

COLUMBIA GLOBAL ENERGY DIALOGUE

ESG INVESTING AND THE OIL AND GAS INDUSTRY: MOVING TOWARD A HOLISTIC APPROACH TO RISK, GOVERNANCE; PERFORMANCE MEASUREMENT, DISCLOSURE, AND RESULTS

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On September 17, 2020, Columbia University's Center on Global Energy Policy (CGEP) held a virtual workshop about environmental performance in the oil and gas industry. Investors, senior oil and gas industry executives, NGOs, and other stakeholders participated in this candid discussion about how environmental risks should be measured, disclosed, and incorporated into investment decisions. The workshop was organized around three main topics:

1. Investors' assessment of environmental risks of oil and gas operations and whether these risks have impacted company valuations
2. Performance measurement and disclosure of environmental metrics (in particular, metrics related to climate change risks)
3. The response of the industry, and specific oil and gas companies, to these environmental issues and growing investor pressure

The workshop was conducted under the Chatham House Rule on a non-attribution basis. This report summarizes the discussion from the workshop and highlights the main points raised by workshop participants.



Introduction

The impacts of climate change are becoming more noticeable to the public, as evidenced most recently in the wildfires in California and the increased severity of hurricanes in 2020. US voters increasingly view climate change as a more important issue than they have in the past. This trend is true for both Democrats and Republicans and is especially pronounced among the younger generations. The world is becoming less complacent about climate risk and there is a rising movement for change within both the US Congress and the European Union.

However, with no industrialized country meeting their Paris Agreement climate commitments, there is increasing urgency to address climate change. For companies this means pressure to measure climate risk; this is especially true for the oil and gas sector, which faces unique investment challenges. In addition to the successive years of weak crude oil prices and historically poor returns on capital, investors must now also contend with uncertain short- and long-term outlooks for oil demand.

With mounting concerns about how climate change and associated regulation will impact the oil and gas industry, investors are paying greater attention to environmental, social, and corporate governance (ESG) risks in their portfolio decisions. However, investors and oil and gas companies are challenged by the current ESG landscape, where there are upwards of 600 ESG ratings and rankings services available. The disclosure of data by companies is currently inconsistent across entities, sectors, and regions, with significant differences between the scope of what is reported, how the metrics are measured, and how the ratings are developed. A 2019 MIT study found that the average correlation of scores between six top ratings agencies was only 0.54¹; for companies seeking to understand their performance, it is a significant challenge when they receive different ratings for the same performance.

Investors' Assessment of Environmental Risks of Oil and Gas Companies

This session focused on discussing investors' perceptions of environmental and specifically climate risks. Is climate change an existential threat? How do investors view the time horizon of these risks? Do they believe that these risks are far enough into the future to still attract investment or are they sufficiently near-term such that they are muting investments into the sector?

Have Climate Concerns Structurally Impacted Company Valuations or Are Current Low Valuations Due to Cyclical Forces?

Financial performance and ESG risks are related but distinct issues; these issues are particularly challenging for the oil and gas sector given the industry's overlay with climate risks. Many of the risks concerning investors today are due to cyclical market factors, poor financial performance, and poor historical returns on capital. The sector's earnings are in line with its market capitalization with no sign of structural de-rating of the sector due to environmental concerns.

Generally, participants viewed the oil and gas sector as still investable, with firms

assessing companies individually rather than judging the sector as a whole. However, oil and gas company valuations are increasingly reflecting climate risks and their respective environmental performance.

For longer-term investors, the outlook for the oil and gas sector is that:

- The energy sector is shifting to an income-generated asset class versus a growth asset class.
- Investors are increasingly uncomfortable with the volatility of the oil and gas sector and will demand a higher return because of this volatility.
- Increasingly, investors are asking for their money back as cash (e.g., dividends and share buybacks) because of the oil and gas sector's tarnished reputation of managing capital.

What Environmental and Climate Risks Are Investors Concerned About?

Participants expressed concern about a number of environmental and climate risks, in particular the potential for stranded assets and the inability to construct pipelines in the US. There was a general sense of urgency and disappointment about the industry's lack of progress in addressing gas flaring and methane emissions. An NGO participant described it as a "self-inflicted wound" given that the solutions are "low-hanging fruit." Another NGO highlighted Pioneer's positive examples and, most recently, Shell and BP's recent comments to the Texas Railroad Commission about ending routine gas flaring.² They also called upon the Texas Railroad Commission to develop policies and regulations to help reduce flaring and methane emissions. Investors are becoming increasingly concerned about the risk that natural gas will no longer be viewed as a transition fuel due to methane emissions and gas flaring. A participant accentuated the concern about lost natural gas demand and highlighted the push for offshore wind in the northeast Atlantic states, which will hurt demand for natural gas power plants in a serious way in the short- and long-terms.

A sustainable investment advisor concisely summarized the five specific ESG risks investors are concerned about in the oil and gas industry as:

- Social license to operate (which also relates to talent retention)
- Acknowledgment and stewardship of climate risks (focusing on whether the management and board are managing these risks)
- Companies' vulnerability to physical risks (e.g., heat exposure, flooding)
- Oil and gas demand risks (which some investors have started to account for in their discounted cash flow models)
- Regulatory risks (including exposure to a carbon tax or other risks that impact the businesses' economics)

Several participants indicated that the scope of these risks should be broadened to other environmental and social risks, such as biodiversity, water use and stewardship, and broader

environmental concerns that are intertwined with social justice. Their view was that “natural capital” (which includes arable soil, water, fisheries, forest land, wildlife, etc.) will become an influential metric. A participant highlighted recent ESG-driven events where companies were unable to access insurance to continue operations: two refineries in California had to shut down, and a Philadelphia refinery closed permanently. This supported the view that the insurance market is really important to watch in terms of the influence ESG and climate risks will play in the future.

How Do ESG Risks Impact Their Investments?

Investors are increasingly assessing a company’s ability to perform during an energy transition. The financial industry is more likely to support management teams that have a clearly articulated investment plan and business strategy that is cognizant of the energy transition. A sustainability advisor indicated that the markets are already starting to reward companies that embrace ESG in their strategies and that can add value to the energy transition. This goes beyond greenwashing, which the market will not reward. A general view was that if oil and gas companies cannot compete effectively in what they are investing in, then they should return capital to shareholders for reallocation. An investment firm participant believed that, in the long run, there will only be a handful of survivors and that the companies with long-term transition plans will be rewarded.

The discussion turned to how private equity firms are engaging with these risks, which varies depending on who their limited partners are. The more progressive firms are moving from “dirtier” investments in mining or oil to power, gas, and liquified natural gas (LNG), and the larger private equity groups are active in raising impact funds that focus on the United Nations Sustainable Development Goals. However, as an NGO participant highlighted, private equity firms back many of the worst performers on flaring in the Permian. Although many private equity firms are increasingly incorporating ESG into their due diligence and reporting and hiring specific personnel dedicated to ESG efforts, they face fundamental data and benchmarking challenges.

While there is increasing convergence around Sustainability Accounting Standards Board (SASB) requirements, there is a distinct lack of data, a lack of standardization (different sponsors using different frameworks), and an inability to benchmark performance in a meaningful way. One company expressed concern that it was difficult to find data on fugitive methane emissions to benchmark against, as some regulatory regions do not require it to be reported. Many institutions are developing their own proprietary ESG methodology and valuations.

A specific point was made that no established ESG framework yet exists for passive investing, which accounts for more than 55 percent of assets under management.

For the high impact, alpha-seeking strategies, investors are looking to buy game-changers such as green technology or industry disruptors. On the opposite end of the spectrum is everything that relates to ESG integration, which often entails screening for higher rated ESG companies and screening out lower-performing ESG companies and/or sub-sectors (e.g., coal). The firms with more developed ESG strategies have begun quantifying ESG as

material factors and tying them into investment decisions. As an example, an investment firm participant described how ESG risks are now an equivalent investment criterion to earnings before interest, taxes, depreciation, and amortization. To achieve this stage, it was critical for the firm to internally identify and agree upon clear ESG metrics that are correlated to capital returns and equity valuation.

Raising the Bar on Oil and Gas Industry Environmental Performance

In this discussion, the general consensus on all sides was that the industry needs to raise the bar on their environmental performance and that oil and gas companies are behind the curve. Part of the industry has coalesced around specific initiatives, but one NGO stated that group efforts, such as the Oil and Gas Climate Initiative and One Future on Methane, have not had much impact on industry performance. An investment firm participant commented that the sector needs to resolve its internal disagreements and move forward for the sake of society and its survival. This participant called upon the companies responsible for 80 percent of the volume to lobby governments for further action to improve environmental performance.

An industry executive remarked that it has historically been difficult for the sector to gain consensus; traditional consensus-building was accomplished through trade associations. Although the Chamber of Commerce and Business Roundtable have recently come out with more progressive statements, an NGO participant criticized trade associations for being defined by their lowest common denominator rather than championing for bold change. The topic of trade associations was raised again and discussed later in the workshop.

The discussion moved to the steps needed to create bolder and broader industry action to improve environmental performance. A necessary first step would be for the industry to align around common principles for disclosure. A possible solution could be for the sector to unanimously agree on using Task Force on Climate-Related Financial Disclosures (TCFD) principles and/or aligning around SASB. Alternatively, the Edison Electric Institute (EEI) was offered up as a potential model for the oil and gas industry to follow. Although dissimilar to the oil and gas sector given that it is a highly regulated industry, the EEI, which represents all US investor-owned electric companies, recently released an ESG/sustainability reporting template that its members will utilize to help provide the financial sector a more standardized and consistent set of ESG data.

Participants advocated for financial investors to pressure oil and gas companies to pay greater attention to their environmental performance by becoming more active in voting on shareholder resolutions and scrutinizing company proposals to ensure executive compensation is tied to ESG metrics and environmental performance. In 2019, three-quarters of the votes on shareholder resolutions that were against the board's recommendations were in energy companies. Additionally, capital owners can "vote with their feet" (i.e., sell the equities) if they deem a company's environmental performance inadequate.

Performance Measurement and Disclosure

The ESG ecosystem is a highly complex landscape with a huge number of players that is currently defined by inconsistencies and lack of standardization. There are different ratings

and rankings methodologies, differences in the scope of what is included, and differences in data sources that are being used to produce these outputs. Despite recent efforts by framework- and standard-setters to converge on consistent disclosure standards and metrics, companies are struggling to define how to measure ESG performance and what information/data are key to disclose.

What Does it Mean for a Company to be Paris-Aligned? What Are the Metrics that Matter?

To highlight the increasing pressures corporations are facing, participants discussed the recent shareholder resolution that failed to pass at JP Morgan Chase's most recent annual meeting. This shareholder resolution would have compelled the bank to disclose its financing commitments and how they measure against the Paris targets; the measure, which failed to pass with 48.6 percent of the votes, entailed measuring the carbon risk of companies the banks have lent to and committing to reduce lending such that the emissions of companies they have financed are in line with Paris targets. Note that subsequent to the workshop, JPMorgan Chase announced that it is adopting a financing commitment that is aligned to the goals of the Paris Agreement. As part of its strategy, the firm intends to help clients navigate the challenges and capitalize on the long-term economic and environmental benefits of transitioning to a low-carbon world. This segment then focused on defining what it means for a company to be aligned with the Paris Agreement. It is complicated by the fact that the Paris Agreement is an overall decarbonization view of the world and is composed of varying country-level contributions.

Participants indicated that an important first step is deciding upon a framework, such as achieving net-zero by 2045–2055, and understanding the different paths to get to the target; this definition allows for an evaluation of companies' performance against ambitions over time. There will be multiple variables that will be beyond the control of a single company, but, nonetheless, companies need to articulate their long-term ambitions and how they will achieve their goals while managing the risks. Some participants highlighted the importance of engaging in dialogue across various stakeholder groups to ensure that the definition of Paris-alignment has credibility.

The discussion also highlighted the need for a framework for thinking about peak oil demand. Oil and gas companies have to think about resilience from a credit point of view and the resilience of portfolios and asset choices given declining business conditions. Companies should advocate for stronger government action. Some examples raised were ConocoPhillips's advocacy for a carbon tax and the important role companies played in working with regulators to develop the EU Taxonomy, pursuing a framework that uses consistent language and metrics and is supplemented by different jurisdictional requirements.

Important considerations raised were the baseline that emissions reductions are compared against and the inclusion of Scope 1, 2, and 3 emissions. A participant raised the example of LNG displacing coal in the power sector where LNG terminals make up a big proportion of total emissions. If only viewed through the lens of Scope 1 and 2 emissions, the emissions reduction potential of LNG would be missed.

The discussion returned to the need for the industry to align around a standardized framework with which to measure and disclose key ESG performance metrics. A participant commented that the lack of data validity, comparability, and accuracy are the biggest problems in executing ESG-focused investment; some asset managers purchase ESG data services from over nine providers. Here again, the example of the EEI, which will soon produce a list of metrics most relevant to the sector, was provided as a potential roadmap for the oil and gas sector to follow.

How Should Performance, Measurement, and Disclosure Be Improved?

Participants provided numerous examples of the technology and organizational work being done in this area; many were specific to methane emissions. The Methane Guiding Principles was highlighted as a good example of a multi-stakeholder independent organization that has worked to improve methane disclosure and measurement.

A question was raised about the role of technology and whether investors view additional investments in technology to improve emissions measurements as good investments. In response, a participant representing a bank replied that reducing emissions in the oil and gas sector needs to be done in a measurable and verifiable way, especially given that current methodologies are inaccurate and underestimate the true emissions challenge. Another participant commented that measurement technology is improving quickly and deploying these technologies can eradicate super-emission events.

A participant shared the relatively “hands-on” approach that one bank is taking in facilitating conversations to bring solutions forward by facilitating the trialing and experimenting of new emissions measurement technology. The bank is incentivizing early movers within the oil and gas sector that are willing to deploy pilot projects to better understand the emissions profile of their operating assets. The bank also believes that the investments in better measurement and emissions reduction technology now will create market opportunities for low-emissions gas in the future, citing individual transactions in North America for net-zero LNG cargoes.

The Environmental and Climate Change Challenge Facing the Oil and Gas Industry

A participant succinctly summarized the three significant challenges facing the oil and gas sector as:

1. meeting the increasing global demand for climate change action, while
2. continuing to fuel the world’s energy demand, and
3. working to align the behavior of financial institutions and corporations to help support this energy transformation.

Many participants shared the view that oil and gas companies will decrease in value, and capital will tighten in the sector, an observation a participant shared is already happening in the US shale industry.

What Are Oil and Gas Companies Doing to Address the Climate Change Challenge?

The final section of the workshop focused on the actions the oil and gas industry are taking to address ESG and climate change risks. There was an array of differences in how oil and gas companies, both large multinationals and smaller independents, are thinking about and acting on the climate change challenge. A major multinational expressed optimism that decarbonization presents a growth opportunity with the potential for gas conversion into hydrogen and partnering with other industries, such as aviation and heavy-duty vehicles, to develop solutions for net-zero pathways. Another oil major participant shared the technology progress they have achieved in improving and deploying monitoring technology where, by the end of this year, 100 facilities will have real-time methane detection sensors, which will drive further emissions reductions down throughout the business. This same participant explained that their engagements with various stakeholders like SASB and TCFD are intended to drive wider change through the industry and noted the advocacy work being conducted through the Climate Leadership Council for a national carbon tax.

A smaller operator spoke about their pioneering work in aggressively highlighting the worst performers in flaring intensity in their basin and the stance they took in opposing the Trump administration's environmental regulation rollbacks. Various companies spoke about the emissions, flaring intensity, and methane targets they are incorporating into their strategy and the need for greater government policy in supporting these efforts. The producers also believed that there was the need to involve the midstream sector in the Permian basin, where their emissions play an important part in greenhouse gas (GHG) emissions for the total supply chain. A challenge cited was that two different regulatory bodies govern the midstream and upstream sectors in that basin, which hampers effective collaboration. A midstream participant responded that many midstream operators are willing to be part of the solution and called for the industry to work together to solve the problem rather than pushing responsibilities back and forth.

Are Trade Associations a Useful Way to Gain Industry Alignment or Are They Defined by Their Lowest Common Denominator?

A key contention was about the ability of trade associations to support the industry's efforts to address climate change risks and to gain industry alignment. An industry participant voiced disappointment that the American Petroleum Institute (API) recently came out in support of regulation rollbacks,³ further derailing confidence in the ability of trade associations to play a supporting role in this energy transition. Various NGO and industry participants underlined the fact that the oil and gas sector (and companies) are judged by the actions of its major trade associations, such as the API, irrespective of what its member companies may be independently advocating. An industry participant called upon investors to pressure exploration and production companies to not hide behind trade associations.

In response, several participants voiced their support for trade associations and urged others not to give up on them, citing that it has always been very hard to move the needle on trade associations and that it takes sustained incremental efforts. A participant highlighted the recent work of the American Exploration and Production Council to address common metrics around ESG reporting and shared his opinion that the industry is not far from a standard GHG

reporting methodology. Another participant shared the opinion that trade associations are powerful messaging and lobbying vehicles for regulations if their members can agree on a climate-friendly path forward.

An institutional investor suggested that industry leaders should not allow the trade associations to set the bar or the pace of change. The US nuclear industry has improved their safety record was cited as an example; the major industry body convenes an annual meeting on safety metrics in which CEOs of the bottom-performing companies have to present to the group actions they will take to improve their respective performance. Additionally, there are other ways in which the industry can collaborate to advocate for change with the Climate Leadership Council, which was cited by another participant as an example of other options available for advocating for more aggressive change.

Path Forward

To conclude the workshop, a discussion about Columbia University's Center on Global Energy Policy's possible path forward on ESG was held, and an outline of the potential next steps is listed below:

1. Convene a group of interested stakeholders to standardize the calculation of ESG climate metrics, particularly for the energy industry.
2. Convene a diverse group of stakeholders to research and recommend flaring regulations.
3. Help financial institutions determine how to measure the progress of oil and gas companies in meeting Paris Agreement targets.
4. Convene a group of interested stakeholders to determine how to utilize new sensing and satellite technology in measuring greenhouse gas emissions.
5. Develop a path for a new gas market that captures the opportunity presented by low-emissions natural gas.

Notes

1. Florian Berg, Julian F. Koelbel, and Roberto Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings," MIT - Sloan School of Management, August 15, 2019.
2. Kevin Crowley, "BP, Shell Urge Texas Regulator to End Routine Gas Flaring," *Bloomberg.Com*, September 11, 2020, <https://www.bloomberg.com/news/articles/2020-09-10/bp-shell-urge-texas-regulator-to-end-routine-gas-flaring>.
3. Noel King, "Oil Industry Group Responds To Methane Limit Rollback," NPR, accessed October 8, 2020, <https://www.npr.org/2019/08/30/755752333/oil-industry-group-responds-to-methane-limit-rollback>.

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