WHY THE WORLD IS STILL INVESTING IN OIL – AN EXPLAINER

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ON THE GREEN AGENDA

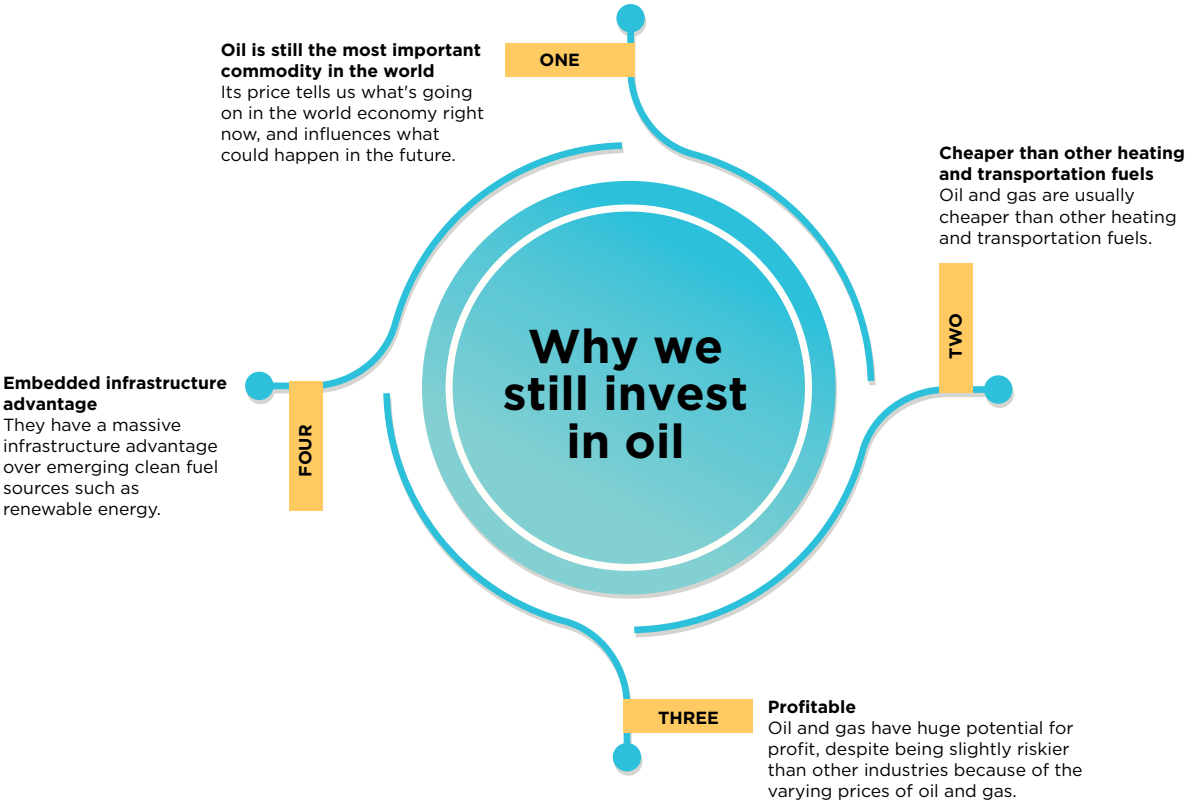
KEY TAKEAWAYS

Despite efforts to achieve net-zero, there is sustained investment in oil due to its importance as a commodity, its cost and infrastructure advantages, and its profitability.

However, oil-rich countries need to diversify to become resilient to the changes in energy markets, with development of renewable energy resources as part of the approach.

Through the Paris accord, the world has committed to keeping the global temperature rise to 1.5°C above pre-industrial era levels.

At the same time, a growing number of countries have committed to achieving carbon neutrality, or "net zero" emissions, within the next few decades, with most countries choosing net zero by 2050 as their goal. Reality, however, paints a different picture. Greenhouse gas emissions have continued to increase, with factors contributing to this including unsustainable energy use, land use and land-use change, and lifestyles and patterns of consumption and production.[1] Geopolitical issues and conflicts are now firmly entrenched as an integral part of the global transition, with energy security requirements taking precedence over the energy transition to low carbon fuels. What this means is that the world is still investing in oil.



[1]"Emissions of greenhouse gases have unequivocally caused global warming, with global surface temperature reaching 1.1°C above 1850-1900 in 2011-2020". IPCC, 2023: Summary for Policymakers. In: Climate Change 2023: Synthesis Report. Contribution of Working Groups I, II and III to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change [Core Writing Team, H. Lee and J. Romero (eds.)]. IPCC, Geneva, Switzerland.

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ONE REASON IS THAT OIL IS STILL THE MOST IMPORTANT COMMODITY IN THE WORLD, AS OIL REPRESENTS MORE THAN A COMMODITY PRICE WITH A SET ENERGY VALUE.

Additionally, oil is used in many industries such as transportation, manufacturing, and agriculture, and is also used to produce electricity and heat. The world is still investing in oil because it is still the most efficient and cost-effective way to power these industries. Additionally, for certain goods, there is, as yet, no competitive alternative to a product derived from oil or gas.

The price of oil also serves as a proxy for general economic conditions worldwide, with the oil price representing consensus opinion on geopolitical and economic reality. First, like other commodities, the price of oil is mainly driven by supply and demand issues. For many years, and even now - when most of the world is concerned about economic transition – the demand for oil, and changes in that demand for oil, are a good proxy for global economic activity. That price tells us what is happening in the economy, and future oil contracts indicate prevailing sentiment about the future. To cite an example, airlines and industrial companies use oil contracts to manage energy cost or to insure themselves against large swings in fixed costs, given the relative unpredictability of future oil prices. For economies, a low oil price can aid economic recovery, or forestall economic decline, given the high impact that oil purchases can have on the external account of small open economies.

IN BARBADOS, FUEL IMPORTS ALONE REPRESENT 17 PERCENT OF TOTAL IMPORT

For example, in Barbados, fuel imports alone represent 17 percent of total imports; for the members of the Eastern Caribbean Central Bank, petroleum products account for over 14.0% of ECCU's total imports and 92.0% of its electricity generation mix. For businesses that depend on fuel (airlines, etc.), a decline in the oil price can have the same effect as a global tax cut.

CHEAP OIL CAN HELP CONSUMING ECONOMIES BOUNCE BACK MORE QUICKLY FROM ECONOMIC SHOCKS AND HELP PREVENT A RECESSION FROM BECOMING A DEPRESSION.

IN ADDITION, ENVIRONMENTAL REALITIES MEAN THAT WHEN OIL IS CHEAP, THERE IS LESS ECONOMIC INCENTIVE TO LOOK FOR ALTERNATIVES.

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While there has been investment in renewable energy over the last decade, it is not yet enough to replace existing capacity.

On the other hand, for oil producers low oil prices are not always good news. Oil companies are some of the largest spenders in terms of operations; low oil prices can lead to a significant decline in energy sector activity and economic activity. The converse is true: high oil prices lead to greater activity and more growth, all things being equal. That is why oil companies and governments prefer relatively stable prices in the middle range, not below US $40 per barrel, not above $80 per barrel — not too cheap to threaten dividends, tax revenue and discourage greener alternatives, not too expensive to place a burden on the economy, or encourage a switch to alternatives.

ANOTHER REASON FOR STILL INVESTING IN OIL AND GAS IS THAT OIL AND NATURAL GAS ARE USUALLY CHEAPER OVERALL THAN OTHER HEATING AND TRANSPORTATION FUELS.

While new energy installations with renewables are cheaper than those with fossil fuels, the addition of storage reserves tends to negate that advantage.

While it is true that a long-term shift to renewables is desirable for Caribbean countries, these countries are nowhere close to achieving them. Despite the declines in the cost of renewable energy in the past few years and its projected competitiveness with fossil fuels, the transition is moving quite slowly. Moreover, the issues around battery infrastructure in the Caribbean remain unresolved.

While there has been investment in renewable energy over the last decade, it is nowhere near the amount needed to replace existing capacity. Operationally, absent significant grid level investment in expensive energy storage, renewables are yet to solve the “spinning reserve” issue, or the need for reserve power capacity for on-tap availability.

OIL AND GAS HAVE AN INFRASTRUCTURAL ADVANTAGE OVER EMERGING CLEAN FUEL SOURCES SUCH AS RENEWABLE ENERGY.

Renewables (solar, wind) do not have the embedded infrastructure advantage (pipelines, refineries, retail petroleum dealer networks) but must build renewable energy generation infrastructure and then be integrated into the electricity grid.

With massive renewable infrastructure investments being carried out in much of the developed world — such as the Investment Plan for Europe, Energy for the EU, the Inflation Reduction Act (IRA) and the Bipartisan Infrastructure Law (BIL) for the US — this advantage will gradually go away, but for now it persists in the short to medium term. However, the concern about climate change and the impact of burning fossil fuels on the environment has led to a shift towards renewable energy sources such as solar and wind power.

DESPITE THE REALITY THAT RENEWABLE FUELS ARE NOW MOSTLY PRICE COMPETITIVE WITH OIL, OIL IS STILL VERY PROFITABLE AND RETAINS THE ABILITY TO GENERATE SUBSTANTIAL PROFITS.

Oil and gas have a huge potential for profit, which is why they are a compelling choice for investment, despite being somewhat riskier than other investments. What attracts investors is the prospect of significant capital gains. As oil prices rise, oil companies generate cash, giving them more money to drill additional wells to increase their oil and gas production, repay debt, repurchase stock, and pay dividends. This creates significant shareholder value. Dividend payments in the sector tend to be higher than average because of the amount of cash that oil companies generate during good times. That

often makes the sector attractive to investors seeking high dividend yields, or investors wanting stable dividends – private pension funds, for example. BP and Shell between them contribute nearly a fifth of all dividend income generated by UK companies. Bad news on the profits front is a significant threat to secure retirement income for millions of people. The oil companies, via tax payments to governments, also pay taxes into public coffers.

THINKING AHEAD

While not here yet, the "end of oil" makes economic transformation imperative. There must be a clear pathway to mobilising the trillions needed to support countries and communities on the front line of the climate crisis and keep the critical 1.5°C goal in sight.

Oil-rich countries need to diversify to become resilient to the changes in energy markets. Countries and businesses reliant on oil and gas must execute the transition, including the development of renewable energy resources.

Oil-rich economies should commit to reforms that reduce obstacles to innovation and entrepreneurship, and reduce the potential for low productivity and wasted resources.

With stranded assets a new and very real risk, shifts in governance in oil-dependent economies are urgently needed. Governments, multinational development banks, and private finance must collaborate to scale up financial initiatives and technical assistance, improve investment conditions within countries, and build high-quality, bankable green projects. With transition, countries that were previously energy dependent may become self-sufficient in energy.

Countries with lots of sun and wind — as in the Caribbean — could not only be self-sufficient but could also export energy. Ultimately, there may be a peace dividend: if the world no longer needs so much oil, there would be less potential for conflicts. ■

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