WALTER SCOTT

QUARTERLY COMMENTARY

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For several years, Walter Scott has monitored favoured companies in the oil and gas industry, ready to invest should fundamentals and valuations align to a compelling degree to offer better long-term financial opportunities.

On our analysis, alignment arrived in late February, when the outbreak of hostilities in the Persian Gulf catalysed our increasingly constructive take on the prospects of some of the industry's best companies.

In our view, damage to energy flows and productive capacity in the Middle East has materially shifted expectations for oil and gas markets. Following a sharp dislocation, supply–demand dynamics look unlikely to return to their pre-war equilibrium in the near term, ushering in a potentially prolonged period of structurally higher energy prices.

We expect **Cheniere Energy** and **EOG Resources** to benefit from this altered landscape, reinforcing already strong long-term fundamentals. Based on our analysis, we believe each combines a clear growth trajectory with a resilient balance sheet, disciplined capital allocation, and high-return, cash-generative assets.

Implicit in the decision to invest in these companies is a recognition of the continued role of hydrocarbons in the global energy mix, even as the world seeks to transition to less carbon-intensive sources. However, each investment also reflects our conviction in the ability of these companies to prosper in a range of transition scenarios.

We assess the financially material risks and opportunities faced by every investment – not just oil and gas companies – in three potential transition scenarios[1]:

- **Orderly**
  Climate policies are introduced early and become gradually more stringent. Both physical and transition risks are relatively subdued.

- **Disorderly**
  Higher transition risk due to policies being delayed or divergent across countries and sectors.

- **Hot house world**
  Some climate policies are implemented in some jurisdictions, but global efforts are insufficient to halt significant global warming. The scenarios result in severe physical risk including irreversible impacts.

Each scenario brings with it opportunities and risks. A hot house world, for example, will see continued high demand for hydrocarbons alongside physical risks to infrastructure from rising sea levels and extreme weather events.

For companies involved in the exploration, production or trading of fossil fuels, however, it is an orderly transition that poses the greatest structural risk. Coordinated global action to limit temperature increases to 1.5°C implies permanent demand erosion and stranded assets. How well equipped are Cheniere and EOG to navigate such an outcome?

Cheniere Energy – the "climate bridge"

Cheniere Energy is the largest liquefied natural gas (LNG) producer in the US and the second largest globally, operating ~50 million tonnes per annum of liquefaction capacity on the US Gulf Coast. From facilities in Corpus Christi and the Sabine Pass, LNG is supercooled and loaded onto ships for export.

Some studies, including from the International Energy Agency, suggest global gas demand could peak as early as the 2030s in 1.5°C-aligned scenarios. In such cases, countries pursuing rapid decarbonisation may scale back import requirements.

Crucially, however, natural gas is widely regarded as the least carbon-intensive fossil fuel. When burned, it generally emits ~40–50% less CO2 per unit of electricity than coal and ~20-30% less than oil, although the exact level of emissions reduction will depend on a range of factors such as the source of the natural gas, the efficiency of the liquefaction plant and the distance that the resulting LNG is shipped. It also typically produces less sulphur dioxide, mercury and other air pollutants.

Even in an orderly transition therefore, we consider that LNG is likely to remain a core component of the energy mix; a "bridge" fuel that displaces coal, partners with renewables to support grid reliability, and underpins energy security – particularly in Asia and Europe.

[1] Climate transition scenarios are hypothetical long-term scenarios designed by NGFS (Network for Greening the Financial System)

We consider that Cheniere's long-term viability is further supported by its natural cost advantage over many international peers, as well as a resilient operational model.

The US shale boom has made domestic gas among the cheapest globally, enabling Cheniere to position itself as a low-cost, reliable supplier of LNG to higher-priced international markets.

That same LNG is traded on long-term, take-or-pay contracts – typically around 20 years in length. Around 90% of current liquefaction capacity is contracted through the mid-2030s with investment grade counterparties. In our view, this confers on Cheniere a degree of insulation from changes in the global energy mix over a multi-year trajectory.

EOG Resources – operational excellence as standard and more gas in the mix

One of the largest independent oil and gas companies in the United States, EOG Resources is a pioneer of the development of the shale energy sector. Founded in 1999, the company has a focus on operational excellence, cost discipline, portfolio flexibility and shareholder returns.

As with Cheniere, we consider the central financial risk for EOG in an orderly transition is that progressively stricter emissions standards and carbon pricing erode the long-term economics of hydrocarbons.

EOG is already exposed to US policy through the Inflation Reduction Act's methane charge, while its export ambitions may leave it vulnerable to increasingly divergent international regimes, including the EU's planned methane limits on imported oil and gas. Should global carbon taxes intensify to align with a 1.5°C pathway, higher end-user prices could further weaken demand, compounding these pressures.

Against this backdrop, EOG has strategically transitioned its portfolio towards gas assets, including the $5.6bn acquisition of Encino Energy's operations in the Utica Shale in the Appalachian Basin. The deal increased EOG's exposure to LNG export markets and US power demand.

Central to EOG's transition approach is operational efficiency. The business continues to be a supplier of fossil fuels to the global energy system, while aiming to do so as efficiently and with as few emissions as possible.

With a publicly stated ambition to achieve net-zero scope 1 and scope 2 emissions by 2040, EOG has made meaningful progress on methane leakage and routine flaring (the controlled burning of natural gas that cannot be processed, stored, or transported). While this approach does not eliminate absolute emissions, it demonstrates a commitment to reducing environmental intensity within the realities of upstream production. In an orderly transition scenario, this operational discipline and technological approach could give EOG a distinct advantage over many peers.

Resilience is key

An important consideration in our research is the extent to which a company can shape its own destiny. We seek to assess how much agency a business has in determining its future success. Climate change operates on a scale beyond the control of any individual company. However, we consider that management teams can – and should – build resilience calibrated to the range and likelihood of potential outcomes. In few sectors is this more relevant than in oil and gas, which faces a complex mix of financially material climate-related and regulatory risks. Equally, those that adapt effectively stand to benefit. We believe Cheniere and EOG are well positioned to be among them.

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