bp and ConocoPhillips: a bond spread curve ball

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The link between long-term financial performance and sustainable transition is nowhere clearer than in the business of hydrocarbon production. Oil demand is set to peak within the decade, and the pace of subsequent demand reduction dependent on how quickly announced government pledges are put into action.[1] There are direct financial risks to 'business-as-usual' oil production strategies, where losses due to stranded fossil-fuel assets are estimated to exceed $1trn.[2]

In previous work we have analysed relative sustainability[3] within the oil & gas sector, to see if it has been a driver of bond spreads.[4] The starkest conclusion was around the shape of bond curves, with little differentiation observed in long-dated bond spreads despite significantly varied future production intentions and climate alignment. We want to review this market pricing.

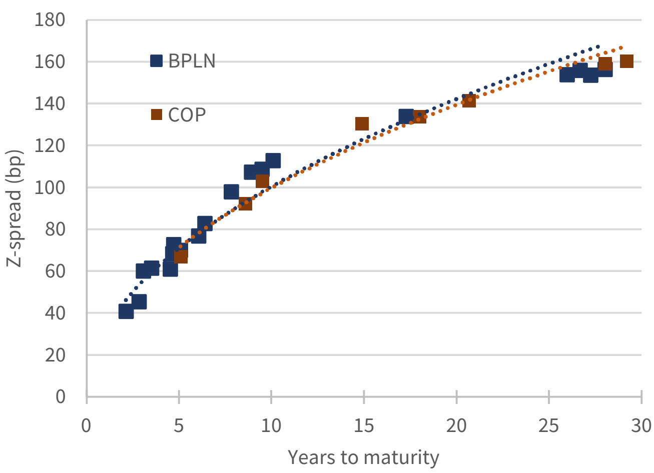
Recent analysis by Carbon Tracker, an NGO, has concluded that the oil & gas sector remains unaligned with the Paris Agreement, despite some more sustainable corporate messaging.[1]

However, within the sector, their analysis shows some differentiated performance, with bp (ticker BPLN) the only oil major with plans to reduce production before 2030 ranking highest in Carbon Tracker's alignment assessment and ConocoPhillips (ticker COP) with the largest planned increases at the bottom (the full ranking is shown in Figure 2).

Despite variations in their transition risk exposure, these two A- rated issuers have bond curves of near-identical steepness (see Figure 1). In other words,**the market appears still to be pricing the 10s30s forward credit risk of the two issuers at virtually indistinguishable levels.**

Due to the long duration of these securities, a single notch downgrade could have substantial negative price implications for investors, as the credit impact of poor transition planning is digested.

Figure 1. bp and ConocoPhillips USD bond spreads. Source: Bloomberg, accessed 21 Mar 2024.



[1] "Paris Maligned II: Climate alignment assessments reveal oil and gas company transition risk exposure", Carbon Tracker, 20 Mar 2024.
[2] "Stranded fossil-fuel assets translate into major losses for investors in advanced economies", Nature Climate Change", 26 May 2022.
[3] We used data such as implied temperature alignment and forward production intentions. We emphasise this was a relative analysis, and reiterate that no oil & gas producer has a credible transition strategy.
[4] For the full analysis please see "Oil & Gas: climate performance and the cost of capital", AFII, 6 Mar 2023.

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Transition risks for oil & gas producers

While there may be debate around the exact timing and speed of transition, the direction of travel is indisputable. The International Energy Agency, an NGO, predicts demand for all fossil fuels will peak before 2030,[5] however even this trajectory is far from sufficient to achieve global climate goals. The UN calculates that 2030 production intentions are 110% greater than those consistent with 1.5°C warming, and 69% more than 2°C.[6] If the 1.5°C Paris Agreement goal is to be met, oil production would need to drop 14% to 2030 or 69% to 2050.[6] This reduction in demand could drive prices as low as $10 a barrel in 2050.[7]

Relative alignment

Figure 2 shows the full ranking from Carbon Tracker's alignment assessment of oil & gas producers. Companies are graded from A-H. Even bp, the top-ranked firm, is not doing enough to align with the Paris Agreement, which is why it only gets a D grade.

Figure 2. Carbon Tracker alignment assessment for Oil & Gas producers. Source: Paris Maligned II by Carbon Tracker.

Company	Individual Unweighted Scores (all out of 4)					Overall Grade
	Investment Options	Recent Sanctions	Production Plans	Emissions Targets	Remuneration	
bp	2	2	3	2	1	D
Chesapeake	2	4*	3	0	1	E
Equinor	2	3	2	1	2	E
Repsol	2	2	2	2	1	E
Eni	2	2	1	3	1	E
Shell	2	2	2	1	1	E
TotalEnergies	2	2	1	2	1	E
Chevron	2	3	1	1	1	F
EQT	2	4*	1	0	2	F
Occidental	1	4*	1	1	3	F
Southwestern	2	4*	1	0	2	F
Coterra	2	4*	1	0	1	F
EOG	2	3	1	0	1	F
PetroChina	2	3	1	0	1	F
CNRL	2	2	1	0	1	F
Cenovus	1	4*	1	0	1	F
CNOOC	2	2	1	0	0	F
Devon	1	4*	1	0	1	F
Sinopec	2	2	1	0	0	F
Suncor	0	4*	1	1	2	F
ExxonMobil	1	2	1	0	1	G
Petrobras	1	3	1	0	0	G
Saudi Aramco	2	3	0	0	0	G
Pioneer	0	4*	1	0	1	G
ConocoPhillips	0	3	0	0	1	H
Weight	30%	10%	30%	20%	10%	-

When comparing bp (the top ranked) and ConocoPhillips (the bottom ranked), several key differences explain their relative performances, amplified by the weighting of certain criteria.

In terms of future production, bp predicts -13% by 2030 whereas ConocoPhillips targets +47% by 2029-2032.

In terms of emissions targets, ConocoPhillips commits to net zero across Scope 1 and 2 only by 2050, whereas bp has a 2030 absolute emissions reduction goal covering Scope 1, 2 and 3.

In terms of alignment of investment options, bp scores a 2, which means over 50% of its potential future upstream capex is not incompatible with 1.7°C warming, whereas ConocoPhillips's score of 0 means that less than 25% of its upstream capex is considered the same.

As Carbon Tracker concludes, the assessed oil majors have recently sanctioned projects and intended investments which fall outside the Stated Policies Scenario (STEPS), which itself falls short of announced government pledges. The longer-term financial risks of these projects are

[5] "World Energy Outlook 2023", IEA, Oct 2023.
[6] "Global fossil fuel production plans far exceed climate targets, UN says", Reuters, 8 Nov 2023.
[7] "Oil could plummet to $10 by 2050 if Paris climte goals are achieved, energy consultancy says", CNBC, 15 Apr 2021.

substantial, and the ranking above serves to estimate relative exposure to such business transition risk. It would be reasonable for this to be correlated with long term credit risk.

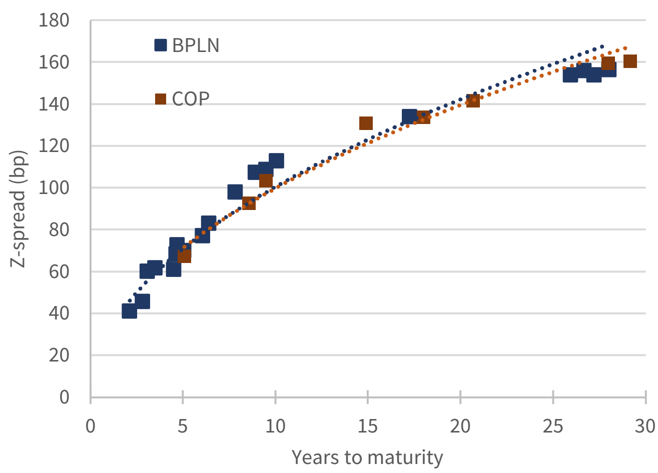
Market Pricing

The top and bottom issuers in Figure 2 provide an easy illustrative comparison. Both are A-rated oil majors with deep USD bond curves.[8]

The bonds in 5y/10y/20y and 30y appear priced virtually on top of each other, a similar conclusion to our earlier report from last year.[4]

We acknowledge that the technicals of the US bond market may be less supportive of sustainability-motivated flows,[9] which may explain the lack of differentiated pricing amongst shorter dated bonds. However, with demand adjustments set to kick-in within the decade, it would be reasonable for the relative degree of transition risk of these two issuers to translate into differentiation in the 20y and 30y credit spreads.

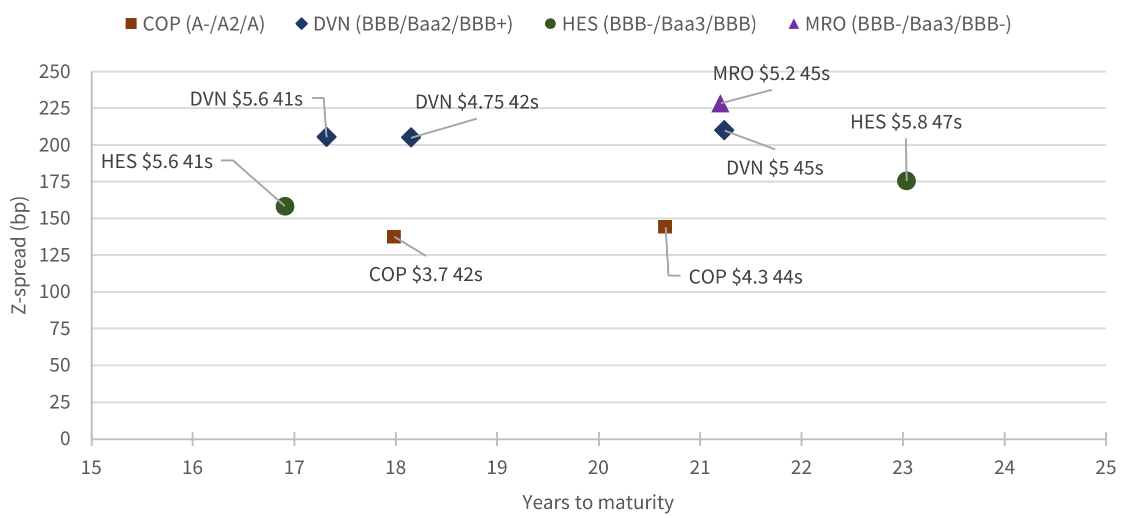
Figure 3. bp and ConocoPhillips USD bond spreads. Source: Bloomberg, accessed 21 Mar 2024.



Impact of downgrade

When considering what the potential pricing impact could be of ConocoPhillips' transition risk, we analyse the impact of a one-notch downgrade. Figure 4 shows bond spreads for securities around 20 years in maturity from BBB-rated oil producers Devon Energy Corp (ticker DVN), Hess Corp (ticker HES) and Marathon Oil Corp (ticker MRO).

Figure 4. Oil producer selected bond spreads. Source: Bloomberg, accessed 25 Mar 2024.



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[8] BPLN is A-/A2/A+ and COP is A-/A2/A, from Bloomberg accessed 25 Mar 2024.
[9] Overall US sustainable funds suffered outflows in 2023 as reported in "[US sustainable funds saw net outflows in 2023: Morningstar]", ESGDive, 6 Feb 2024.

These bonds trade with a premium of 30-70bps to COP's current levels. Applying this spread move to COP $4.3% 44s (with a duration of 11.35) suggests a downward price move of 3.4%-7.9%, which could potentially be greater for the longer maturity securities.

Conclusions

Hydrocarbon production is a business highly exposed to transition risk, and yet investments are still being made that are inconsistent with stated climate policies which will limit future demand. This has implications for the long-term credit risk of those issuers.

Our earlier analysis concluded that intra-sector relative climate alignment was not priced into bond spreads.[4] This seems still to be true for bp and ConocoPhillips, since the shape of their bond curves are near-identical despite materially different production intentions.

As these transition risks are increasingly considered by rating agencies,[10] due to the long duration of the bonds in question, price moves could be substantial in the event of a downgrade. It is also reported that fossil fuel producers will need to refinance significant sums in the near future,[11] which could provide impetus for some of these risks to be scrutinised by investors.

[10] "Credit rating agency evolution on climate change risk and fossil fuel financial viability", IEEFA, 14 Mar 2024.
[11] "A $3.2 Trillion Refinancing Wall Looms for High-Carbon Issuers", Bloomberg, 20 Mar 2024.

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