

Arctic oil & gas: left out in the cold

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The Arctic produces 10% of global oil and 25% of global gas,[1] is an ecosystem uniquely vulnerable to the damage from drilling, and is disproportionately impacted by climate change.

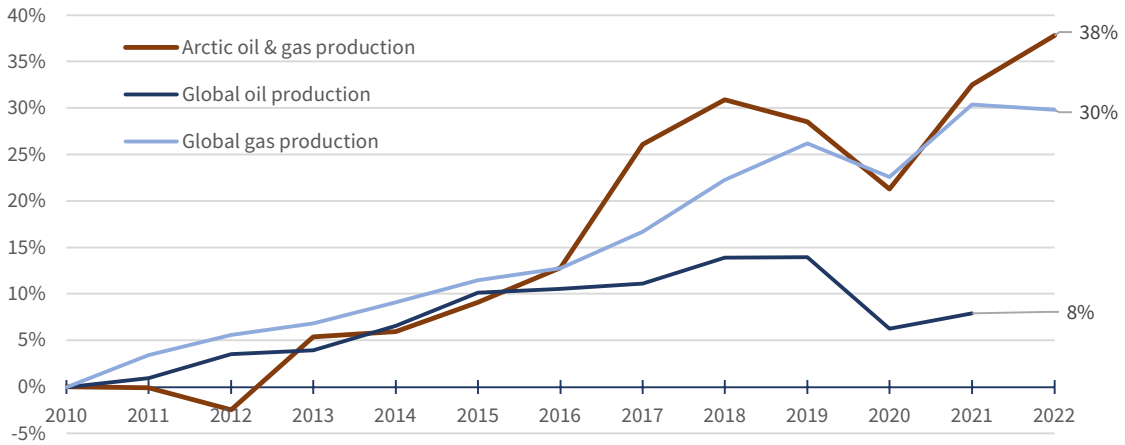
MSCI recently made changes to the exclusion criteria of a range of 'ESG screened' indexes,[2,3] barring investments in companies generating over 5% of their revenue from Arctic oil & gas from a family of equity indexes. Exclusions narrow the investor base, and so drive bond spreads wider. These exposures are therefore relevant for all investors who hold debt in the oil & gas sector.

This note analyses the exclusions and their possible impact. It considers the universe of potentially affected issuers and highlights the most relevant for fixed income investors – the significant producers in the region with plans for further development.

Norway's Equinor (ticker EQNR) currently generates 17% of its revenue from the Arctic, by producing 133.5 million barrels of oil equivalent (mmboe) in 2021. Norway is actively offering exploration licenses in the region,[4] and so production is expected to increase. **With nearly $4bn debt set to mature in the next two years, EQNR is a likely candidate for near-term new issuance.**

American multinational ConocoPhillips (ticker COP) generates 13% of its revenue from the Arctic, by producing 95.0 mmboe, and is expanding production via the recently approved "Willow Project".[5] **Due to recent bond issuance it may not raise new capital soon, unless needed directly in response to this Arctic expansion approval.**

Figure 1. Arctic oil & gas, global oil and gas production growth since 2010. Source: Statista, accessed 25 Apr 2023.



[1] "Oil and Gas", Arctic WWF, accessed 25 Apr 2023.
[2] "MSCI tightens metrics on BlackRock's $15bn ESG screened ETF range", ETF Stream, 15 Feb 2023.
[3] "MSCI ESG Screened Indexes", MSCI, accessed 25 Apr 2023.
[4] "Norway plans to offer record number of Arctic oil, gas exploration blocks", Reuters, 24 Jan 2023.
[5] "Outrage as US government advances $8bn Alaska oil drilling plan", The Guardian, 1 Feb 2023.

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Negative screening and cost of capital

This is a popular 'entry-level' sustainable investment strategy, where investments in specific sectors or areas are excluded. It benefits from being easy to explain and simple to implement. Historically it was the most popular sustainable investing strategy,[6] but was recently knocked into second place by the rise of 'ESG integration' strategies.[7]

Having one's debt on a negative screening list will reduce the universe of potential investors. Historic analysis on sectors that have been under negative exclusions for some time shows this reduction in demand does lead to a wider cost of capital for debt,[8] with less observable impact for equity investments.

Looking at oil & gas issuers, a sector with longstanding environmental concerns, it is disappointing to see little intra-sector differentiation based on environmental performance.[9] Although exclusions for other sectors, such as tobacco, are currently more common, the number of fossil fuel exclusions has been increasing.[10] It is observed that in general the whole sector faces wider spreads when controlling for credit fundamentals, which is attributed to increasing investor exclusions of the sector.[11]

At end 2020, the Global Sustainable Investment Alliance reported that $15trn of assets were invested with negative screening. Research on the broader sustainable investment universe has shown that 24%/29% of SFDR classified Article 8/Article 9 funds offer exposure to fixed income respectively, and so we estimate $3.6-4.3trn of fixed income investment is subject to negative screening strategies.

Arctic oil & gas production

From an environmental perspective, drilling in the Arctic is particularly damaging. It harms vulnerable ecosystems; the noise pollution from increased shipping and construction impacts marine mammals and fish, and spill response is slow with clean-up impossible.[1] Ironically, soot deposits (produced by oil & gas operations such as flaring) reduce the amount of solar radiation reflected by the frozen white surface, which diminishes the Arctic's ability to cool the planet.[12]

The costs of drilling in the Arctic are also impacted by the lack of infrastructure, as well as the difficulties operating in such treacherous conditions. This means the break-even price for the fossil fuels produced in the Arctic is higher, tightening profit margins.[13]

Oil & gas production in the region has increased 38% since 2010 (see Figure 1), now representing roughly 10% of oil and 25% of all gas production.[1] While some producers are reducing or avoiding

[6] "Global Sustainable Investment Review 2020", Global Sustainable Investment Alliance, 2021.
[7] ESG integration is the systematic inclusion of ESG factors into financial analysis.
[8] "Does ESG Negative Screening Work?", Eccles et al., SSRN, 30 Apr 2022.
[9] This was the subject of an earlier research piece, please see "Oil & Gas: Climate performance and the cost of capital", AFII, 6 Mar 2023.
[10] "Demystifying negative screens: The full implications of ESG exclusions", Schroders, December 2017.
[11] "SustainaWeekly - Does climate impact oil and gas company bond spreads?", ABN AMRO, 27 Mar 2023.
[12] "Drill, Baby, Drill", Reclaim Finance, 23 Sep 2021.
[13] "These Days, the Smart Money Is Staying Away From Arctic Drilling", Bloomberg, 24 Nov 2020.

having a presence in the Arctic,[14] some companies such as ConocoPhillips continue to make development in the area a core part of their strategy.[15]

Arctic oil & gas exclusions

MSCI's change to the exclusion criteria of a range of 'ESG screened' indexes has removed,[2,3] companies generating over 5% of their revenue from Arctic oil & gas from a family of equity indexes.

Arctic oil & gas exclusions are also becoming more frequent for large banks; Goldman Sachs announced an end to their lending in 2019,[16] and JPMorgan in 2020.[17] There are questions on how effective these announcements are at truly ending this activity, but they show the increasing interest and scrutiny of activity in the region.

Oil & gas production is funded by debt, and so translating these exclusions to the public fixed income market will allow them to have the desired impact.

Affected issuers

To determine the list of potentially affected issuers, the Global Oil & Gas Exit List (GOGEL)[18] was used. This database provides both the percentage of total revenue from fossil fuel-related business activities as well as the proportion of hydrocarbons produced from assets in the Arctic.[19]

Table 1 shows the issuers with estimated revenue from Arctic production greater than 5%, alongside their outstanding debt. The table is sorted according to 'hard currency' outstanding debt, defined as being issued in a G7 currency.[20]

[14] "Once eager to drill, oil companies exit leases in Arctic refuge", Washington Post, 2 Jun 2022.
[15] "ConocoPhillips CEO Doubles Down on Alaska Oil as Competitors Leave Arctic", The Wall Street Journal, 26 Mar 2023.
[16] "Goldman Sachs to stop financing new drilling for oil in the Arctic", The Guardian, 16 Dec 2019.
[17] "JPMorgan Chase will halt financing of Arctic oil, gas drilling, coat plants", Sierra Club, 25 Feb 2020.
[18] "Global Oil & Gas Exit List", Urgewald, 10 Nov 2022.
[19] It should be noted there is not a consistent definition of the Arctic. GOGEL uses the Arctic Monitoring & Assessment Programme (AMAP) whereas MSCI defines the Arctic as activities north of 66.5° latitude (roughly equivalent to the Arctic Circle) which is smaller than the AMAP area. Drill, Baby, Drill analyses a selection of alternative definitions of the Arctic and concluded that the Arctic Circle left out the fewest assets, 168 out of 599, which is still a reasonable number. All our identified issuers on this list have revenues well in excess of a 5% threshold, so we would expect them to be covered in the Arctic Circle definition.
[20] The initial universe included 30 companies with greater than 5% of hydrocarbons produced in the Arctic. Ten Russian entities were excluded due to ongoing sanction restrictions around investing (the largest being Novatek, Gazprom, Rosneft and Lukoil). Four companies (The Silk Road Fund Co Ltd, Petoro AS, Trafigura Group Pte Ltd, and INEOS Ltd) were excluded due to lack of data on fossil fuel share of revenue, but none have oil & gas production as their primary industry. Finally, three companies (PetroVietnam, PGNiG, and ONGC) were excluded due to insufficient information regarding their debt.

Table 1. Issuers affected by Arctic exclusion. Source: GOGEL, Bloomberg, accessed 24 Apr 2023.

Company Name	Bond Ticker	Country of incorporation	Estimated Arctic O&G share of revenue (2021)	Total Bonds Outstanding ($bn)	Total G7 currency denominated Bond Outstanding ($bn)
Equinor ASA	EQNR	Norway	17%	25.5	25.0
ConocoPhillips	COP	USA	13%	15.5	15.5
OMV AG	OMVAV	Austria	26%	10.9	10.9
Wintershall Dea AG	WNTRDE	Germany	55%	6.1	6.1
Aker BP ASA	AKERBP	Norway	15%	5.7	5.7
Hilcorp Energy Company	HILCRP	USA	27%	2.8	2.8
China National Petroleum Corporation (CNPC)	CNPCCH	China	16%	26.9	2.5
Vår Energi AS	VARNO	Norway	51%	2.5	2.5
Oil India Ltd	OINLIN	India	15%	1.6	1.6
Bharat Petroleum Corporation Ltd	BPCLIN	India	49%	2.0	1.1
Indian Oil Corporation Ltd	IOCLIN	India	28%	4.0	1.1
DNO ASA	DNONO	Norway	6%	2.5	2.0
OKEA ASA	OKEAAS	Norway	43%	0.5	0.5

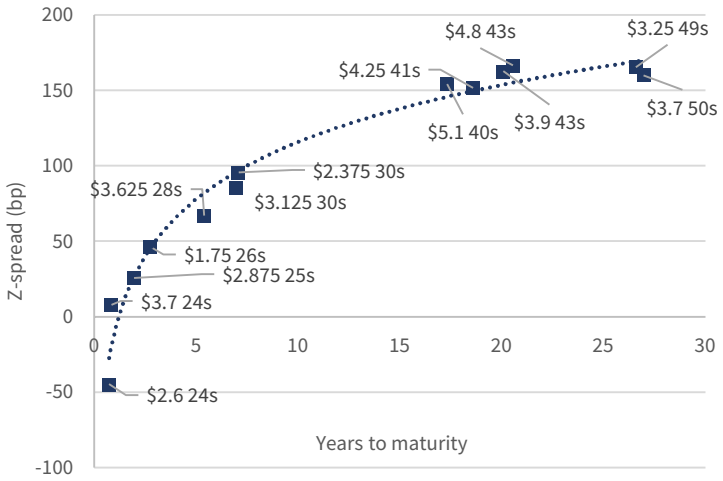
In total $104bn of debt is potentially in scope of such an exclusion, of which $48.5bn is denominated in USD, $24.8bn in EUR and $2bn in other G7 currencies.

These are the issuers whose debt would be expected to be in scope for exclusion, should exclusions for Arctic oil & gas producers become more widely adopted, and at risk of suffering associated credit spread widening.

Deep dive – Equinor

Norway has just moved into second place in terms of production volumes of Arctic oil & gas.[21] Norway's largest producer Equinor, is likely to keep increasing their Arctic production, given they are still exploring and making discoveries in the region.[22] Equinor is a regular issuer but has not come to the debt market for three years; it last issued in 2020 with $5.5bn and

Figure 2. Equinor USD bond spreads. Source: Bloomberg, accessed 24 Apr 2023.



[21] Russia is the clear leader with 91.64% production in 2022. From 2021 to 2022 Norway moved ahead of US to take second place with 4.19% production. Please see "The enduring threat to the Arctic from Big Oil", Energy Monitor, 21 Mar 2022.

[22] "Equinor make significant Arctic discovery", Arctic Today, 27 Mar 2022.

€1.75bn split across maturities. Current bond spreads for USD debt (rated AA-/Aa2) are shown in Figure 2.

Four bonds will mature within the next two years, with total amount $3.15bn and €0.65bn, which may present the need to tap the bond market. In the USD market, issuance is typically focused at 5/10/30 year maturities which leads to the observed gap in the bond curve between 8 and 18 years.

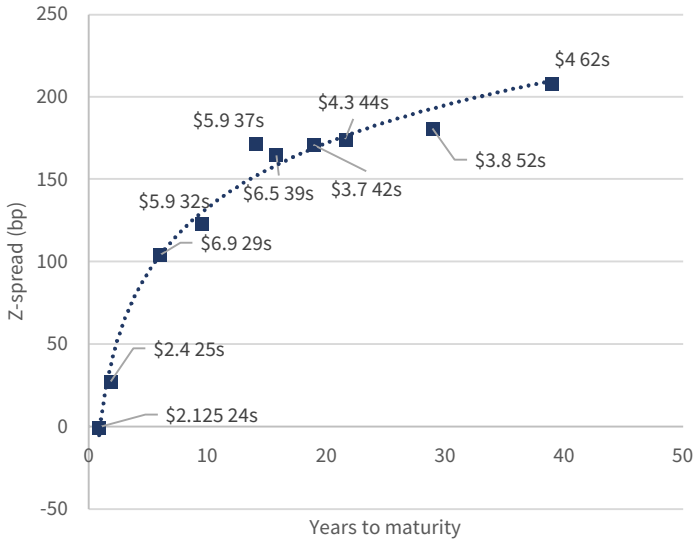
Aside from pricing risks associated with this potential exclusion, we note that Equinor's remuneration policy still directly incentivises the production of fossil fuels, with over 10% of variable pay linked directly to production growth.[23] This would suggest that executive pay is inconsistent with their own sustainability objectives, and transition risk for Equinor investors is high.

Deep dive – ConocoPhillips

US producer ConocoPhillips is Alaska's largest oil producer, and still actively investing in developing new sites. They are the owner of the Willow Project, approved by the Biden administration despite fierce opposition from environmentalists.[5]

The issuer (rated A-/A2/A) has its full capital structure in USD bonds, totalling $10.1bn outstanding. Current bond spreads are shown in Figure 33.

Figure 3. ConocoPhillips USD bond spreads. Source: Bloomberg, accessed 24 Apr 2023.



It brought two bond deals to market in 2022 totalling $5.4bn outstanding, and is unlikely to have new financing needs in the course of its regular business, although new production or acquisitions may need to be funded.

Deep dive – OMV

Austrian oil company OMV made one of the first discoveries of Arctic oil in Wisting Central, part of its reorientation of revenues away from unstable regions towards more secure western projects.[24] However, perhaps in response to environmental pressures, it has sold its stake in this field to Swedish company Lundin Energy in 2021.[25]

[23] Figure 4 in "Crude Intentions", Carbon Tracker, 4 Nov 2022.
[24] "OMV makes Arctic oil discovery", FT, 6 Sep 2013.
[25] "Lundin Energy buys OMV stake in Norway's Wisting oilfield", Upstream Energy Explored, 29 Oct 2021.

As OMV has no remaining Arctic assets, we would expect it to be removed from the potential exclusion list on 2022 data.

Conclusions

Production of oil & gas in the Arctic has an unparalleled impact on nature, over and above the implications for climate change of burning the hydrocarbons produced.

Excluding these producers via ESG negative screens is gaining momentum and is predicted to impact the prices for debt of the affected issuers. Investors in oil & gas debt should consider this potential negative price impact.

For hard currency debt investors, Equinor and ConocoPhillips could be most affected; they are significant producers in the region with plans for further development. Equinor is more likely to bring primary issuance soon due to its near-term debt maturities.

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