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Managing ESG Risks through the Energy Downturn

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As environmental, social and governance (ESG) issues have gained ever more attention in recent years, energy companies have experienced increasing pressure from a wide array of constituents, including shareholders, employees, customers, suppliers and the communities in which they operate, to develop strategies for the integration of ESG factors into management decisions and company operations.

At a time when the energy industry is facing the “perfect storm” of depressed commodity pricing, decreased demand for its products due to the COVID-19 pandemic and rising expressions of concern over the short- and long-term effects of climate change, boards and executives are grappling with evolving expectations regarding ESG-related performance and disclosures.

From an investment perspective, interest in ESG is grounded in the premise that investors will benefit by factoring ESG factors into investment decisions. The theory is that ESG-positive activity by companies leads to growth that is resilient to adversity over the long term, because measures have been taken to mitigate ESG risks, if not also to capitalize on them. This hypothesis has been supported by recent research from institutional investors and other market observers claiming that sustainable index funds outperformed their broad market counterparts in 2020. These findings will likely be a subject of ongoing debate in 2021.

For the energy industry, investors are keenly interested in steps being taken to address climate change risks, manage through decreased energy demand and respond to increased pressure to transition from fossil fuels to renewable or carbon-free energy. The COVID-19 pandemic has highlighted the role of ESG on the ability of both investors and energy companies to withstand crises. Many energy companies are taking the position that now is the time for the energy industry to develop ESG programs and goals and to manage ESG risk through the downturn, rather than to resist calls to adapt.

Beyond creating shareholder value, companies’ ESG profiles are beginning to affect how the market prices risks, credit ratings and the cost of capital; financial prospects at an initial public offering or spin-off; management of mutual funds, exchange-traded funds and indices; company oversight and risk management practices; executive compensation; and board composition. ESG also affects how institutional investors cast their votes at annual director elections. The market currently is seeing historical fund flows into ESG-themed funds, and energy companies do not want to be left out of this.

Although climate change has been an area of focus for the energy industry for decades, the outcome of the U.S. presidential election will significantly impact the energy sector. President-elect Joe Biden has published an ambitious climate change plan that is designed to ensure that the United States achieves a 100% clean energy economy and reaches net-zero emissions no later than 2050. It is expected that a Biden administration would enact regulations and push for legislation that limits greenhouse gas emissions from oil and gas operations and places restrictions on drilling on federal lands.

In recognition of the possibility of increased regulation and changing attitudes of investors and other stakeholders regarding climate risk, energy companies and energy-focused investment firms have been developing new strategies. These include greenhouse gas and consumption reduction targets, discontinuation of freshwater use for drilling and plans to increase investments in ESG-conscious funds. Several public companies in the energy sector have addressed these initiatives in earnings calls. Each new strategy carries its pros and cons for meeting investment goals and environmental and social targets.

For example, public announcements of net-zero carbon emissions goals are becoming more frequent among energy companies, particularly in Europe, but they have also been the subject of criticism from ESG-proponents for being insufficient to meet the challenges of climate change. Many energy companies are nevertheless adopting the view that revising their strategies and improving their profile from the ESG vantage point may be useful for obtaining capital and financing on favorable terms, and additionally for maintaining a positive rapport with investors in the years ahead.

Every member of the senior management team has a role to play in addressing ESG considerations. Beyond the CEO, CFO and general counsel are leaders of the health, safety and environment, human resources, procurement, marketing, government relations, investor relations and public relations teams. While officers and directors may have different perspectives on ESG issues and the demands of investors, they should be on the same page regarding the company’s values and goals for implementing ESG strategy. Coordination is beneficial not only for business strategy but also for mitigating legal risk. CEOs should take a careful look to ensure that management is well situated and staffed to handle new demands related to ESG and has access to advice and training that may be needed to accomplish goals.

Executives in the energy industry can also take advantage of benefits to be gained from working with industry associations and coalitions such as the International Association of Oil and Gas Producers, the International Petroleum Industry Environmental Conservation Association, the American Petroleum Institute, the Independent Petroleum Association of America and the Energy ESG Council. These organizations are involved in initiatives to help energy companies manage sustainability reporting and to navigate emergent challenges for the industry in an increasingly ESG-conscious era.

Through the development and implementation of a multifaceted ESG approach, energy companies can demonstrate their commitment to addressing climate change risks and other ESG factors while focusing on strategies that can give confidence to investors of the prospect of strong and sustainable value growth ahead, even in the midst of an economic downturn.

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