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HOW THE ESG INVESTING FRAMEWORK APPLIES TO NATIONAL OIL COMPANIES: WORKSHOP REPORT

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On November 16, the Center on Global Energy Policy (CGEP) at Columbia University SIPA convened a private workshop to discuss the applicability of the current ESG (environmental, social, and corporate governance) investing framework on national oil companies (NOCs). The workshop brought together representatives from NOCs, international oil companies (IOCs), international organizations, multilateral banks, private banks, institutional investment firms, ESG rating agencies, think tanks, and non-governmental organizations, as well as academics.

The group discussed the types of ESG pressures that NOCs face, how NOCs are responding to these challenges, whether all the components of ESG are equally relevant when it comes to

This event summary reflects the authors' understanding of key points made in the course of the workshop. It does not necessarily represent the views of CGEP.

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NOCs, the challenges associated with ESG reporting and ratings, how investors are integrating ESG considerations into their investment process in relation to NOCs, and the risks of future access to financing.

The main takeaways of the discussion are as follows:

1. ESG has gone from optional to essential for NOCs.

Workshop participants had a clear awareness of the relevance of ESG considerations for NOCs and the need for these companies to adjust. Some representatives from NOCs viewed ESG as essential for retaining these companies' social license to operate. The pressure on NOCs to adopt some form of ESG framework manifested from different sources. Some of the most pressing ESG considerations derived from the need to access international capital markets given NOCs' financing requirements. However, participants said partnerships with IOCs in joint ventures and regulatory pressures in global financial markets are relevant considerations for ESG adoption. Some representatives from NOCs identified a wider range of stakeholders pressuring for ESG compliance, such as employees and sometimes governments. However, the discussion revealed the complex role of governments as NOC shareholders and in NOCs' adoption of ESG standards.

Participants shared examples of how ESG considerations—mainly those related to environmental concerns—had the potential to impact NOCs' market access and borrowing costs. One NOC representative presented anecdotal evidence that some commercial partners were not only interested in the price per barrel of oil but also starting to inquire about the carbon intensity of the barrel of oil transacted. An NOC representative mentioned that negotiations with financial institutions can result in lower borrowing costs if projects can be proven to be environmentally sound.

2. NOCs are not monolithic—they face different ESG challenges and are likely to pursue different strategies.

Some participants stressed that when it comes to ESG, it is important to recognize that NOCs face different challenges across several aspects. These differences relate to their level and type of production, diversity of assets, technical and management skills, and particular trade-offs when dealing with their respective governments. According to one participant, the very role of NOCs in domestic economies is being revisited.

Some participants asserted that the ESG agenda and energy transition discussions are likely to generate different strategies among NOCs: some will move away from hydrocarbons and into other businesses, while others will optimize the production of hydrocarbons. One participant suggested that some might redirect themselves toward natural gas.

Even in the case of an NOC optimizing its use of hydrocarbons and not seeking to diversify into other business lines, there was a clear recognition of the need to follow a decarbonization path.

3. The ESG agenda has the potential to bring changes to NOCs' corporate strategies—some NOCs are already adapting, but others are progressing slowly or not at all.

Part of the discussion focused on whether ESG considerations are starting to revamp corporate strategies and facilitate a culture change within these organizations.

Some participants suggested that ESG considerations are already affecting the project pipeline of NOCs in terms of carbon intensity and could have a significant impact on their capital allocation in the future. Others saw even more far-reaching potential for ESG as a driver of institutional change within companies, mostly in terms of the "E" side of the equation.

One participant observed that ESG has evolved over the past 20 years from being largely a public relations exercise with loose links to business to being inextricably linked to business and increasingly used externally on the same level as traditional financial metrics.

However, another participant asserted that despite awareness of ESG some NOCs are simply repackaging the corporate social responsibility commitments that they have been making for years and that the cultural change that ESG could potentially bring is either happening slowly or not happening at all. (This was a reminder of the need for differentiation within NOCs.)

4. NOCs and IOCs are different but less so when it comes to the "E" in ESG.

Participants were keenly aware of the differences between NOCs and IOCs in regard to ESG considerations, particularly given the critical role that NOCs play in the economic development and energy security of their own countries. Such awareness led some participants to ask whether the ESG framework designed for publicly listed companies in the developed world is applicable to NOCs from developing countries, suggesting a need to be thoughtful when it comes to evaluating ESG performance in NOCs.

Participants generally shared an understanding of the critical role that NOCs play in oil markets, as evidenced by their high global share in current production. Some participants questioned whether NOCs should even be following IOCs in terms of business model diversification as they own the best oil reserves (in terms of costs and carbon intensity) and, in one participant's opinion, would surely be among the last suppliers of hydrocarbons even in a net-zero world. This point highlights the consideration that while the ESG agenda and energy transition are coming together, they are not necessarily the same thing.

One participant suggested that the standardization of environmental metrics should evolve quicker and should be the same for IOCs and NOCs. This point aligned with the views of participants from financial institutions, some of whom are looking at IOCs' ESG performance and including their non-operated assets in their scope of analysis.

Given the importance of NOCs to global oil markets, one participant argued that they are key to achieving climate goals. This participant highlighted the increasing number of NOCs making carbon emissions reduction pledges, with some even committing to net zero by 2050. Similarly, another participant suggested that convincing NOCs to join efforts to reduce methane emissions was crucial to meeting climate goals on a global scale.

Differences between IOCs and NOCs in terms of ESG became more apparent in the discussion of "S" and "G."

5. Corporate governance is a critical component of ESG for NOCs.

One participant suggested that the ESG framework for NOCs should really be labeled the "GSE or GES framework," given the importance of corporate governance to NOCs. This point echoed comments by other participants that governance was key for getting "E" and "S" right.

Given the distinct ownership structure of NOCs, the workshop addressed the role of shareholders in NOCs' adoption of ESG standards. Some believed that NOCs must get ahead of their shareholders given the potentially negative consequences of not adopting ESG standards, including those related to access to capital. Others recognized the challenges posed by government ownership to meeting certain ESG requirements from investors and even to achieving further progress on ESG transparency.

Some participants discussed how governance factors among state-owned companies in the energy sector and NOCs differ. Several participants underscored that these factors are more crucial for NOCs, given their role in capturing and distributing oil rents, than, for example, a state-owned company that consumes or produces energy. One participant argued that mitigating corruption and political capture should be a major part of "G" for NOCs. Another participant emphasized the importance of governance factors particularly in the case of NOCs that are 100 percent owned and face the risk of key positions being assigned through political arrangements, unlike publicly listed NOCs, which must consider their minority shareholders.

Some participants highlighted board appointments in NOCs as an area of improvement in terms of governance as they remain nontransparent and discretionary. One participant cited the importance of independent board directors in NOCs.

6. The "S" dimension in ESG emerged as one of the more complex and ill-defined categories for NOCs.

Some of the NOC representatives believed that the "S" category, as defined currently, does not adequately account for the historical role that NOCs have played in energy security and as providers of public goods. Participants emphasized how this historical role was a critical measure of stakeholder value in a NOC's home country. In fact, some participants considered the "S" category the most ill defined for NOCs, with a few even suggesting a developed market bias that does not allow for a more objective measurement of NOCs' relevance and underestimates their contribution to achieving certain United Nations Sustainable Development Goals.

Some participants affirmed that NOCs will continue to play a valuable role in providing affordable and secure access to energy in the energy transition. The high cost of energy was raised during the discussion, with one participant cautioning that the transition to a cleaner world should not come with a higher price tag. In the view of one participant, such an outcome risks alienating the large portion of the global population that is still dealing with energy poverty. There was a general call for better integration of contributions to energy affordability and energy security as metrics in the "S" category.

This part of the discussion also led to disagreements. Some participants questioned whether NOCs are the most efficient way to deliver public goods or conduct social policy. Others noted governance issues surrounding such non-core activities.

In response, some participants underscored that the relative operational capabilities of NOCs within their home countries leads shareholders to rely on them for a range of issues including disaster relief. Another participant suggested that the ability of NOCs to separate themselves from the demands of governments as shareholders related to the provision of public goods depends on their size as well as their weight in the economy. Another participant suggested that publicly listed NOCs face more limitations in the provision of public goods.

7. Investors' view: ESG is becoming a key component of investment strategies around NOCs even as investors understand the need for oil and gas in the foreseeable future and the role that NOCs play in their local economies.

There was general consensus among investors that oil and gas will be needed for decades to come. One investor pointed out that oil and petrochemicals will continue to be vital for many industries and that natural gas, and liquefied natural gas in particular, has the potential to serve as a transition fuel. Some investors believed that NOCs have a critical role to play in the energy transition. One participant highlighted the fact that two-thirds of the coal-fired power generation plants in emerging economies are state owned, and another emphasized how a large share of global hydrocarbon production is produced in joint-venture enterprises involving NOCs.

Several participants spoke about how ESG has grown to become a core component of their investment strategies and how the demand for sustainable investment funds has been soaring. One speaker highlighted the fact that currently an estimated $40 trillion, or 40 percent of global assets under management, is managed and subject to some form of ESG consideration.

Some participants argued that ESG risks are particularly acute for NOCs given their significant role in hydrocarbon production; however, many investors recognized the different set of considerations they face compared to other kinds of companies. As one participant mentioned, NOCs not only serve to generate money for their shareholders but also must contribute to the national budget by monetizing national resources and must catalyze national growth by providing affordable and accessible energy.

8. Investors will be demanding more integration of energy transition considerations into ESG frameworks.

Many investors invoked the importance of integrating the energy transition into the "E" of ESG. Not only is it important for companies to have good environmental performance but they should also be aligned with the low-carbon transition. This priority should manifest in science-based long-term and interim targets aligned with net-zero pathways along with the disclosure of decision-relevant information. As one participant emphasized, transparency regarding ESG metrics is vital for building trust between regulators, investors, and corporations and allows investors to hold companies accountable for their performance.

A broader point that investors were making is how companies, including NOCs, need to be planning for the energy transition and future-proofing to the extent possible given regulatory changes, the rising cost of carbon, changes in consumer preferences, a need to attract talent, and the realization that peak oil demand will happen eventually.

Some participants saw real long-term value in the companies that are attentive to ESG factors and best able to prepare for the future. However, another participant pointed out that the incentives for NOCs to pursue ESG-type projects need to be significant and material. This participant explained that a difference of 25 basis points in the costs of capital of green bonds if environmental metrics are not met is insignificant for a company in the emerging market space.

9. NOCs and the risk of future access to financing: There seem to be enough investors wanting to engage versus divest, but their willingness to do so could become conditional on real progress toward ESG compliance, particularly on "E."

Several investors referenced their clear preference for an engagement rather than a divestment strategy to drive change within companies. Some stressed that investors want to engage with companies in a constructive way and that progress can be measured relative to each company's starting point.

Another speaker mentioned the concept of equitable disclosure when working with NOCs to balance investor needs for information with what NOCs and their respective governments are comfortable providing. In addition to the theme of engagement, the opportunity for NOCs to help accelerate the transition was discussed. One participant pointed to the important role that NOCs play in generating cash for the many capital-intensive projects that the energy transition requires.

Another participant spoke about the opportunity for NOCs to facilitate the transition from legacy to new assets (i.e., hydrogen, green ammonia, and renewable energy) with their significant balance sheets, expertise, and government links. This participant opined that the use of carbon offsets will be key in driving capital into these new areas and that NOCs also have an important role to play in developing the use of and marketplace for high-quality offset projects.

In keeping with the theme of access to finance, one participant discussed the significant investments needs required to finance the energy transition in emerging markets. But the main barrier to large-scale capital flows, in this participant's view, is typically related to ESG concerns, which result in high country-level risks. These risks are tied to legal, reputational, and macroeconomic risks.

10. The convergence of frameworks and regulations is key to unlocking sustainable investment practices.

Workshop participants called for a convergence of the various ESG frameworks and regulations, especially on the "E" standards. Anything less, several speakers warned, would risk the global fragmentation of markets and hinder the development of sustainable investment practices. A representative from a major IOC stressed that this convergence of standards is key for IOCs and NOCs to retain a "shared license to operate." This participant elaborated that given that the energy transition is a relevant issue for both NOCs and IOCs, there is much to gain from working together and sharing best practices to build standards and help ensure that access to financial markets remains fluid. Such benefits would be at risk if regulations in the key regions of the European Union and the United States continue to diverge in ESG disclosure standards.

This aspiration for a global standardized ESG framework was at odds with observations regarding the expected Securities and Exchange Commission (SEC) rules around climate-related disclosures as shared by an expert on these regulatory movements. This expert indicated that expectations are that the SEC's initial focus will be on material climate risks and as such is likely to be narrow in scope. The SEC is expected to make explicit that mandated ESG disclosures must clear a "double materiality" threshold (i.e., have a material effect on a company's financial performance and impact society or the world). For example, the disclosure of Scope 3 emissions is unlikely to be mandated as its relation to materiality is unclear and hotly contested. However, this expert raised the possibility of the SEC requiring specific disclosures such as scenario analyses that are aligned with the Task Force on Climate-Related Financial Disclosures framework and need not be subject to the materiality screen. Although the expected narrow scope of coming SEC rules may exclude what is not important for companies to disclose, this participant suspected that there is still a long way to go before a globalized framework is in place, especially as the proposed rules might be challenged in court and take some time to come into effect.

A representative from an NOC said double materiality as a reporting principle should help reduce reporting distractions.

One participant pointed out that ESG reporting could be overwhelming for organizations. The participant said that it is becoming a discipline that is resource intensive and that building internal competence will take time. Controls and data management systems are necessary to produce high-quality ESG data that will meet formalized reporting requirements, on par with financial data disclosure. This participant stressed the role of ESG reports in lending credibility to energy transition plans.

However, some participants pointed out that ESG frameworks have largely been developed from the perspective of publicly listed companies with private shareholders and thus have not adequately accounted for the state-ownership perspective.

Investors were also skeptical about the use of ESG ratings, with one participant dubbing the landscape an "alphabet soup." With third-party ratings relying on web-scraped data and many not engaging with the companies they assess, investors found the ESG ratings, and the methodologies used to calculate them, unhelpful in understanding and comparing the ESG performances of different companies. For example, as one participant pointed out, a company could be rated at the lowest quintile of performance even if there is no information available on that company. Another participant shared the view that many of the ratings agencies are backward looking and do not provide a picture of future performance, while yet another suggested that from the companies' perspective, the requests from ratings agencies, combined with the requirements of the various ESG reporting frameworks, can be overwhelming and may put companies at risk of losing track of what is really important to them.

Note

1. Luisa Palacios, "The Impact of ESG on National Oil Companies," Center on Global Energy Policy, November 21, 2021, https://www.energypolicy.columbia.edu/sites/default/files/file-uploads/NOC%20ESG%20commentary,%20designed%20v2,%2011.12.21.pdf.

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Before her time at Citgo, Palacios was a Senior Managing Director and member of the management committee of Medley Global Advisors, a macro policy research firm. She headed Medley's Latin America and later the firm's emerging market research efforts. She previously worked at Barclays Capital as a Director in the emerging markets research department, and as an economist in the risk department at Société Générale in Paris. She also worked as a senior economist at the Japan Bank for International Cooperation and was a consultant in the Office of the Chief Economist for Latin America at the World Bank.

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