# Fortune smiles on oil majors as crude prices recover

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**Higher crude prices are transforming the** fortunes of international oil companies. Instead of focusing on cost reductions and reining in capital investment, the industry's latest puzzle could be figuring out just what to do with all the cash it's collectively expected to generate. Big oil has three obvious options: they can keep shareholders happy by returning more money to investors with buybacks and cash dividends instead of scrip; they can throw caution to the wind along with their balance sheet discipline by sanctioning the risky acquisition of rivals; or they can invest in capacity by signing off on new upstream projects. Despite lingering concerns over the sustainability of recovering prices, the third course of action could be the best option for both energy markets and shareholders in the long term.

Take BP for example. Europe's second-largest producer is emerging from the financial shock caused by its Gulf of Mexico oil disaster in 2010. Fourth-quarter earnings released this week more than quadrupled year on year, boosted by a mixture of recovering oil prices and rising production. Despite a dip in the quarter, BP's operating cash flows excluding the payments it still makes for the Macondo spill were up almost 37 per cent last year to $24.1 billion.

Investors probably care about this number more than any other because it shows an oil company's ability to fund its investments and dividends without having to load up on extra debt. After four years of tightening their belts to be profitable with prices even below $50 per barrel, the world's publicly traded majors such as BP are now in a position to leave the downturn behind.

With oil now trading just below $70 per barrel, BP like many of its rivals once again has options. If these levels are sustained through to 2019 the company can afford to maintain capital expenditure of up to $17bn and still generate enough money to pay cash dividends, which shareholders crave.

Chief executive Bob Dudley was coy when last week when pressed by analysts about what the company plans to do with the increased free-cash flow it will be generating by the beginning of the next decade. For the time being the message from the industry is to maintain balance sheet discipline and reduce debt. But eventually shareholders will demand to see more growth to support long-term returns.

"2018 should be a year where operating cash flow can cover cash capex, full cash dividend and Macondo payments without disposal proceeds," Rohan Murphy, an energy analyst at Allianz Global Investors, told Bloomberg.

Gearing up to buy a smaller rival would be risky, especially when the company is already carrying almost $38bn of net debt on its balance sheet. BP has also spent the past eight years batting away speculation that it could be a target for either a buyout or a break-up. Ploughing more of its cash back into new large-scale projects, which can generate higher returns for investors, may make more sense.

And there is evidence this process has already begun. S&P Global Platts reported last month that more delayed upstream oil and gas were approved last year. According to Rystad Energy, final investment decisions were taken on 18 major initiatives last year, double the figure for 2016. The trend is set to continue in 2018. Bain & Company is forecasting an increase of up to 20 per cent in capital expenditure by oil majors.

Despite growing concern over the potential for peak demand, there is evidence to suggest more capacity will be required soon. S&P Global Platts Analytics forecasts that oil production will have to continue increasing to meet rising demand for the next two decades. Global demand is expected to exceed 100 million barrels per day this year, according to S&P Global Platts' estimates.

Of course, big oil could use its spare cash to consolidate. Large-scale mergers and acquisitions in the sector have been limited since Shell pulled off its $52bn raid to buy natural-gas focused BG Group. Since then few deals have emerged in a sector dominated by the offshoots of the "Seven Sisters". However, with the outlook for oil prices remaining uncertain since the rise of US shale, few chief executives among the majors have been willing to consider the idea of buying their rivals.

For the Middle East, an increase in spending by IOCs [international oil companies] could be a double-edged sword. The region's major state-owned producers are currently limiting their output as part of Opec's deal with non-member countries including Russia to reduce production by 1.8 million bpd. IOCs sanctioning a new swathe of projects could test the strength of their pact at a delicate time.

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