Why ESG Considerations Matter For Energy Executives

By **Heather Palmer, Leonard Wood and Samina Bharmal** (October 8, 2020, 5:05 PM EDT)

Environmental, social and governance, or ESG, issues are now top of mind for boards and managers of companies in all industries. Energy companies, in particular, are grappling with evolving expectations regarding ESG-related performance and disclosures, as communicated by shareholders, employees, customers, suppliers and communities, as well as by regulators, rating agencies and standard setters.


Heather Palmer


Leonard Wood


Samina Bharmal

In the current environment, where companies are navigating the COVID-19 pandemic and facing expanding expressions of concern about climate change and social justice, energy executives need to remain focused on sustainable long-term value creation for shareholders and building positive relationships with other stakeholders, while crafting communications and engagement strategies that resonate when reviewed through an ESG lens.

Investors have been interested in ESG-related principles for a number of years, but this interest has only heightened during the global pandemic. Institutional investors increasingly see a direct link between ESG factors and financial value, and they are urging executives to focus on ESG risks and opportunities to bolster long-term performance. As a result, it is important for energy executives to consider the following emerging trends in navigating the ESG landscape:

Climate Change Risks and Net Zero Commitments

Climate change has been an area of focus for the energy industry for decades. Public energy companies have enhanced their disclosures around climate change risk over time in response to the U.S. Securities and Exchange Commission's Guidance Regarding Disclosure Related to Climate Risk,[1] published in 2010, and increased interest from investors and other stakeholders in how the company manages and mitigates those risks.

Recent weather events in the western U.S. and the Gulf of Mexico have led to more public and media scrutiny on energy companies and their approach to addressing climate change concerns. In recognition of changing attitudes of investors and other stakeholders regarding climate risk, energy companies and energy-focused investment firms have been developing new strategies, such as greenhouse gas reduction targets, consumption reduction targets and plans to increase investments in ESG-conscious funds.

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.[2]

In establishing ESG goals and reporting on related milestones, a company should consider the potential legal risks associated with overreaching or overstating its achievements. Notably, a company could face regulatory scrutiny or shareholder actions arising out of inaccurate or misleading environmental disclosures. "Greenwashing" allegations might also materialize in the form of lawsuits under state consumer protection laws or other novel legal theories.

Even when successfully defended, such actions can damage the company's reputation and negatively impact the company's financial performance. To address these risks, in setting ESG targets, energy executives must balance between achievable goals that the company can measure and substantiate, and aspirational goals that rely on outside factors beyond the company's control.

Since the SEC issued its 2010 guidance, investors and other market participants and observers have called on the commission to look into expanding and standardizing disclosure requirements regarding environmental factors in company operations. In May, the Investor-as-Owner Subcommittee of the SEC's Investor Advisory Committee recommended that the SEC initiate an effort to update its public company reporting requirements to include "material, decision-useful" information relating to ESG issues, including climate change.[3]

Members of Congress have also called on the SEC to expand disclosure requirements for environmental and social factors by taking guidance from nongovernmental standard setters and framework developers.[4] While the SEC's recent amendments to Regulation S-K do not address climate change risk, it is expected that investors' calls for enhanced climate change disclosures will continue to grow.

Addressing Social Factors

The COVID-19 pandemic has underscored the importance of looking after the S factors in ESG — the social dimensions around employee health and safety, employee support and motivation in a virtual workplace, and hiring, retaining and retraining employees. Additionally, lawsuits and empirical studies appearing during the pandemic have highlighted gender and racial pay gaps as a basis for concern and potential corporate liability.[5]

Institutional investors are increasingly advocating that a company's performance on these social issues is inextricably linked to business continuity, resilience, reputation and brand values. An energy company that addresses these issues proactively — for example, by committing additional resources to maintain a safe and healthy workplace, or by investing in virtual training and collaboration tools — can demonstrate to investors a stepped-up commitment to create sustainable value.

Boards are increasingly focused on management's efforts to identify issues and risks around health and safety and the financial and operational risks that are presented by the pandemic and reopening the workplace safely — such as implementing sanitation protocols and virus testing requirements, and addressing workspace density concerns.

The Sustainability Accounting Standards Board, or SASB, which aims to identify issues most likely to affect the financial condition or operating performance of companies in different industries, views employee health and safety as a significant material issue for energy companies generally.[6] Enhanced scrutiny around worker health and safety is expected to continue into 2021, as more workers return to the office and oil and gas drilling increases.

In addition, as expressions of concern rise in the U.S. regarding social justice, energy executives need to be attuned to these issues and strategic in their responses. This is a moment to take an in-depth look at how the company is emphasizing and implementing a commitment to diversity and equal opportunity through the recruitment, training and promotion of employees.

Energy executives who are perceived as falling short in addressing diversity and inclusion issues risk appearing detached and, in the view of ESG proponents, missing opportunities to foster stronger relationships with employees and customers who are increasingly interested in associating with businesses that have a socially and environmentally responsible profile.

Institutional investors are beginning to demand more in the way of commitments to diversity and disclosures to reflect related progress. In August, State Street Global Advisors Inc. sent a letter to board chairs of public companies informing them that, beginning in 2021, State Street will expect companies to provide specific communications to shareholders regarding a company's goals for board and workforce diversity, measures of board and workforce diversity, and board oversight of diversity and inclusion.[7]

State Street indicated that it is prepared to use its proxy voting authority at annual meetings to hold companies accountable for not addressing these expectations. State Street is not alone in increasing pressure on public companies to boost the diversity of their boards and workforce and to expand related disclosures. The past four proxy seasons have seen over 350 shareholder proposals at U.S. public companies calling for disclosure about board and workforce diversity, diversity policies, discrimination and gender pay gaps.[8]

The SEC recently revised Regulation S-K to require further disclosure regarding a company's human capital resources.[9] The amendments to Item 101 of Regulation S-K require companies to provide a description of their human capital resources, including any human capital measures or objectives that the company focuses on in managing the business, to the extent material to an understanding of the company's business taken as a whole.

This new, principles-based rule does not constitute a prescriptive requirement for disclosure of specific diversity statistics or the use of specific measuring criteria. Rather, disclosure can be tailored to a company's particular business, workforce and facts and circumstances, which will evolve over time. Energy executives should steer their companies in evaluating how human capital resources impact the business and crafting appropriate disclosures.

Energy executives seeking to enhance a company's diversity policies and related disclosures must be mindful that doing so can mitigate existing risks while creating new ones, such as inspiring allegations that the company failed to adhere to or achieve projections and objectives regarding diversity. It will be important for companies to compare prospective diversity disclosures against their existing governance policies, regulatory documents and public filings, as well as statements made in any litigation, to address potential risks from perceived inconsistencies.

Accordingly, companies looking to elaborate on their diversity and inclusion objectives should be careful how they frame these objectives, considering how these statements will read in the future, and the timeframes that may be needed to meet their stated goals.

Rising Influence of Nongovernmental Standard Setters and Raters

In the absence of more specific mandates for the disclosure of environmental and social factors from the SEC, institutional investors are increasingly demanding voluntary disclosure of ESG data that is quantitative and facilitates easier comparison of ESG performance across companies.

In connection with this trend, a number of nongovernmental standard setters and framework developers, such as SASB, the Global Reporting Initiative, or GRI, and the Taskforce on Climate-related Financial Disclosures, have gained prominence as more companies and investors look to these standard setters for guidance on ESG best practices in disclosures and operations.

The coexistence of competing, voluntary disclosure standards and frameworks is a two-edged sword. The existence of multiple disclosure regimes may be viewed as a plus for investors who support the continuing expansion of companies' ESG disclosures. Conversely, the variety of disclosure methods leaves companies unsure as to which methods to use, and makes it difficult for investors to compare ESG performance across companies.

The nongovernmental standard setters continue to explore ways to collaborate and align on a unified, global standard for ESG disclosures. In July, the GRI and SASB announced a new project to collaborate for the purpose of "promoting clarity and compatibility in the sustainability landscape."[10] In September, CDP (formerly the Carbon Disclosure Project), the Climate Disclosure Standards Board, the GRI, the International Integrated Reporting Council and SASB issued a statement of their shared vision for a comprehensive corporate reporting system and a commitment to collaborate to achieve it.[11]

Third-party raters, such as MSCI Inc., Refinitiv, Sustainalytics BV and S&P Dow Jones Indices, to name only a few, are rating energy companies on a wide variety of ESG factors, resulting in scores that purport to allow investors to reliably compare the ESG performance of public companies across the energy sector. Institutional investors are increasingly factoring ESG considerations into their investment and voting decisions and engagement activities, relying on ESG disclosures and a company's ESG performance ratings to determine which companies to invest in and which companies to include or exclude from their new ESG-focused funds and portfolios.

Energy executives should consider steering their teams to rigorously benchmark the scores assigned to their company with those of its peers, to ensure that its strategy for disclosing ESG risks remains in line with other industry participants.

Transition to the New Normal

A related and central consideration for energy executives in 2021 will be the pivot to the new normal. Executives should be asking questions that will help to set the company on a strong footing from a legal standpoint, as well as the business standpoint: What are the aspects of the business that are likely to change in a reopened economy and in the long term? How does the company plan to manage through decreased energy demand or the transition to renewable or carbon-free energy? What are the opportunities and the risks that will emerge? How is management actively managing those opportunities and mitigating identified risks?

Board scrutiny is likely to intensify as management is tasked with addressing and evaluating the broader, bigger picture of how to create long-term value for shareholders if global demand for fossil fuels continues to shift and pressure on energy transition accelerates.

Through the development and implementation of a multifaceted ESG approach, energy companies can demonstrate their commitment to addressing climate change risks and social issues, while focusing on strategies that can give confidence to investors of the prospect of strong and sustainable value growth ahead.

Heather M. Palmer is a partner, and Leonard Wood and Samina M. Bharmal are associates, at Sidley Austin LLP.

[1] SEC, Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469 (Feb. 8, 2010), http://www.sec.gov/rules/interp/2010/33-9106.pdf.

[2] See, e.g., Growing Commitment to a Net-Zero Future, Center for Climate and Energy Solutions, May 12, 2020, https://www.c2es.org/2020/05/growing-commitment-to-a-net-zero-future/; The Race to Net Zero: Decarbonization Commitments in the Oil & Gas Industry, Sustainalytics, July 15, 2020, https://www.sustainalytics.com/esg-blog/the-race-to-net-zero-decarbonization-commitments-in-the-oil-gas-industry/.

[3] See Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure (as of May 14, 2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf.

[4] See, e.g., Warner on New GAO Report Highlighting Importance of Requiring Corporate Disclosure of Environmental, Social and Governance Issues, July 6, 2020, https://www.warner.senate.gov/public/index.cfm/2020/7/warner-on-new-gao-report-highlighting-importance-of-requiring-corporate-disclosure-of-environmental-social-and-governance-issues.

[5] See, e.g., Sonam Sheth et al., 7 Charts Show the Gap between Men's and Women's Salaries in the US, Aug. 26, 2020, https://www.businessinsider.com/gender-wage-pay-gap-charts-2017-3?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+businessinsider+%28Business+Insider%29.

[6] SASB, SASB Materiality Map, https://materiality.sasb.org/.

[7] State Street Global Advisors, Diversity Strategy, Goals & Disclosure: Our Expectations for Public Companies, Aug. 27, 2020, https://www.ssga.com/us/en/institutional/etfs/insights/diversity-strategy-goals-disclosure-our-expectations-for-public-companies.

[8] Based on data from Institutional Investor Services Inc. as of Sept. 1, 2020.

[9] SEC, Modernization of Regulation S-K Items 101, 103, and 105, Release No. 33-10825 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10825.pdf. The amendments will become effective 30 days following publication in the Federal Register.

[10] SASB and GRI, Promoting Clarity and Compatibility in the Sustainability Landscape, July 13, 2020, https://www.sasb.org/wp-content/uploads/2020/07/GRI-SASB-joint-statement_2020_07_13_FINAL.pdf.

[11] CDP, CDSB, GRI, IIRC and SASB, Statement of Intent to Work Together Towards Comprehensive Corporate Reporting, Sept. 11, 2020, https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf .
