Diversion ahead
Middle East Energy and Resources
Managing scarcity for the future

Eighty five years
in the Middle East

Environmental issues are changing the energy and utilities industry as never before, and their influence can only increase

Despite the geopolitical upheavals of the past 50 years, the energy industry has never failed to meet energy demand around the globe, although prices at times of peak demand have been significant. In response to sustained fears over energy security during the past decade, consuming countries, some of whom are also producers, have devised strategies to lessen their dependence on imported energy. These strategies have included increasing the geographical diversification of energy sources, for example natural gas into the UK, as well as increasing exploration for and production of domestic sources, such as shale oil and gas in the US. As a result, energy security issues in the future may well dominate geopolitics to a lesser degree than in the past.

Currently, Brazil and Russia are amongst the world's largest energy producers, while India and China are large and increasing energy consumers, and their influence over global energy issues can only grow, by changing the dynamics of supply and demand away from more established producers and consumers, particularly as their own financial strength increases. Other, smaller emerging markets, such as a number of East African countries, are already starting to offer up natural resources to a world where 'easy' oil and gas is now less available. The overall effect of rising emerging markets on global energy issues should, in theory, be to stabilize energy supply and demand. However this assumes benevolent development of accompanying geopolitics which may be optimistic.

In the years ahead, key Western countries will struggle to address a number of competing energy policy objectives such as energy security versus renewable energy versus energy safety versus nuclear energy. Whilst energy demand in the West is not expected to increase as significantly as that of some emerging markets, per capita energy demand does need to be reduced and quickly, in order to reduce currently unacceptable levels of carbon emissions. A key Western policy challenge will be the extent to which this reduction can be achieved through government carrots and sticks, rather than by expecting market forces to accomplish this objective on their own. So far, neither governments nor their private sector counterparts have successfully promoted renewable energy, reduced demand, and diminished emissions on their own.

Environmental issues are changing the energy and utilities industry as never before, and their influence can only increase. The need to reduce demand, increase supply diversity, promote energy efficiency and reduce carbon emissions is both desirable and necessary. We will see a combination of various policy initiatives, mainly government-led, which are designed to achieve these objectives, rather than a single focus on renewable energy and green projects. If anything, governments are adapting more quickly to this new and necessary landscape than companies, forced as they are to respond to the aspirational demands of youthful populations concerned about the type of world they will inherit. By contrast, although a number of companies may already have the technical expertise to lead the charge on environmental issues, their business case is not yet compelling enough for them to do so.

In terms of promoting energy efficiency, there is likely to be an increasing focus in three specific areas: policy initiatives aimed at making consumers pay more towards the real cost of energy; major capital expenditure to create or modify buildings and facilities that are more energy-efficient; and minor capital expenditure aimed at consumers to improve measurement of energy usage, in turn enabling policy initiatives to be tuned more finely.

Government imperatives to increase energy security by promoting domestic energy production have resulted in shale gas, coal, and nuclear energy, although quite different, all recently rediscovering their prominence. However, they have also come under severe scrutiny from environmental groups concerned about the unfettered development of these rediscovered energy supply sources. The key to their future development will be the extent to which the energy industry, which has done a poor job so far, will satisfy environmental concerns. Will the cost of satisfying these concerns render these sources ultimately uneconomical?

The challenges facing energy and utility executives are wide-ranging, depending on whether their main focus is in oil, gas, power, or water, and whether they are at the helm of vertically integrated or unbundled organizations. For the CEOs of vertically integrated oil and gas companies for example, a key challenge will be to drive a strategy down through their organizations which increases profitability, in privately owned enterprises, and efficiency, in government owned enterprises, against a background of shortage in natural resources, be they human or geological. These desired increases must also be achieved whilst addressing a serious, growing agenda of corporate and social responsibility.

The financial well-being of energy and utilities companies, in terms of their balance sheets, cash flow and access to capital, has traditionally been healthy. For the time being, the lessons of Enron from 2002, which demonstrated the dangers of excessive financial leverage, have been learned. However the Enron saga also evidenced the increasing convergence of financial institutions engaged in energy and utilities activities, with energy and utilities companies adopting sophisticated financial instruments. This increasing convergence will make it more difficult to judge the financial health of the industry in the future.

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There have been some notable demergers, divestitures, and unbundling of energy and utilities companies, many with the objective of increasing shareholder value, and these are set to continue. For example, the demerger of ConocoPhillips' upstream and downstream operations bravely acknowledged privately-held beliefs of many senior executives in the industry that some of the largest energy companies had grown too big to manage fundamentally different operations – exploration versus refining – within a single vertically integrated structure. The move was greeted enthusiastically by the market, and similar demergers, divestitures, and unbundling are likely to increase as the quest for sustainable increases in profits and dividends intensifies against the background of energy sources that are more challenging to exploit.

This trend of demergers will continue in the next 12 months but we will also equally see consolidations. The key driver behind both of these trends will be diversification, both geographically and technologically, to spread portfolio risk as well as securing customers, resources, and markets. We live in an uncertain world, and energy and utilities companies are more accustomed than most industries to managing uncertainty.

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