The institution of environmental, social and governance (ESG) values and metrics represents a true revolution in how corporations are managed, measured, and operated. This sea change will continue to drive companies away from the familiar framework of short-term profits toward success that is not only defined by profitability, but also by a “sustainable” and measurable contribution to the betterment of society at large. This new paradigm brakes a long-established mold. While ESG is perceived by some to be— and can be— difficult to implement, and it may seem like a profit-killer, the irony is that for most companies that implement
ESG programs, including those within the oil and gas industry, it has the opposite effect.

According to the International Energy Association’s (IEA) 2021 Global Energy Review, renewable energy grew 3% in 2020, inclusive of a 7% increase in electricity generation from renewable sources. Logic would imply that, all things being constant, fossil fuel demand would decline. But all things are not constant, and due to an estimated 4.6% increase in global energy demand this year, a year when the world continues to feel the effects of COVID-19, the demand for fossil fuels has not diminished and will not any time soon. Coal, driven largely by Asia, is a significant part of that demand, but natural gas is a driver across nearly all geographies. Even as we seek to supply more of our growing energy needs from renewable sources, the demise of fossil fuels – for good or for bad – is greatly exaggerated. While the industry itself is not going away, the way in which it operates and its contribution to the economy and society most certainly will be transformed.

Why is that? Certainly the societal implications of a focus on ESG represents an ethical imperative. But the truth is that money talks. BlackRock is the world’s largest investment manager with $10 trillion of assets under management. According to S&P Global, as of February 2021, oil and gas represented 2.55% of its total investments and coal and consumable fuels accounted for 0.36%. Despite these small percentages, the investments are material and represent close to $255 billion and $36 billion respectively in the energy sector. As such, when BlackRock’s CEO Larry Fink speaks, people listen, including those in the energy sector. To that end, in a 2020 letter to investors, Larry Fink warned that “Given the groundwork we have already laid engaging on disclosure, and the growing investment risks surrounding sustainability, we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them.”

While BlackRock has been and is instrumental in creating the ESG imperative, it is just one of the many stakeholders pushing companies in all sectors to embrace ESG and to develop metrics to measure progress towards identified goals.

Despite all the talk about the energy transition, net zero economy goals and the importance of ESG overall, energy companies should not lose site of the fact that 1) it is unlikely there will be a decline in global energy demand - populations are continuing to grow - and 2) broad index funds, as opposed to actively managed funds, simply cannot abandon the sector or create stranded assets. But, a lack of an ESG strategy will ultimately affect a company’s access to public, and increasingly private, capital. And that will happen to all companies, whether publicly funded or not.

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Aside from the monetary pressure on companies to implement ESG programs, there also is increasing pressure on companies to properly manage ESG issues stemming from the federal government due to this Administration's effort to address global climate imperatives and environmental justice. The Biden Administration has made
both the fight against climate change and environmental justice foundational to its agenda. Upon his inauguration, President Biden quickly rejoined the Paris Agreement and set a 2030 target to cut GHG emissions by 50 percent from 2005 levels. Getting there will require stepped-up federal regulation and enforcement of environmental protection across a wide range of industries. Additionally, within days of his inauguration, President Biden signed Executive Order 14008 entitled *Tackling the Climate Crisis at Home and Abroad*, further making clear his intent to establish a government-wide approach to address the “climate crisis” and ensuring environmental and economic justice issues are key considerations in how the Administration governs.

Widespread support of ESG policies, matrices and the overall energy transition is no doubt rooted in some critical and likely accurate assumptions. Climate change poses a serious threat to the destabilization of global economies in decades to come. Large tracts of farm land could become unproductive due to shifts in temperatures. Major coastal cities could become uninhabitable due to rising ocean tides. The prospect of such catastrophic change makes a compelling case that long-term economic prosperity is dependent on the mitigation of greenhouse gas (GHG) emissions as quickly as possible. And the social unrest and realities of COVID-19 over the last two years have pushed to the forefront of everyone’s mind the importance of social issues across the board. These images drive a belief that the “E” in ESG is defined only by climate change caused by fossil fuel production and consumption and the “S” is defined by diversity, equity and inclusion programs. But both definitions are too narrow. “E” includes a much broader range of considerations and takes into account a company’s utilization of natural resources, including land and water use, and the effect of its operations on biodiversity and the environment generally, both in their direct operations and across their supply chains. Pollution and waste covers not just carbon emissions, but also packaging, other regulated and emerging contaminants, and the depletion of limited natural resources such as rare earth metals. Investments in renewable resources represent a clear environmental opportunity, but not the exclusive one. There is much that energy exploration and production (E&P) companies can do to align themselves with ESG values that extends well beyond their end product.

Most of the large integrated energy companies are well on their way to establishing ESG policies and programs and have begun efforts to reduce and minimize their impact on the environment. Just a few examples include:

- In November of 2020, Occidental Petroleum Corp. became the first large U.S. petroleum producer to set a net zero emissions target associated with their own emissions by 2040, and a commitment to reduce GHG associated with their products by 2050.

- Shell Oil, held a shareholder vote this past year to approve their sustainability strategy which was met with 89% approval. The premise of that strategy was their goal to reduce by 100% their carbon intensity by 2050.

- ExxonMobil has announced a four-prong sustainability framework that includes the investment of $3 billion in carbon capture and storage projects.

- British Petroleum invested and continues to invest significantly in wind, solar,
and hydrogen and is one of the largest contributors to renewable organizations globally. In 2020 they divested operations that reduced the company’s overall emissions by 5.4 Mte making an initial step towards their stated goal of reducing emissions by 41 Mte by 2050.

- And, Kinder Morgan recently formed a new unit to explore green energy opportunities, including the storage and handling of liquid renewable transportation fuels such as ethanol, biodiesel, renewable diesel, and hydrogen.

What’s clear from the headlines and to anyone working in the industry is that energy companies are paying attention and embracing the ESG revolution. Shareholder buy-in, media pressure, customer expectations and demands are the drivers of change for Big Oil. But what about mid-sized and small players? As noted above, they too will increasingly be motivated by access to capital along with customer expectations and ethical concerns. How ESG programs are instituted at these companies, however, may look a little different with thinner operating margins and limited human capital.

The key for any company is to know where it stands now so that it can get where it wants to be. Every company must understand where they stand within the ESG framework and have policies tailored to that company with goals aligned with business strategies. It seems basic, but it is critical. Only then can progress be measured.

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Intentional implementation of metrics over a prescribed timeline is critical to longer term success. Amy Stutzman, Managing Director of Opportune, a leading global energy business advisory, was right when she said, “I think you start small and then scale up over time. From what I’m hearing in the market and from private equity, there’s not an expectation of perfection in year one but rather the expectation is that companies are engaging in the issues and showing progress over time.”

But what about adherence and compliance? The answer for small and mid-size companies is no different than that for large public companies: industry specific standards and guidelines are needed, companies need to identify goals and targets, and managements need to be incentivized for success. A September 2020 report by Kimmeridge rightly or wrongly points out with regard to E&P companies that “without a realignment of management incentives, the drive for volume over returns will continue, as will wasteful production and more flaring, coupling poor economic outcomes with poor environmental outcomes.” What we all can agree on, and what investors like BlackRock expect, is that companies begin to benchmark, identify policies, develop programs, track progress towards goals, and align executive compensation packages to short and long term progress towards ESG goals.

Establishment of reporting guidelines has begun, which of course will provide a guidepost for the development of programs and benchmarking against other companies. The Securities and Exchange Commission, the Sustainability Accounting Standard Board (SASB), the American Petroleum Institute (API), Carbon Disclosure Project (CDP), and the Task Force on Climate-related Financial Disclosures (TCFD),
are each designing frameworks based on stakeholder input for disclosures and reporting. But regardless of these standards, companies need to create programs that are tailored to their operations.

With regard to the “E”, Kimmeridge’s report suggests three specific goals for E&P companies:

- Zero flaring of gas. Gas flaring produces 2% of global methane.
- 100 percent recycled water for fracking.
- Net zero emissions.

Beyond that, and in line with the reasoning above, E&P companies can indeed look at water recycling in fracking to address the “E” component, but also monitoring pipeline leaks, undertaking clean air initiatives and generally focus on reducing environmental releases and incidents of non-compliance. Employment practices, community engagement, and worker safety measures address the “S” part of ESG, as do the development and implementation of diversity, equity and inclusion programs, efforts to improve customer satisfaction, product safety and quality assurance programs, and overall improvements in data security. As for the “G” in ESG, this refers to the governance factors – policy making and the distribution of rights and responsibilities among different participants in a company, including the board of directors, managers, shareholders, and stakeholders. Governance drives incentivization and adherence to guidelines and includes the role and makeup of boards, compensation and oversight of top executives. These are just a few considerations that are illustrative of ESG opportunities for an industry perceived as antithetical to the framework’s guiding principles. But, as Ms. Stutzman astutely points out, ESG “is an opportunity for oil and gas companies to tell their stories and positively impact the market perception of the industry because the industry already does so much for the environment and is already giving back to the communities that they work in.”

The fact is – ESG has gone mainstream. Bloomberg tracked almost 300 mentions of ESG on energy company earnings calls in the first quarter of the year. Self-recognition of the role E&P companies play in climate change and other ESG initiatives as well as a more creative perspective on the framework will hasten the process for any size of company. The genie is out of the bottle, and ESG is here to stay for the good of society at large. While the ESG movement may well be a functional and cultural change that seems daunting to tackle on the front end, all that is expected of companies right now is that they embrace the concept and take action.

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Below are a few steps that can help E&P (or any) company start down the road.

- Create a cross-functional team to develop a process to craft a plan. Ensure that this team includes members of the company’s disclosure committee.
• Consider retaining an outside consultant to help craft your plan and reporting framework—preferably someone with experience assisting companies in the same industry.

• Work with energy industry trade groups to learn what peers are doing with respect to climate plans and preparations for disclosures.

• Review policies and procedures to ensure they address ESG and climate risk and then continue to evaluate how effectively the company has executed on these policies. The board should be satisfied that implementation of the policies and procedures effectively aligns with the board's overarching strategy and is moving the company towards net-zero.

• Require reporting throughout the company so that managers know that corporate executives are focused on climate change as a business imperative.

• Continue board education on frameworks for the plan and related disclosure obligations. Education is not a one-time event, and effectively should trickle throughout the organization.

• Establish regular board review cadence and oversight of the planning process, the plan itself, and progress against the plan.

• Document steps, process and progress in a way that does not create an undue distraction for your company. Many small-cap companies will not be able to devote a large staff or resources to climate issues. The roadmap and the goals must be credible and authentic to what the company can realistically deliver.

BlackRock and other shareholders, the SEC, proxy advisory firms, and trade groups will undoubtedly continue to pressure companies to address climate risk and adopt ESG policies and goals. Taking small steps today with additional steps planned for the future can put your company on the right path to stay aligned with various stakeholders.

There is no rule prohibiting creativity. In fact, looking at your business through a different lens may offer some opportunities for reframing your basic assumptions and unlocking value in hidden corners. In many cases, embracing ESG and it has to offer is a journey that produces long-term benefits for a company. Good sustainability practices can sometimes produce savings over time and satisfy some of your company's most-important constituencies. It also may create a value proposition and a marketing narrative to bring in new investors, along with new capital.

“The creation of sustainable index investments has enabled a massive acceleration of capital towards companies better prepared to address climate risk,” Fink wrote in a 2021 letter to CEOs, adding that he has “great optimism about the future of capitalism and the future health of the economy—not in spite of the energy transition, but because of it.” Hopefully, he will be proven right.