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Oil and gas: The case for higher returns

> "The longer you can look back, the farther you can look forward."
>
> Winston Churchill

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Consider a hypothetical USD 300 million investment in 2004, diversified equally across three assets: a major integrated oil and gas company, a consumer staples firm and a popular, well-loved technology brand specializing in portable digital music players and computing devices.

By 2024, the initial USD 100 million allocated to the integrated oil and gas company would have appreciated to USD 474 million. The consumer staples investment would have returned slightly under USD 513 million. But the tech investment? It exploded to a staggering USD 59 billion.[1]

This illustrative example underscores a crucial point about long-term investing: energy companies, despite their foundational role in facilitating the growth of other sectors, have delivered only modest returns. On average, returns on invested capital over 30 years were only 10%. While these returns may seem respectable in absolute terms, they pale in comparison to tech and are even lower than the stoic consumer staples sector. From an investor's standpoint, these returns are consistent with a commodity industry lacking a sustained competitive advantage.

Furthermore, these historical returns were achieved during an era characterized by significant increases in energy commodity prices, near-monopolistic dominance of oil and gas within the global energy system, and a stable investment climate.

The operating paradigm for the sector, however, has shifted significantly since 2004. The sector now faces structural risks, including competition from alternative energy technologies, heightened policy volatility and amplified litigation risk. While oil and gas retains a dominant position, it operates within a more heterogenous energy system undergoing rapid electrification and diversification. Oil and gas prices may not enjoy the wild upside volatility of previous eras as the energy transition may constrain or even exert a downward effect on prices. Finally, unlike the previous three decades, the industry faces higher political risk and a less stable climate for international investments.

We argue that the historical returns of the oil and gas industry are insufficient to compensate investors for the higher risks now associated with the industry. To adequately compensate investors, we believe that oil and gas companies must aim higher and allocate capital only to projects that can deliver returns significantly above historical averages to accommodate for higher risks. Without this stringent capital discipline, our view is that the industry faces value destruction in an era of heightened political and technological risks, where assets could be stranded by regulation, returns taxed away or projects abandoned due to technological changes.

1 We assume a USD 100 million investment on 2 January 2004, with full dividend reinvestment and complete divestment on 29 December 2023. Reference to returns is in the context of total shareholder returns.

A view from the past

A commodity market with limited pricing power and a poor history of capital allocation

The oil and gas industry operates within a classic commodity market structure, characterized by limited pricing power and ease of entry and exit. This is reflected in the sector's historical return on invested capital (ROIC), which has averaged **around 10% over the past 30 years**. While these returns might seem respectable in absolute terms, it falls short of returns generated by the technology sector and is even lower than prosaic consumer products companies.

The industry's fragmentation further limits pricing power. ExxonMobil, the largest publicly listed oil and gas company, holds less than 5 percent of global market share. Given the cyclical nature of oil and gas prices and the geopolitical risks, the modest historical returns of 7%-10% have barely compensated investors for the volatility they have endured. More important, even this 10% return was the result of unique and unlikely-to-be-repeated circumstances.

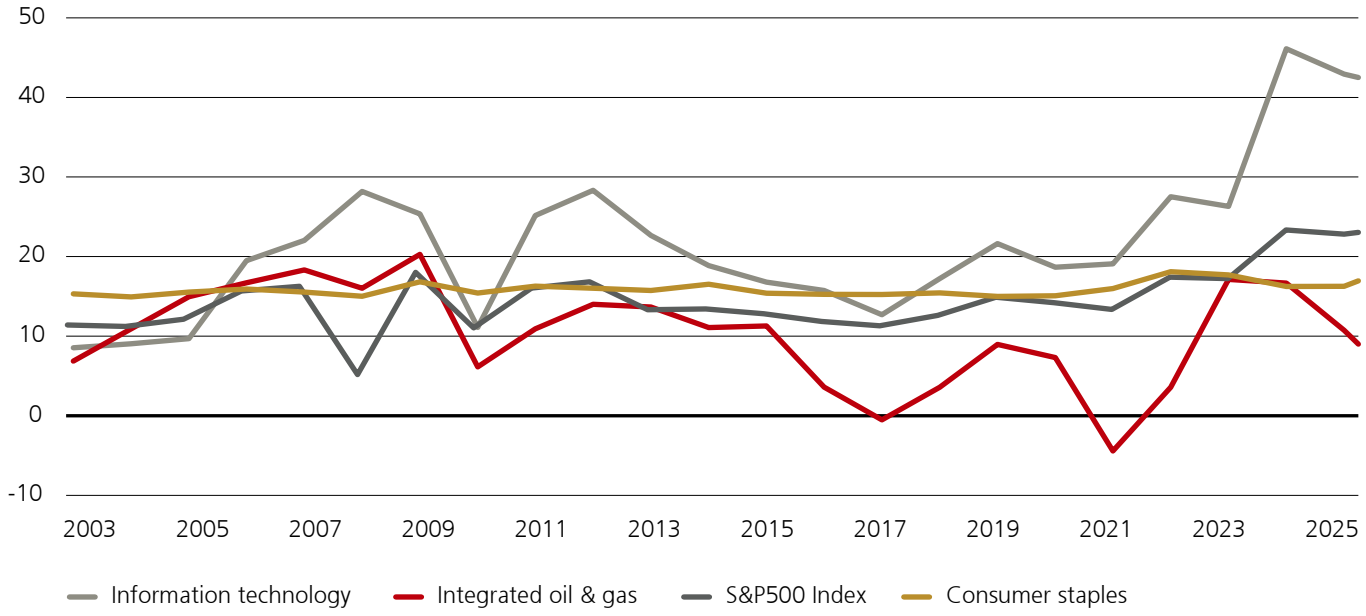
Table 1: Energy returns (%) have been historically poor in comparison to alternative industries (ROIC[2])

	US integrated oil & gas sector	S&P 500 Index	US technology sector	US consumer staples sector
5 yr avg	8.5	18.9	32.3	17.0
10 yr avg	6.7	15.9	24.7	15.9
20 yr avg	10.3	14.9	23.2	16.0
30 yr avg	10.2	14.4	21.0	15.6

Source: Data provided by Bloomberg, collated by UBS Asset Management, as of April 2025.

Figure 1: Suppressed ROIC[2] in US integrated oil and gas vs other sectors.

Annual return on invested capital (%), 2003 - April 2025

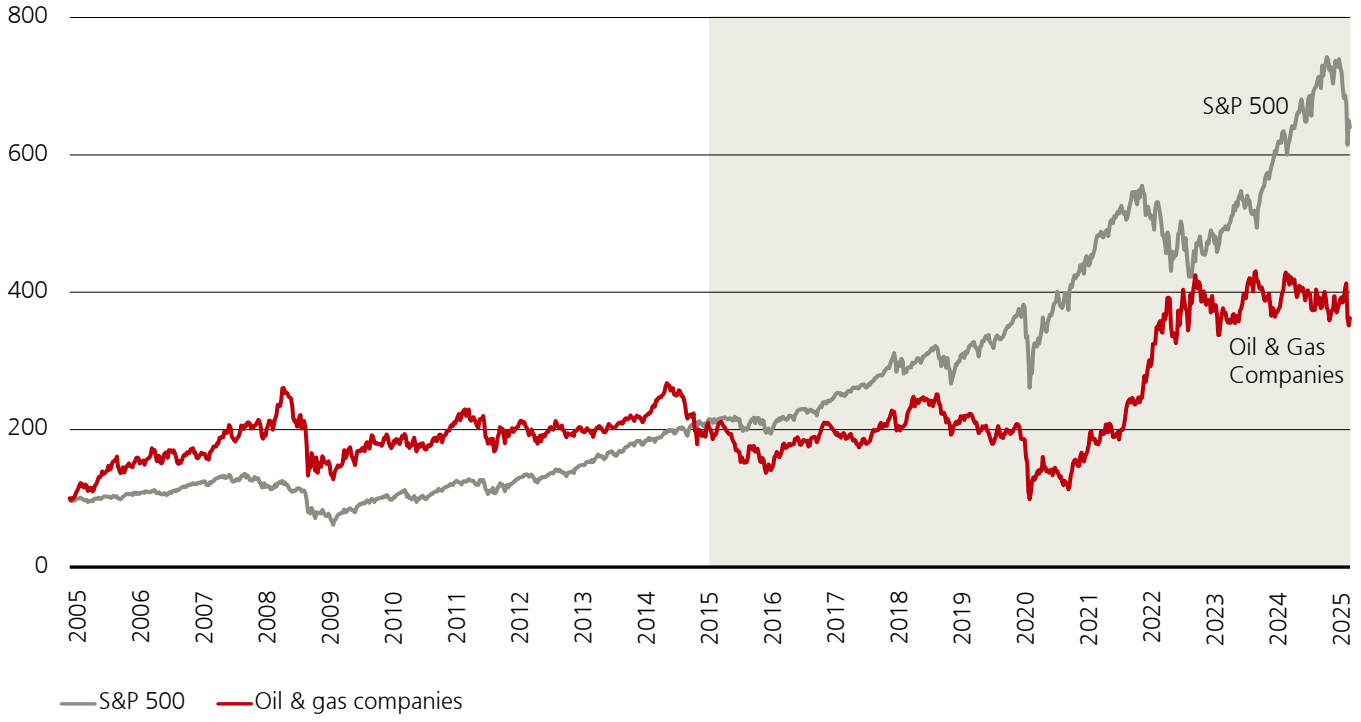


2 Return on Invested Capital (ROIC), is a measure of value creation. Theoretically, a 2x ratio would mean the net operating profit after tax of a company is twice as large as the average invested capital. Sector-level data is sourced from MSCI US Sector Indices.

Source: Data provided by Bloomberg, collated by UBS Asset Management.

Figure 2: The oil and gas industry has underperformed against the S&P 500 over the past 20 years.

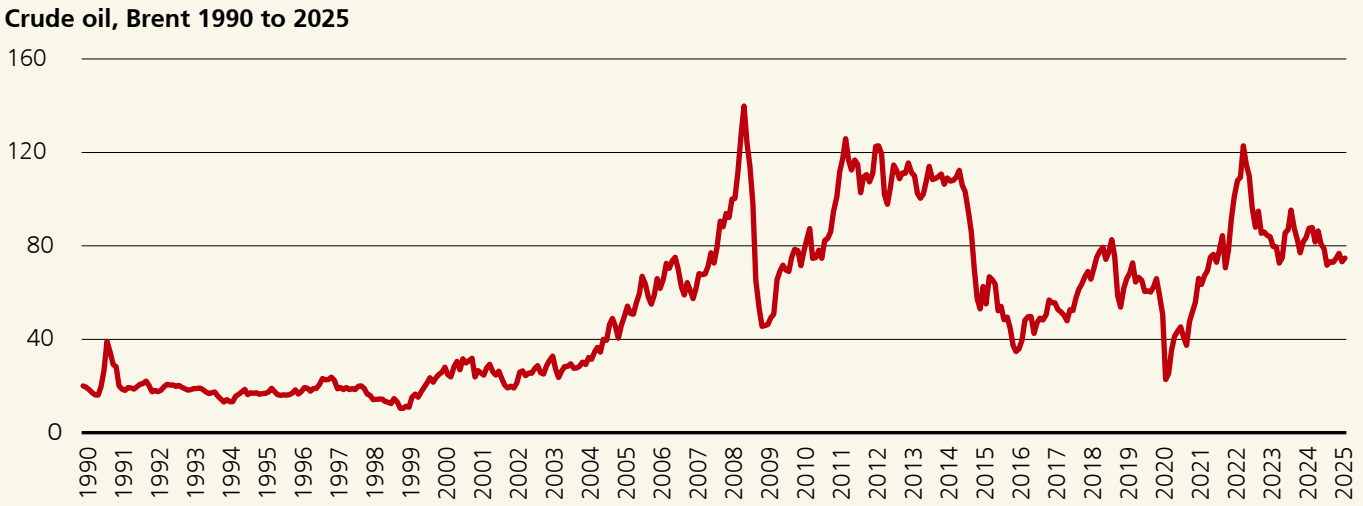
Cumulative total returns to shareholders, index (100 = 31 December 2004)



Source: Data provided by Bloomberg, collated by UBS Asset Management, as of April 2025.

Figure 3: Crude oil, Brent monthly prices, 1990 to 2025

Monthly prices in nominal US Dollars, (USD/bbl)



Source: Data provided by Bloomberg, collated by UBS Asset Management, as of April 2025.

A unique set of circumstances enabled the industry's returns

The industry's historical returns were achieved during an era characterized by unique circumstances, including significant increases in energy commodity prices, near-monopolistic dominance of oil and gas within the global energy system, and a stable investment climate.

The role of oil price volatility in securing returns

The industry's returns have historically been driven by price fluctuations rather than operational excellence or superior capital allocation. From 1990 until 2004, the industry mostly operated with stable oil prices at USD 18-30 per barrel, which guided investment decisions. However, a sharp price surge up to USD 140 per barrel between 2004 and 2008, followed by a decade where prices averaged USD 70 per barrel (a 250% increase from the low point) created a windfall for projects that had been initiated under much lower price expectations.

This price volatility has inflated the industry's returns. The 10% return over the past 30 years stands in contrast to the roughly 6.7% return observed over the last ten years, a period of comparatively stable oil prices (discounting Covid). Replicating the gains of the past may require a similar dramatic price surge – equivalent to USD 250 per barrel in the next decade. While some investors view oil and gas companies as an inflation hedge and are bullish on price increases, very few, if any, expect such extreme movements.

A careful review of industry returns over the past 30 years shows that upward moves in oil prices in the period between 2004 to 2014 appear to have masked a structural fall in industry returns. Returns were greater than 10% with oil prices of USD 18-20 during the Nineties; now, returns are closer to 6% over a comparable 10-year period, even as oil prices have averaged around USD 70 per barrel.

A favorable international investment environment

Beyond price volatility, the past 30 years coincided with a generally favorable investment climate for the energy sector. The post-Cold War era saw a trend towards economic liberalization and globalization, supported by institutions like the International Monetary Fund (IMF) and World Trade Organization (WTO) enforcing these norms. This resulted in international trade and investment agreements, which facilitated large investments in upstream operations and reduced the risk of nationalization and adverse tax changes.

This period stands in contrast to earlier decades, when oil-producing nations frequently expropriated foreign-owned assets. Nationalization of oil fields in Iran, Iraq, the Soviet Union and Mexico are examples of the political risks associated with the industry in this previous era. We believe that had the past 30 years been marked by similar levels of political risk, industry returns may have been lower.

A legacy of underperformance even in high price environments

Despite these favorable conditions, the oil and gas industry has consistently struggled with capital discipline. The sector's history is riddled with over-investment during boom cycles, with companies prioritizing growth over returns.

For example, between 2004 and 2010, when oil prices were high, companies doubled capital expenditures despite declining returns on capital employed.[3] From 2005 to 2020, the sector lagged the S&P 500 by 7% annually.[4] This overspending persisted, even as profitability continued to erode, despite oil averaging USD 90 a barrel from 2011 to 2014.

The consequences of poor capital allocation became evident when oil prices moderated in 2015. Oversupply, combined with increased OPEC production, exposed the inefficiencies of past investments. For instance, investors in the largest US exploration and production (E&P) company in 2006 saw a 95% loss by 2019, despite stable oil prices (averaging USD 75 a barrel) and production growth.[5] The second and third largest E&Ps delivered losses of over 65% and 50% respectively. Poorly timed acquisitions and overconfident management further exacerbated these issues.

There are lessons to be learned from this historical view. A period of extreme price fluctuations and a uniquely favorable international investment climate helped to drive returns, but even then, the industry's performance trailed other sectors. Moreover, the sector's history of overinvestment and poor capital discipline means it failed to capitalize even in periods when oil prices were high.

Despite a currently favorable policy landscape for oil and gas investment, there is a risk that companies may, once again, revert to complacency and lose focus on cost discipline. This concern is amplified by a volatile demand outlook and the industry's tendency towards boom-and-bust cycles. According to one 2024 analysis, organic spend in upstream is already at its highest level since 2015 in absolute terms, and this has only increased going into 2025.[6] Upstream investment constitutes between 60%-90% of total investment within the sector.

3 https://www.bcg.com/publications/2023/report-on-oil-and-gas-tsr-in-volatile-times

4 https://www.mckinsey.com/industries/oil-and-gas/our-insights/oil-and-gas-after-covid-19-the-day-of-reckoning-or-a-new-age-of-opportunity

5 https://www.brandes.com/insights/investment-team-corner/In-conversation-with-Chris-Duncan-CFA-May2024

6 https://www.woodmac.com/blogs/the-edge/complexity-of-capital-allocation-oil-gas-companies/

The view from today

A focus on growth rather than returns

The previous section highlighted that the oil and gas industry's historical 10% return was largely a product of unique circumstances rather than superior capital allocation. Despite some recent improvements in financial discipline, the sector continues to face structural inefficiencies that hinder sustainable value creation. These challenges stem from persistent returns slippage, outdated investment hurdle rates and an executive compensation model that prioritizes growth over profitability.

Cost discipline has improved across the sector
We engaged with multiple companies in the sector – from oil majors to mid-cap energy companies – to better understand capital allocation decisions in the current environment.

It is evident that well-capitalized and sophisticated players have tightened their project economics, including by setting up dedicated teams to challenge assumptions from project sponsors. Short duration projects are favored and there is some enhanced transparency regarding investment hurdle rates, payback periods and breakeven costs.

Additionally, companies are factoring in carbon price assumptions and project-level carbon intensities before sanctioning final investment decisions (FIDs). This strategy has enabled the sector to deliver shareholder value in recent years despite an 18% drop in crude oil prices from 2022 to 2023.[7] Additionally, most of the sector has also set interim targets to reduce emissions from their operations on an intensity or absolute basis, recognizing long-term decarbonization trends.

7 https://www.eia.gov/todayinenergy/detail.php?id=61142#:~:text=The%20price%20of%20Brent%20crude,demand%20fell%20short%20of%20expectations

Despite cost discipline, returns slippage remains a persistent issue

Where we found the most discrepancy was a lack of clarity on the slippage between project-level targets and overall corporate returns. On average, companies target project returns of around 15%, and reported a slippage of about 5%, largely because costs associated with exploration, corporate overhead and general and administrative (G&A) are typically excluded from project economics.

Yet, the numbers tell a different story – one of returns slippage far higher than 5% over the last 10 years. Out of 17 companies, both mid-cap and integrated majors, none have delivered a ROIC exceeding 10% in this period. Notably, 10 companies failed to meet even a 5% return threshold over the last decade.[8] While many companies in the sector may claim to be more disciplined, the numbers tell a different story.

Additionally, the high slippage rates between project hurdle rates and corporate returns raise questions about the adequacy of current project hurdle rates in delivering high shareholder returns. Our discussions with companies indicate that project hurdle rates have remained fairly consistent over the last decade despite high returns slippage. The integration of carbon pricing, where it occurs, does slightly increase implied hurdle rates, but not enough to meaningfully impact targeted returns.

Figure 4: Oil and gas industry ROIC, 5-year average vs. 10-year average (%)

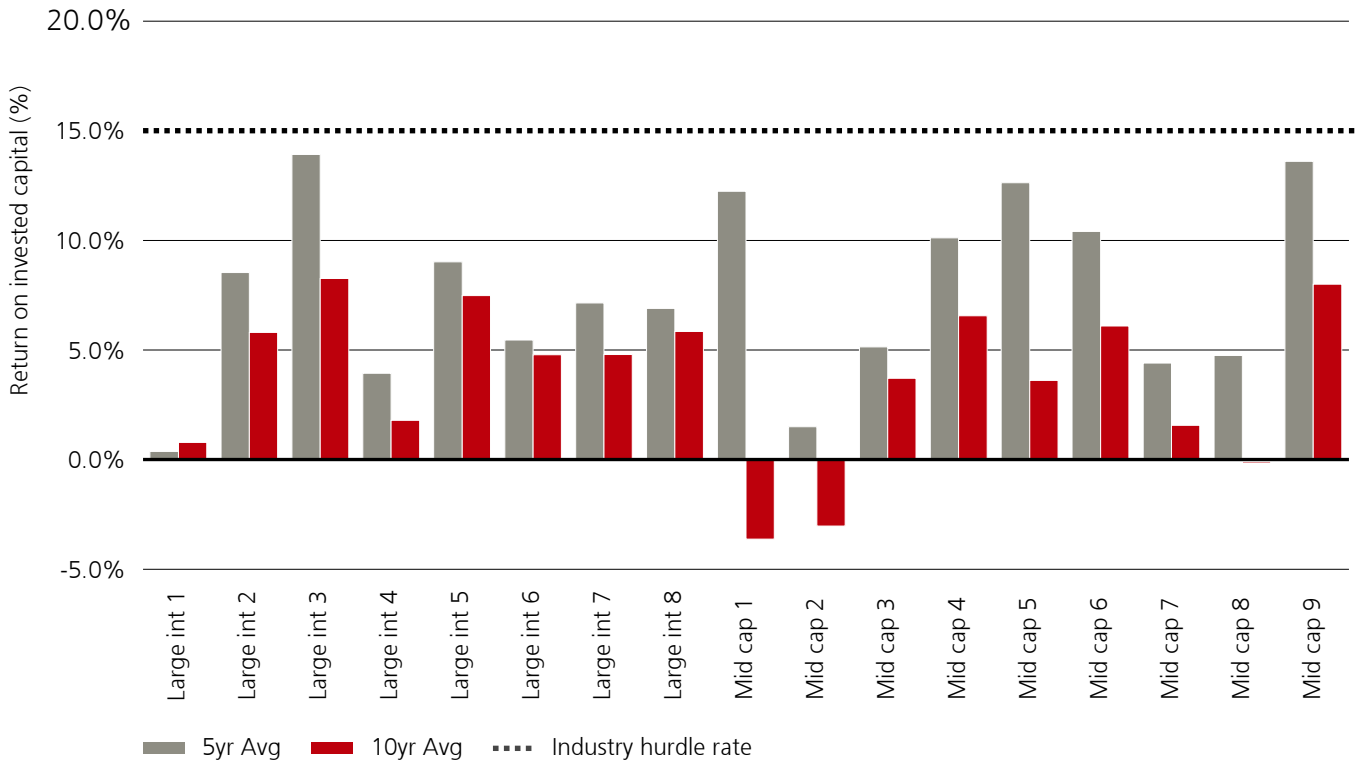


Figure 4: Across the sector, corporate returns over the long-term (10 years) and short-term (5 years) have consistently slipped well below 15%.
For these calculations we use reported numbers including all write downs and special or one time" losses.
While oil prices were very low during the COVID pandemic in 2020, oil prices have averaged 70 dollars over 5 years and 66 dollars over 10 years so upstream returns do not appear to be distorted by abnormally low commodity prices over these periods. We also note that even with the inclusion of the COVID period, we see a clear differentiation in returns across the sector.
We use ROIC as our core metric as it is an after-tax metric as upstream oil and gas is a very heavily taxed industry in many countries.

Source: Data provided by Bloomberg and collated by UBS Asset Management.

8 For these calculations we use reported numbers provided by Bloomberg, and included all write downs and special or one-time losses.

A compensation structure designed for growth over value

Despite a historical track record of poor capital allocation, executive compensation schemes in the oil and gas sector have continued to incentivize growth over value creation.

A review of integrated majors and mid-cap companies reveals that nearly 60% of all financial compensation metrics for integrated majors, and over 50% for mid-caps, are directly or indirectly tied to growth.[9] This emphasis on growth is particularly evident in annual incentive plans, with 50% of companies basing bonuses on direct or indirect growth targets – predominantly hydrocarbons growth.

We believe that to create sustainable value, companies may have to fundamentally reassess executive compensation plans and shift towards financial metrics that incentivize value creation over volume growth.

Overall, despite improvements in cost discipline and transparency, many companies in the oil and gas industry continue to struggle with inefficiencies that prevent them from delivering consistent, high-quality returns. The persistent gap between project targets and corporate returns suggests that companies have not fully addressed the factors that erode profitability. Executive compensation schemes that prioritize growth over value creation exacerbate these issues. We believe that to ensure sustainable growth, the industry must move beyond short-term financial discipline and reassess its approach to capital allocation.

Figure 5: Average split of financial compensation metrics for large integrated majors vs. mid-caps

Percentage of compensation (%)

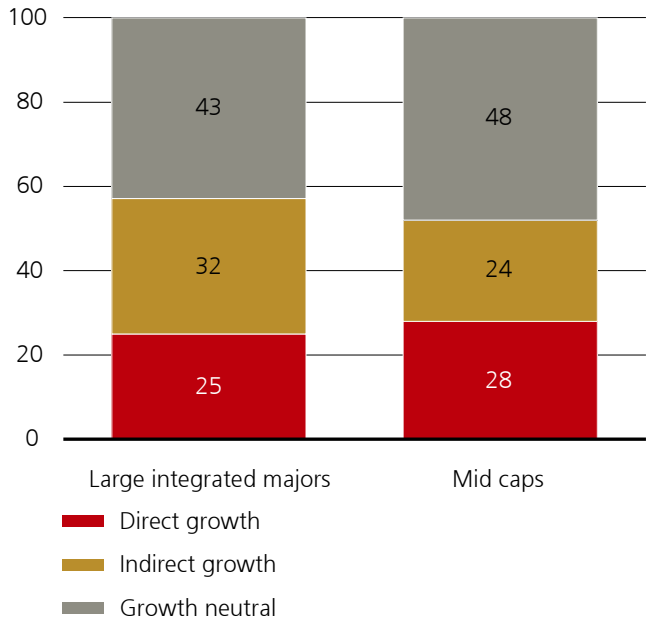


Figure 5: Types of financial metrics used in compensation schemes across large integrated majors and mid cap energy companies. (Note: does not include non-financial metrics such as process safety, etc.)

Source: Collated by UBS Asset Management using data from 2024 company reports.

9 Performance based metrics were classified using the methodology suggested by Carbon Tracker's report Crude Intention III. The metrics are Direct Growth, Indirect Growth, and Growth Neutral. Direct Growth measures are those that "directly incentivize exploration and production work". Examples include production, reserves, and capital expenditure metrics. Indirect Growth measures "incorporate a value angle as well as a growth angle". Examples include free cash flow and earnings per share. Growth Neutral metrics "encourage improved performance but without incentivizing growth". Examples include personal/process safety, GHG emissions/intensity, operational cost savings and total shareholder return. In our analysis, we do not include non-financial metrics such as process safety and GHG emissions.

A view into the future

The oil industry faces a new era of risks with potential for unpredicted negative outcomes

We highlighted the historical reasons for the industry's modest returns and argued that ongoing inefficiencies and a growth bias continue to hinder the sector's ability to achieve sustained high returns. The industry has had historically modest returns and ongoing inefficiencies and a growth bias continues to make sustained high returns ellusive.

And even more problematic, going forward higher returns will need to be delivered in an environment unlike any in recent history: the rise of alternative energy sources, the threat of increased fiscal uncertainty, and the resurgence of political volatility in a multi-polar world collectively present a trifecta of challenges, making hyper-discipline in capital expenditures crucial.

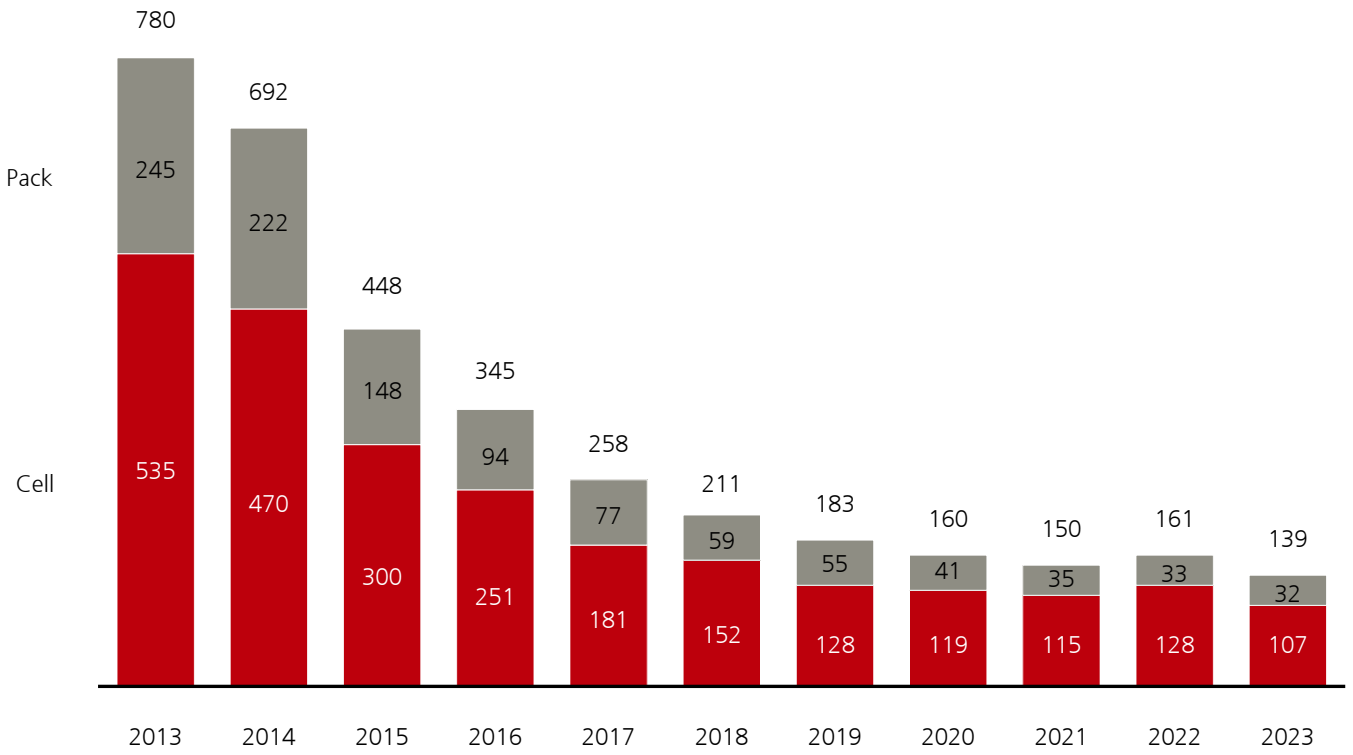
A policy environment that has accelerated the growth of viable alternatives

In 2005, the energy transition appeared to pose minimal threat to hydrocarbon demand. This is no longer the case. While demand for oil and gas is expected to persist until 2050 (perhaps longer), the extent of this demand will hinge on the pace of the energy transition. Even if the most aggressive net-zero scenarios do not materialize, governments may still deliver – at least partially – on their current national energy and climate pledges. If current commitments are met, the share of fossil fuels in final energy consumption could drop to little over 35% by 2050 compared to 66% today.[10] While commodity forecasting is difficult and we do not want to paint an overly bearish picture, there is certainly a non-zero risk that transition efforts could lead to structurally lower oil prices beyond 2030.

The global policy environment has strongly favored accelerating the energy transition. Two thirds of the USD 3 trillion in global energy investment in 2024 was directed towards clean technologies aimed at replacing conventional energy sources. These include renewables, low-emissions fuels, electric vehicles (EVs), nuclear power, grid enhancements, energy storage, heat pumps and other efficiency improvements.[11] This has fueled innovation and massive productivity improvements in alternative energy technologies. Over the last few decades, utility scale solar photovoltaic costs have dropped by more than 80%,[12] battery costs have dropped by 99%[13] and sales of electric and plug-in electric vehicles are estimated to have reached over a quarter of all global new car sales in 2024, up from just 4.8% in 2020.[14] EVs of all kinds currently displace around 1.7 million bbl/day of oil usage, mainly in the form of gasoline, representing around 3-4% of total road fuel demand.[15] This is expected to jump to 6 million bbl/day by 2030.[16]

Figure 6: Volume-weighted average lithium-ion battery pack and cell price split, 2013-2023

Real 2023USD/kWh



Source: BloombergNEF. Historical prices have been updated to reflect real 2023 dollars. Weighted average survey value includes 303 data points from passenger cars, buses, commercial vehicles, and stationary storage.

10 IEA (2024), World Energy Outlook 2024, IEA, Paris https://www.iea.org/reports/world-energy-outlook-2024, Licence: CC BY 4.0 (report); CC BY NC SA 4.0 (Annex A)

11 https://www.iea.org/reports/world-energy-investment-2024/overview-and-key-findings

12 https://www.nrel.gov/news/program/2021/documenting-a-decade-of-cost-declines-for-pv-systems.html

13 https://rmi.org/the-rise-of-batteries-in-six-charts-and-not-too-many-numbers/

14 https://about.bnef.com/blog/five-energy-transition-lessons-for-2025/#:~:text=But%20achieving%20scale%20means%20that,of%20all%20new%20car%20sales

15 https://about.bnef.com/electric-vehicle-outlook/#:~:text=by%20vehicle%20segment-,Oil%20displacement%20from%20EVs,of%20total%20road%20fuel%20demand.

16 https://www.iea.org/reports/world-energy-outlook-2024

One should be careful not to overstate the displacement potential of new technologies nor the policy support undergirding their growth. The intermittency of renewables, inflationary pressures and lack of charging infrastructure all contribute to a transition that is happening in fits and starts. We are seeing these pressures moderate demand for EVs and challenge the offshore wind industry currently. In 2024, investment in the low-carbon energy transition grew to a record USD 2.1 trillion, yet the year-on-year pace of growth of 11% was lower than previous years, when growth accelerated by 24%-29%.[17] Current US policy direction has created uncertainty and points to a slower pace in transition-related investments.

While the energy transition is unfolding in stages, regional trends suggest it is resilient. UBS Research has noted that the Asia-Pacific region, which accounts for 47% of cumulative transition spending globally since 2004 and over 60% of annual renewable capacity additions since 2013, has strong incentives to reduce fossil fuel imports, mitigate exposure to extreme weather events that disproportionately impact its economy and benefit from value-added exports of technologies and commodities essential for the transition.[18] China exemplifies this trend, responsible for over 40% of clean tech manufacturing. The rapid adoption of EVs in China has likely led to a peak in refined oil consumption and crude oil imports. According to the research arm of China's largest oil producer, gasoline consumption and diesel demand are projected to decrease by 35%-50% by 2035 from 2023 levels.[19] This will have implications for global oil demand going into the next decade.

In addition, emerging technologies, such as small modular reactors (SMRs) and electrolyzers, could mitigate the intermittency challenge and other limitations of renewables.

Nuclear power, particularly SMRs, have gained political support in response to growing electricity demand, including from AI.[20] Although the technology is still in development and project costs remain high, a small reactor with a capacity of 0.3 GW could, in theory, scale up reliable carbon free power with lower capital costs driven by mass produced units installed on site.

Meanwhile, in China, the use of electrolyzers is growing dramatically, increasing by 316% in 2024 on the back of a supportive regulatory environment.[21] [22] With Chinese companies already holding 50% of the global electrolyzer capacity, they are continuously improving efficiency and optimizing electrolyzer technology.[23] A breakthrough in green hydrogen costs opens the door to e-fuels which can utilize much of the existing hydrocarbon-based infrastructure, reducing transition costs and barriers to adoption.

Even if one thinks that the risk of these technologies replacing fossil fuels is low, it is no longer zero: even a 5% probability will influence the risk-adjusted project economics of oil and gas investments.

17 https://about.bnef.com/blog/global-investment-in-the-energy-transition-exceeded-2-trillion-for-the-first-time-in-2024-according-to-bloombergnef-report/
18 https://neo.ubs.com/shared/d2Pcvia0IvU/
19 https://www.reuters.com/world/china/chinas-oil-consumption-peaked-2023-cnpc-says-2024-12-13/
20 https://www.pewresearch.org/short-reads/2024/08/05/majority-of-americans-support-more-nuclear-power-in-the-country/
21 https://www.rystadenergy.com/news/china-hydrogen-targets
22 https://www.hydrogeninsight.com/policy/china-tells-regional-governments-to-actively-and-orderly-advance-green-hydrogen-production/2-1-1734332
23 https://www.woodmac.com/news/opinion/the-competitive-edge-of-chinas-electrolysers/

A new era of political and policy volatility creates risk and uncertainty

Beyond technological disruption, a confluence of political and policy shifts is fundamentally altering the risk landscape for oil and gas investments.

Historically, political risk was largely confined to contract enforcement or resource nationalization in frontier markets. Companies investing in these regions would often target a 20% plus return due to these risks, with assets traded at significant discounts. Today, political risk transcends geographical boundaries. This new era of heightened political and policy volatility is driven by three main factors.

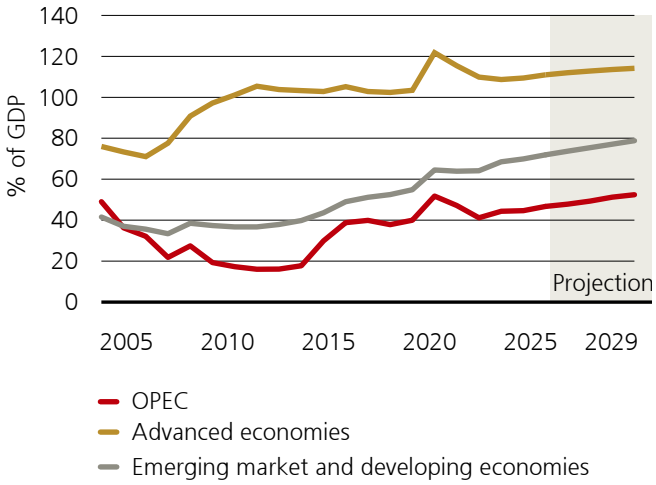
1. Elevated global debt is driving fiscal uncertainty

Global government debt exceeded USD 100 trillion, or about 93% of global gross domestic product by the end of 2024 and is forecasted to approach 100% of GDP by 2030.[24] This staggering figure is likely an underestimate. As illustrated in the Figure 7, global debt-to-GDP has steadily risen across developed and emerging markets. Countries are likely to face additional costs linked to an aging population, energy transition, climate adaptation and infrastructure needs, all of which will exacerbate debt levels.[25]

This unprecedented debt burden creates fiscal policy uncertainty and is already translating into targeted fiscal measures against the oil and gas sector. In many countries, governments absorb significant value from oil and gas production. Additionally, there is a growing risk that governments seek additional compensation ex-poste. For example, the UK's Energy Profits Levy (the so-called 'windfall tax'), established in May 2022, initially set at 25% and set to expire at the end of 2025, which was slowly expanded to 38% currently and has been extended until 2030.[26] Similarly, the European Union's (EU's) 'solidarity contribution' on oil and gas companies in September 2022 reflects a broader pattern of governments using the oil industry to solve short-term fiscal problems. Multiple EU member states extended the tax until 2025.[27]

Figure 7: Debt-to-GDP is increasing

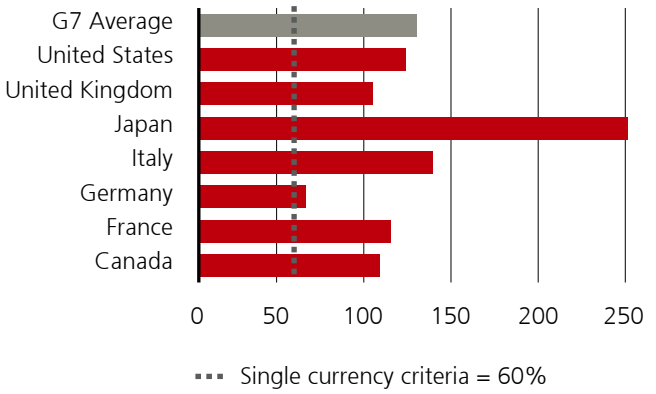
General goverment gross debt (percent of GDP)



Source: IMF 2025, World Economic Outlook Database.

Figure 8: G7 debt-to-GDP, 2024

General goverment gross debt (percent of GDP)



Source: IMF 2025, World Economic Outlook Database.

24 https://www.imf.org/en/Blogs/Articles/2024/10/15/global-public-debt-is-probably-worse-than-it-looks#:~:text=Global%20public%20debt%20is%20very,percent%20of%20GDP%20by%202030.

25 https://www.spglobal.com/en/research-insights/special-reports/look-forward/global-debt-2030-can-the-world-afford-a-multifaceted-transition

26 https://www.bbc.co.uk/news/business-60295177#:~:text=The%20Energy%20Profits%20Levy%20%2D%20the,extracting%20UK%20oil%20and%20gas.

27 https://taxfoundation.org/research/all/eu/eu-windfall-profits-taxes-oil-gas/

2. Increased geopolitical fragmentation
While the past three decades saw a golden era for global investment in oil and gas, underpinned by free trade and investor protections. Today, geopolitical fragmentation and the transition to a multipolar world are introducing new layers of complexity to international investments, including asset seizures, trade restrictions and investment disputes.

The Russia-Ukraine conflict prompted nations to expropriate energy assets, and the recent US tariffs indicate a general step back from free trade and investment policies.

Table 2: Examples of recent political risk events show that, in recent years, developed market losses have been greater than those in frontier markets.

Year	Event	Companies impacted	Estimated cost
2010*	Macondo Oil Spill	BP	USD 65B
2012	Environmental fines at Sakhalin II	Shell	USD 4.2B
2012	YPF Nationalization	Repsol	USD 7.5B
2014	Libyan Civil War	ENI	Unknown
2017**	Venezuela collapse	Repsol, Chevron, COP	USD 9.7B*
2020*	Keystone XL	TC Energy, Exxon, Shell, Total	USD 1.8B
2022	Russia – Ukraine War	Total, Shell, BP	USD 33.4B
2022*	UK Windfall profits Tax	BP, Shell, Serica, Harbour	USD 25.3B
2022*	EU Windfall profits Tax	Shell, Exxon, Total	Limited

* 100% of developed market political risk losses could be related to climate policy.

** Denotes only those losses that could be quantified via International Institute for Sustainable Development (IISD) arbitration judgements. Actual industry losses are likely to be 2-3 times this figure.

Source: UBS Asset Management estimates.

3. Climate activism and litigation
These challenges are exacerbated by climate activism. The surge in climate-related litigation presents a significant and evolving threat. The Sabin Center's Climate Litigation Database currently contains over 2,666 climate litigation cases, 70% filed since 2015 (when the Paris Agreement was adopted).[28] These lawsuits often seek compensation for climate damages or allege false advertising and deception.[29]

Legal risks can impede the development of projects. Activism has focused on pipelines as a potential way to disrupt development, since an oil field without a way to transport oil risks becoming a stranded asset. In 2024, for example, activists were successful in blocking the construction of the Williams Northeast Enhancement Project, a new fracked gas pipeline to supply gas to New York. The EU took the final step to exit the Energy Charter Treaty (ECT), as the agreement's investment protections were seen as a barrier to climate policy.

In the UK, the development of one of the largest undeveloped oil and gas fields was derailed by a court ruling in 2025 that agreed with environmental activists that the decision to approve the projects was unlawful since it did not consider emissions from the use of oil and gas. Shell has spent more than GBP 800 million since the project was approved.[30] While the companies expect the project to move forward, the decision has introduced further uncertainty and risk more akin to frontier market operations.

28 https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2024/06/Global-trends-in-climate-change-litigation-2024-snapshot.pdf
29 https://www.nytimes.com/2024/09/12/climate/climate-lawsuits-major-cases.html
30 https://www.offshore-energy.biz/multi-billion-projects-at-stake-another-blow-for-uks-largest-untapped-oil-gas-duo-but-shell-equinor-and-ithaca-remain-upbeat/

Overall, the oil and gas industry is navigating a complex landscape of evolving political risks, legal challenges, and the accelerating energy transition. While demand for oil and gas is expected to persist, the rise of alternative energy technologies coupled with heightened political and legal risks are reshaping market dynamics.

Given the sector's history of below-average market returns, inefficient capital allocation, and the significant gap between project returns and corporate returns, companies must adopt a more conservative approach to project returns, factoring in the increased probability of regulatory changes, litigation and technological disruption.

The case for targeting higher returns instead of growth

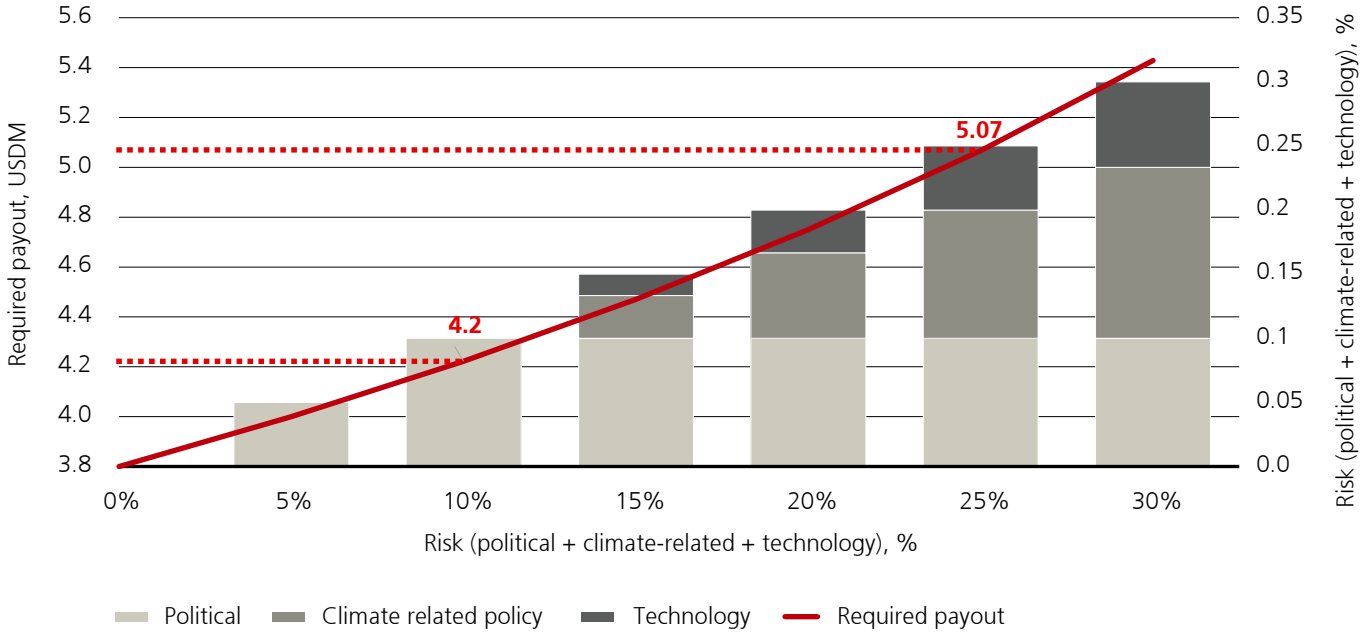
Let's undertake a simplified thought exercise. Consider the historical experience of a hypothetical integrated oil and gas company X. In a previous era, X may have invested USD 1 million in a developed market oil project that paid out USD 4.22 million after 15 years.

While political risks, such as nationalization, were a concern, they were estimated at a 10% probability. Technology disruptions and substitution risk were considered negligible. Factoring in this political risk, the project's expected returns are USD 3.8 million, a 10% return that matched the company's cost of capital.

Today, the same project must account for greater risks. Assuming a 20% probability of policy-driven losses and a 5% probability of technological obsolescence, the project would now need to yield at least USD 5.07 million to generate the same expected return (10%).

Figure 9: The shift in the risk paradigm must be reflected in returns

(Theoretical example): 10% project return on a USD 1 million investment



Source: UBS Asset Management.

The implication of this is that underlying project returns need to increase by over 20% for the company to generate the same probability weighted outcome for investors. In reality, returns likely to need to go up even more as outcomes have become more uncertain and investors dislike uncertainty. This exercise does not account for the fact that increased risk and uncertainty have likely driven up the cost of capital for company X.

There may be considerable debate about the precise figures that companies should use, but the directional outcome of this exercise is clear: project level returns need to rise significantly to compensate investors for the higher risk of unpredicted negative outcomes.

The way forward

Hyper-capital discipline and higher returns targets

The industry has already started to move in the right direction. Our research indicates that capital budgets are lower than in the industry's heyday and it is notable that much of the capital spending today is shorter cycle, implying that long duration capital spending is down more than total capital expenditure. We believe this process needs to continue and increase over time. Unless they can find projects that generate adequate returns, energy companies should return cash to shareholders rather than making sub-optimal investment decisions.

A review of publicly listed oil and gas companies demonstrates that many companies are targeting average returns of 10%-15% on future investments, a target that does not seem to reflect today's risk-adjusted landscape. Instead, companies should consider adopting the following principles:

Target at least 18%-20% returns for new upstream projects

Given the industry's tendency to make poor capital allocation decisions and the increased probability of adverse outcomes, we encourage companies to only invest in projects with the potential to deliver significantly higher returns. Long-duration projects should demand an even higher premium due to elevated uncertainty.

Target 15% returns at the corporate level

There is little justification for the sector delivering an average of 10% given the increasing risk profile of the industry which implies a higher weighted average cost of capital (WACC). As we have seen, many companies have failed to deliver even 5% over the last 10 years. We believe that companies should target 15% at the corporate level, which may require only sanctioning projects that target 18%-20% returns.

Ensure that the incentive structure reflects a pure focus on returns rather than growth

We recommend that financial targets in compensation schemes be based mainly on return measures such as ROIC or total shareholder revenue (TSR) rather than production growth.

Disclose material information to investors to demonstrate higher returns from incremental investments

With any new major investment, we encourage companies to consider disclosing:

- Overall company level return expectations
- When possible, project timelines and payback periods
- Breakeven costs
- Assumptions on commodity price

Ultimately, without adequate returns, companies should not be afraid to shrink. This will result in both higher returns and lower hydrocarbon production over time. Less hydrocarbon production means lower Scope 1, 2 and 3 emissions.

Engagement and capital allocation

How companies invest shareholder capital matters for our investments. Our investment framework for traditional energy companies focuses on valuation and management quality. A company's return history and project level hurdle rates are integral to how we evaluate management, and our expectation of future returns is a key driver of valuation. This leads to a strong preference for companies with a proven history of high project level hurdle rates and strong returns.

We have been taking this argument to companies in the sector, especially where we see evidence of poor historical returns driven by a lack of discipline in capital allocation. We have already seen some success through our discussion with an integrated oil major, which recently committed to increase its target hurdle rates to over 20% for new incremental investments.

Sparking necessary conversation

The oil and gas sector has undeniably supported energy needs to drive human progress. But the industry now operates within a risk framework that no longer holds. Fossil fuels face growing competition from viable alternatives, while political, regulatory and legal uncertainties are mounting. If investors are to continue to invest in the oil and gas sector, they should be compensated for these growing risks.

Over the past two decades, the sector has delivered returns typical of a commodity industry – marked by volatility and lacking a sustained competitive advantage. Too many companies have misallocated capital, generating weak returns despite an era of sustained high prices. Now, more than ever, oil and gas companies must reassess their investment strategies, focusing only on projects that can provide a minimum 15% return (at the corporate level) to their shareholders. Those that don't believe they have opportunities to earn high returns should consider shrinking so they can return capital to investors.

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