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Energy: Oil & Gas 2022

Introduction

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INTRODUCTION

Contributed by: John B. Connally, Vinson & Elkins LLP

Global Overview

Driven by supply and demand, global energy markets have always been susceptible to broader economic trends and political developments impacting supply and demand. So far, 2022 has been an extraordinary year in terms of these broader trends and developments, particularly Russia's invasion of Ukraine beginning on 24 February 2022.

Trends

Longer-term trends

A number of significant trends, years in the making, continue to influence the energy space. In addition to having operational and demand ramifications, they impact access to capital and thus levels of investment in an industry requiring high levels of capital deployment simply to maintain existing production levels.

Social and government pressures

Concerns regarding the potential climate effects of conventional sources of energy have become more embedded and widespread. As evidence mounts of a warming global climate, there is an increasingly negative focus on hydrocarbons. This is the background for a tightening regulatory framework and investment climate.

Energy player consolidation

In part as a result of pressure from the investing public and interest groups, the number of investors and financing sources in the traditional energy space continues to consolidate. This has also been true on the public company side. This consolidation has meant fewer sources of capital for new investment.

Accelerating investment in energy transition

Although the capital deployment required in order to meaningfully impact aggregate hydro-

carbon consumption is enormous, significant capital deployment into energy transition is underway, both on the generation side and in terms of carbon capture, utilisation and storage (CCUS) technology.

Shorter-term trends

During 2022 we have seen a number of developments, some of which have driven supply and demand, resulting in rising energy commodity prices through the first part of the year.

Post-pandemic economic resurgence

Although COVID-19 is still with us, the end of the most acute phase of the pandemic in terms of widespread lockdowns has brought a vigorous resurgence in economic activity. This has resulted in corresponding increases in aggregate global demand for hydrocarbons, although global demand is not expected to reach pre-pandemic levels until later in 2022 or 2023, depending on the forecast.

Cautious production expansion

Out of Middle East national oil companies (NOCs), European majors, Russian companies, Chinese NOCs, other NOCs, US majors and independents, the International Energy Agency estimates that only the Middle East NOCs are planning to invest more in traditional oil and gas in 2022 than they did in 2019. With a wasting asset, relative changes in investment levels have significant effects on supply. The capital discipline imposed by market forces on US public producers and the corresponding slower increases in production levels exemplify this phenomenon.

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Relatively conservative OPEC production increases

Before the invasion of Ukraine, OPEC was implementing a series of planned relatively modest production increases. As the world was gripped by the effects of the invasion of Ukraine and inflationary pressures, OPEC+ at its 2 June 2022 meeting brought forward increases to offset Russian losses, but actual OPEC+ production continues to undershoot its production increases as of mid-year.

Inflation pressures

On the back of massive pandemic fiscal stimulus, continuing global supply chain challenges and the post-pandemic economic resurgence, inflation is raging around the world. Central banks have begun to respond. According to the *Financial Times*, “[p]olicymakers around the world have announced more than 60 increases in current key interest rates in the past three months [preceding 29 May 2022]... the largest number since at least the start of 2000.”

The Invasion of Ukraine

Triggering a tragic and continuing humanitarian crisis, Russia’s invasion of Ukraine has also had significant geopolitical and energy industry implications, the contours of which continue to develop. These comments focus on the energy industry implications.

Investment realignment

The departure of Western investors and companies from the Russian energy sector has been swift and comprehensive. As the world’s second-largest oil producer prior to the invasion of Ukraine, Russia was the recipient of significant investments by a number of Western firms. The loss of this capital and know-how has had a negative impact on the Russian energy sector and has freed up some capital investment for projects in other countries.

The extent to which the gap in Russia will be filled by others, such as Chinese NOCs, remains to be seen.

Energy source realignment Consumption

With sanctions (and the desire for more sanctions) and threats of supply disruptions, those countries depending on Russian oil and gas are desperately searching for alternative sources and potential energy-saving measures. The situation starkly demonstrates the dangers of such reliance. The implications of this could be far-reaching as Europe moves to increase LNG imports from the United States and Africa, for example.

Sources

In a remarkable testament to the issues presented by the invasion of Ukraine and the resulting increases in commodity prices, there has been talk that more markets will end up being open to Venezuelan and Iranian crude oil. If this comes to pass, it could be significant over time, although the upstream industries in both countries have been starved for capital for years and require major investment.

Shifts in public opinion

The supply disruptions precipitated by the war in Ukraine have resulted in a greater appreciation of the significance of traditional sources of energy and our reliance on them. In the shorter term, efforts have centred around bolstering and diversifying sources of conventional energy, as well as some enhanced efficiency measures in more acutely impacted jurisdictions. This reflects an acknowledgement of the superior scalability and infrastructure compatibilities of oil and gas as compared to renewables, given current technologies and infrastructure build-out.

In the longer term, geopolitical concerns may be added to the list of reasons articulated to accelerate energy transition.

Regulatory adjustments

As policy makers face supply disruptions and high gas prices, we have seen efforts to encourage greater oil and gas production. For governments that traditionally have not been allies of the conventional energy industry, it will be interesting to see if this results in any meaningful regulatory relaxation.

Fascinating, of course, is the European Parliament's recent approval of a proposal to define natural gas as environmentally sustainable energy. Potentially, this will help facilitate the supply realignment arising out of the Ukraine crisis.

Supply/pricing impacts

Sanctions have reordered, to a certain extent, the global energy markets. In the absence of serious consequences for certain Western economies of more comprehensive sanctions, it is likely more sanctions from Western countries would be put in place. There is also the threat of further supply disruptions imposed unilaterally by Russia.

Although there are other potential markets for some Russian oil and gas production, the effect of the uncertainty of Russian supply on energy prices has been jarring on markets in a context where aggregate global demand is increasing.

Inflation

The effects of the war in Ukraine on a number of commodities, including hydrocarbons, have resulted in price increases that are stoking already hot inflation.

Recession fears

Further significant moves by central banks with respect to interest rates are anticipated as high levels of inflation continue. The question, of course, is whether these moves will push (or in some cases, are pushing) economies into recession.

As production levels continue to recover post-pandemic, drops in demand arising out of economic contraction could be a significant negative factor for oil and gas pricing.

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professionals in key industries driving the global economy forward. The firm's market-leading approach comes from its experience – experience gained from representing entrepreneurial innovators in important deals and disputes for over 100 years. V&E's commitment to excellence, coupled with its commercial approach to solving problems, allows it to work successfully with clients to achieve outstanding results.

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John B. Connally is the head of Vinson & Elkins' energy transactions and projects group. Considered one of the country's pre-eminent oil and gas transactional lawyers, John B. represents a wide range of clients, including public companies, private enterprises and private equity firms, in domestic and international upstream and midstream M&A, joint ventures and development transactions.

Over the course of more than two decades, he has developed strong relationships with his clients that regularly lead to repeat engagements. John B.'s oil and gas transactional practice has been recognised by leading legal directories. He is a member of the Association of International Energy Negotiators (AIEN). He also serves on the advisory council of the Kay Bailey Hutchison Center for Energy, Law & Business at the University of Texas.

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