand will still exceed 87 mbpd by 2040, corresponding to a decrease of 1.5% per year on average, according to S&P Global Commodity Insights (Platts)' forecasts.
- Should demand decrease more steeply, S&P Global Ratings believes credit risks for the oil sector will be partly mitigated by OPEC's ability to adjust supplies and by the typical annual 4%-5% natural decline of oil fields.
- We see the access and cost of funding as an important new credit risk for the sector, given investors' increased focus on climate change.

Global oil demand growth is set to continue this decade. It had already peaked in developed countries in 2019, before the pandemic, but further growth will now be fueled by developing countries. Oil demand is currently set to reach its highest level in 2037, at 112.5 million barrels per day (b/d), based on S&P Global Commodity Insights (Platts)' reference case (see chart 1), versus the 101 million b/d projected for this year.

Chart 1

Oil Demand To Rise Through The 2030s, Despite COVID-19 Impact



Source: S&P Global Commodity Insights (Platts)

That said, a host of factors could place the actual peak at any time between 2030 and 2040, since oil demand is projected to stay relatively flat after 2030. On the one hand, efficiency gains and electrification will continue to depress oil demand growth. However, a growing global middle class and related increase in transportation demand will outweigh these measures over the next decade or more. In addition, S&P Global Commodity Insights (Platts) believes the petrochemicals sector will likely remain a vector of growth on the back of steady demand for chemicals in many non-fuel applications.

Transitioning Away From Oil Will Take Time

Changes to consumer behavior and mobility prompted by COVID-19, as well as ongoing economic volatility, have resulted in the trajectory of demand growth being about 5 million b/d lower than the pre-pandemic projection in S&P Global Commodity Insights (Platts)' reference scenario. However, even considering this sizable decline, the current oil demand trend is far from consistent with limiting global warming to 2 degrees, let alone to 1.5 degrees or lower in line with the Paris Accord. Global oil demand needs to peak by 2025 for global emissions to be in line with S&P Global Commodity Insights (Platts)' 2 degree trajectory by 2050. Under this less likely pathway, oil consumption would still exceed 87 million b/d by 2040.

The impact of the energy transition will therefore likely be more gradual when it comes to oil, considering that oil underpins a major part of the global economy. Moreover, there are limited immediate alternatives to oil in some use cases, unlike for coal and gas, which renewables can replace in power generation for instance. Equally important is that transitioning existing capital stock and hydrocarbon infrastructure will take decades, particularly in developing countries given the costs involved.

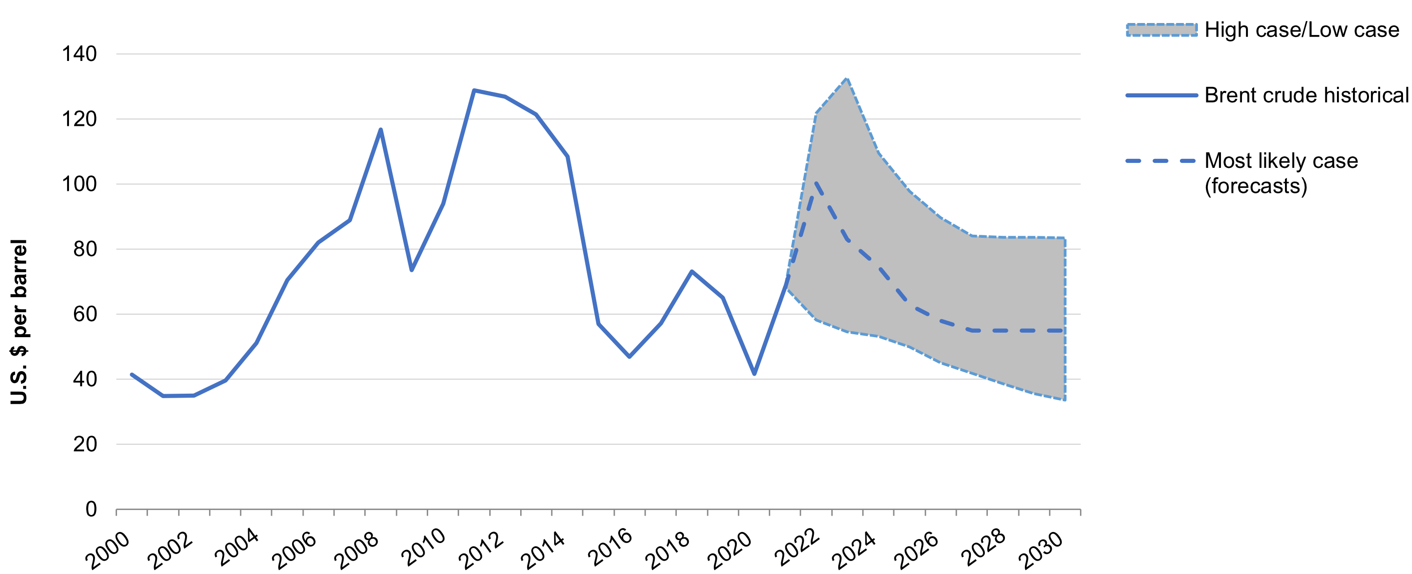
Long-Term Oil Prices Could Vary Widely Between $40 And $80 Per Barrel

Looking beyond current market tightness and the inevitable recalibration period, economic cost fundamentals indicate that the price of oil should settle near $55 per barrel (/bbl) in real terms according to S&P Global Commodity Insights (Platts) (see chart 2). However, should geopolitical tensions and disruptions to oil supplies last, such as the Russia-Ukraine conflict, long-term oil prices could certainly climb to average $80/bbl or more, at least temporarily.

Upward pressure on long-term oil prices could also be influenced by increased climate-related costs for producers, such as voluntary or compliance-related carbon costs, or requirements for higher returns on investments. On the other hand, the reduction of oil production costs and further policy efforts to push down oil demand could see oil prices fall to the low $50s or even to $40/bbl (in real terms) under a 2 degree scenario, with only supply at the lowest cost able to compete in a smaller oil market.

Chart 2

Crude Prices: Where Do They Go From Here?
Brent crude since 2000



Source: S&P Global Commodity Insights (Platts).

Investors Are Calling For Action On The Energy Transition

S&P Global Ratings observes additional pressure on oil companies from financial markets because of environmental considerations. As a highly capital-intensive industry, oil relies heavily on the capital markets for development, and we observe that the investment community is currently using its influence to push oil companies to reduce Scope 1 and 2 greenhouse gas emissions.

Rather than a sudden cut-off of investment or funding, we anticipate a gradual increase in standards and requirements from the investment community and shareholders. Some banks have even implemented policies that prevent them from supporting new oil developments, but sometimes this does not preclude refinancing debt relating to existing projects. Some sovereign wealth and pension funds, on the other hand, are divesting investments in the oil industry altogether, but this is so far not a widespread phenomenon. The current energy crisis has made it clear that striking a balance between security of oil supplies, price affordability, and decarbonization is a trilemma.

Oil Majors Are Adapting To Evolving Conditions

Factoring in the above heightened risks, S&P Global Ratings revised its credit view on industry risk for the oil sector in January 2021. Nevertheless, large, diversified oil and gas companies still have strong investment-grade credit ratings, reflecting their continued cash-flow strength over the next decade. Even if oil demand undergoes a climate-induced decline in the long term, cyclical oil supply-and-demand dynamics benefit from OPEC's ability to adjust supplies, as well as from inherent adjustments, in that existing oil fields face a natural decline of 4%-5% per year, which compares with a 1.5% per year average reduction in S&P Global Commodity Insights (Platts)' 2 degree scenario.

Oil and gas producers are also implementing operational changes to respond to the energy transition, and this is where companies in the U.S. and Europe tend to differ in their approach. Those in Europe are more likely to concentrate on renewables development, focusing on solar and wind. U.S. companies, on the other hand, are more likely to reduce their carbon footprint by using carbon capture, biofuels, and low-carbon oilfield services such as electricity-powered rigs.

This report does not constitute a rating action.