

Supermajors, dividends and the energy transition

May 8, 2020

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I am sitting in my garden at home on a sunny afternoon with a glass of white wine – and yes I had booked this day off as leave. I check my phone and see that all hell is breaking out on the news feeds. No, it's not that we have passed the milestone of 200,000 COVID-19 deaths globally or that WTI has gone negative for the first time in history. There is another huge story (connected to these) that is taking off.

"A pillar of the UK stock market has tumbled" wrote Nils Pratley the Financial Editor of the Guardian. Sarah McFarlane in the Wall Street Journal referred to a "fundamental bargain" between oil majors and their investors having been "upended".

So what was the story? Shell had cut its dividend. Really ??? With a lot of the world in lockdown and the whole world in economic crisis one might be forgiven for having thought that a cut in dividends by any oil and gas company would be not unexpected. But this was Shell. I started trying better to understand the shock and horror.

This was "the first time Shell has cut its dividend since the Second World War" I kept reading. 1944 to be precise which is 76 years ago. Well OK, but this is the biggest crisis in the oil markets in history so still why such shock?

It was a big cut. Shell's shares fell 7% on the announcement. It was enough to relegate it from the number 1 spot in the FTSE (overtaken by AstraZeneca whose stock is riding high following its tie up with Oxford University to develop and produce a COVID 19 vaccine). It was a cut of two-thirds, from 47 cents to 16 cents. One commentator commented "a two-thirds cut in its dividend is not surgical precision, it's an amputation" Another commented that Shell's generous dividend is considered "sacred" in the City of London. Shell's own CEO described the decision as "monumental".

But still neither of those facts seemed quite to answer for me why this had rocked the business establishment in the way it had.

Then I looked to the significance of the Shell dividend. Shell's dividend (at £11.6bn in 2019) was the largest dividend of any company in the world excluding Saudi Aramco. Between them, Shell

and BP are reported to pay almost one-quarter of all FTSE 100 dividends. It is estimated that Shell is a top ten holding in two thirds of funds in the UK equity income sector.

In a business climate with already few places for asset managers and other investors to find yield this has left a gap that income seeking funds will struggle to replace.

So why did Shell do it and what might it mean for Shell and others?

Shell's CEO commented "This is a big move and something that is difficult and hard to do but also very necessary. We want to preserve the financial resilience of the company even though we have no idea what might happen".

Shell was the first of the supermajors to make the move, though Equinor cut its dividend by a similar percentage a week earlier. However the other European supermajors BP and Total decided not to cut their dividend and ExxonMobil and Chevron, the US's two biggest energy producers, indicated that they will not cut their dividend but instead focus on cutting capital spending.

Some commentators have observed that maintaining the dividend is a bit of an albatross for these companies. One commented "Both Shell and BP have been slowly digesting themselves to keep the dividend ticking over". Removing that pressure allows companies to focus on the future and opportunities. Maintaining dividend levels as a policy reduces flexibility to respond to commodity cycles and preserve balance sheet in times of economic stress. Those companies with more of a cash war chest are also better placed to take advantage of M&A opportunities that present themselves and it is widely expected that there will be consolidation in the sector. Also of importance is that fact that those energy companies whose balance sheets are less stressed have more funds to invest in the energy transition and long pay-back renewable assets. However at a time when oil and gas companies have already fallen out of favour in the capital markets due to their role in climate change, upending the "fundamental bargain" with investors (as the Wall Street Journal put it) must have been a very difficult decision. It was reported that it took Shell four board meetings and countless side meetings to reach the decision.

There is of course a wider debate playing out on the subject of how the 2020 oil price crash will impact the energy transition. While the cost and efficiency of renewable sources of energy is continuously improving it has been widely argued that the oil price crash will make renewables less economic compared to (now cheaper) fossil fuels and so slow the transition. Equally the opposite has been postulated; that investors going forward will shy away from the volatility of the oil and gas sector and look to the lower but more stable returns of renewable projects.

Whichever view you hold one thing is clear and that is that the energy markets are going through a period of seismic change. With seismic change it should be unsurprising to see some pillars tumble or have to be repositioned.