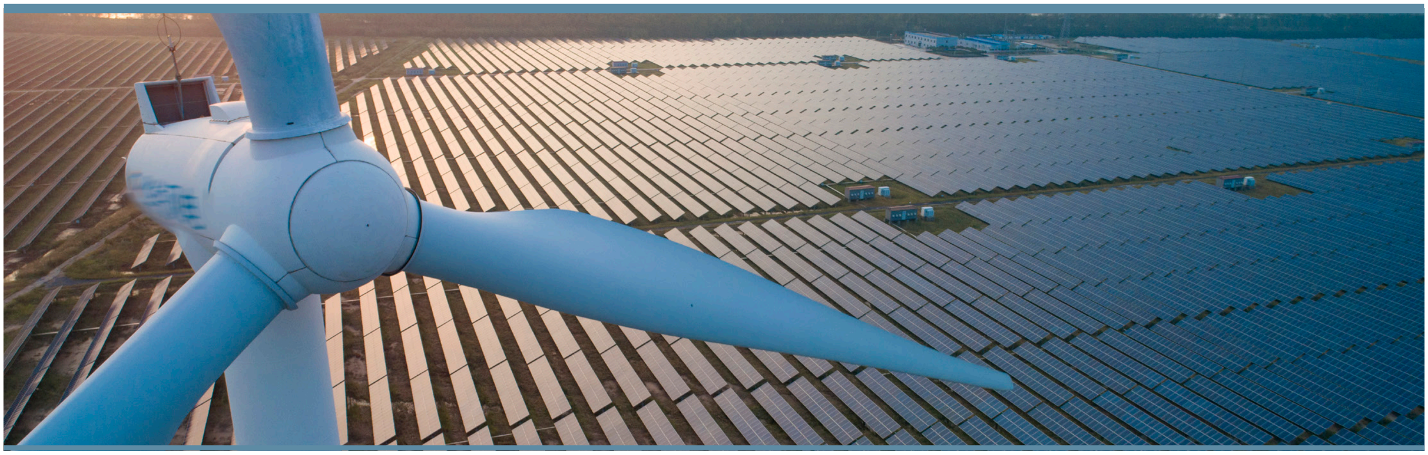

Executive Insights

How Should the Oil and Gas Industry Plan for Increasing ESG Pressure?

In recent years, environmental, social and governance (ESG) goals and programs have emerged as a significant area of focus for companies across the oil and gas production chain. Environmental concerns — and the resulting drive for energy transition — have received the lion's share of attention. But the full spectrum of ESG has been increasingly top of mind for industry leaders.

The novel coronavirus crisis and the related, severe downward pressure on oil prices have significantly disrupted the industry, and in the short term one would expect all such programs to be on hold.

But as the industry emerges into a changed world — one in which there may be increasing focus on community needs and goals — it is expected that ESG goals will be reasserted and ESG programs will become an even more central priority for players across the industry.

In the immediate wake of the coronavirus crisis, environmental concerns may continue to command visibility, and for good reason. The industry, when including downstream consumption, remains one of the top contributors to global emissions.

Exploration and production (E&P) and oilfield services businesses should expect to face an unwavering push for broader limits on carbon emissions. Total S.A. recently faced such a resolution, filed by 11 European asset managers and shareholders seeking a greater focus on scope 3 emissions, which are those caused by the use of its end products.

Further supporting this expectation are several studies noting the dramatic reduction in emissions and improvement in air quality as a result of coronavirus-driven stay-at-home orders and restricted activity. Momentum toward reduced emissions and other environmental mitigations might intensify as a result,[1, 2, 3] though it is also possible that reduced energy prices will lead to more energy consumption as economic activity restarts.

ESG is about more than the environment, though. It encompasses social and governance initiatives as well, and the three taken together have the potential to impact the entire organization. That means that they must be:

- **Strategic** — ESG programs must be matched to the organization's needs and capabilities. What fits one organization will not fit another.
- **Substantive** — ESG programs will no longer succeed if they are limited to public relations or communications activities and impacts. They need to be integrated into operations.

How Should the Oil and Gas Industry Plan for Increasing ESG Pressure? was written by **Nilesh Dayal** and **Clare Chatfield**, Managing Directors, and **Amar Gujral**, Principal, at L.E.K. Consulting. Nilesh and Amar are based in Houston, and Clare is based in Paris.

For more information, contact oilandgas@lek.com.

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- **Impactful** — ESG programs must have a real and measurable impact on the business. ESG initiatives are increasingly the result of investor and stakeholder pressure for better returns, and should be directly and quantifiably responsive to those demands and reflected in scores from the ESG rating agencies. In this regard, governance initiatives can be as important as more visible environmental projects.

The good news is that a strategic ESG program can address all those concerns and satisfy the full range of stakeholders. In this paper, we will examine the considerations that industry players should incorporate into ESG planning and will describe a framework for developing the right solution for your company.

What are the elements of ESG, and how do they impact oil and gas?

At the outset, it is important to establish definitions — both to clarify that ESG is about more than the environment and to identify the range of ESG initiatives that oil and gas leaders will likely want to consider.

A comprehensive oil and gas industry ESG program would include:

- **Environmental stewardship**, including carbon capture and carbon emissions reduction, energy portfolio diversification, operational energy efficiency, resource conservation, and waste disposal
- **Social responsibility**, including worker safety and health, community involvement, and supply chain relationships
- **Corporate governance**, including reporting transparency, leadership diversity, executive compensation and shareholder rights

Discussion of environmental concerns in the context of oil and gas naturally calls up the subject of energy transition, another urgent matter for oil and gas leaders. The good news is that the challenge of energy transition is driven by environmental concerns — it is, in fact, an implementational response to climate change and other environmental impacts. As a result, energy transition dovetails well with ESG goals.

Several of the major themes common to ESG and energy transition priorities include:

- **Energy diversification** as a result of the shift to natural gas and renewables
- **Carbon footprint reduction** via transition to cleaner energy and refined products
- **Electrification** through renewable energy and transportation fuel transition
- **Natural resource sustainability** through adoption of cleaner renewable energy and products

Companies will be most successful in developing their responses to energy transition demands if they consider these demands in the broader context of ESG.

Demand for broader ESG initiatives is a new development

The oil and gas industry has a long history of dealing with some of the elements of ESG, but the demand for comprehensive ESG programs is a more recent development.

Major oil companies have long faced environmental pressure. In the past this was usually in response to such major environmental disasters as the Exxon Valdez and the Deepwater Horizon. Yet the response generally fell into the category of crisis management rather than programmatic environmental initiatives.

In addition, national and international oil companies (NOCs and IOCs) have a strong reputation for building corporate social responsibility programs in the countries where they operate. ExxonMobil's initiatives in Guyana represent one prominent example, but IOCs continue to focus operations in resource-rich nations where developing a mutually beneficial social contract is a table stake. Total, with significant operations in Africa, has a track record of developing initiatives to support local communities in the areas of youth inclusion and education, cultural dialogue and heritage, road safety, and enterprise development.

Starting around 1990, core elements of good business practice and of sustainability reporting began to evolve into a more coherent framework. Both an increase in shareholder activism and the rise of values-driven investing served to accelerate the development of modern ESG programs.

In the past decade, pressure on the industry for environmental action has increased. The driver, of course, is climate change. High-profile activism of Greta Thunberg's variety — supported by public sentiment and accelerated by media coverage — has played its part, but there is more to the story. Energy transition — the continuing shift from fossil fuels to renewables — has gathered momentum and is increasingly driven by state policy and international regulatory initiatives (the UN's Sustainable Development Goals being prominent among them). Compliance and reporting requirements imposed by these programs are on the increase, and in many jurisdictions extend beyond the environment to social and governance targets.

Also at the heart of the environmental matter is investor pressure. Investors press funds to take sustainability into account, and last year an alliance of the world's largest pension funds and insurers, accounting for $2.4 trillion of global investment, committed to carbon-neutral portfolios by 2050. Investment is increasingly flowing through ESG funds, but investors are not merely responding to a societal drumbeat on climate — they are also seeking productivity and operational efficiency to drive higher margins, and they see environmental initiatives and energy transition as the way to get there.

Momentum toward environmental and broader ESG goals is likely to continue in spite of — or because of — the COVID-19 pandemic

Although in the short term, environmental priorities may seem under threat as the COVID-19 crisis drives down the price of fossil fuels, that is likely to be a transitory effect. Many structural factors indicate that both environmental and ESG themes are in a strong position. The pandemic is putting a greater emphasis on community and shared sacrifice in ways that are consistent with ESG goals. The ESG structural trend, driven by both investors and the public, is unlikely to slow down.

Energy transition remains front and center, both for governments and for major industry players. The EU's 27 heads of state have declared that "the green transition" is central to their post-COVID-19 recovery plan. BP is going ahead next year with a shareholder resolution in support of its goal of net-zero emissions by 2050. That goal is shared by Shell. Schlumberger announced a step change in its commitment to ESG and decarbonization, with both the recent launch of its "new energy" business and progress toward its science-based emissions target. Total is maintaining its investments in energy transition even as it cuts elsewhere.

The fact that these programs are proceeding underscores how far along energy transition already is — technologies such as wind and solar are now structurally competitive even as they continue to evolve. The initiatives themselves underscore another change. Major IOCs are much more fully committed to environmental programs than they were a decade ago when they entered into the Green Climate Fund. They are retaining their focus on energy transition even if in the short term they are reducing their overall investment spend.

And in contrast to those early days, their programs have moved far beyond public relations and communications, and are tightly integrated with operations. Other players are a step behind, but they are evolving. It seems possible — perhaps even likely — that in the future these substantive, operationally integrated initiatives will become the norm.

Finally, in terms of broader impacts, current pressure on company financials may offer an entry point to restructure governance boards that better align to best-in-class ESG profiles.

The main imperative for ESG programs is to be strategic

Do not make the mistake of thinking of ESG as an isolated response to a discrete set of issues. The approach should be holistic. There are sound reasons for this. A holistic and strategic approach to ESG greatly increases the likelihood that the ESG program will have a whole-of-business impact and benefit.

A successful oil and gas industry ESG program can be — and should be — one that:

- **Bolsters innovation and long-term growth** — Clean fuel investments enable access to high-growth markets
- **Stimulates innovation** — Innovation is a proven result of employee and board-level diversity
- **Mitigates regulatory and cyclical market risks** — Environmental action preempts future regulatory restrictions and cost impacts
- **Enhances operational efficiency and productivity** — Production cost reduction and operational efficiency improvements can result from new technologies in worker safety and greenhouse gas reduction
- **Attracts and retains top talent** — Top talent is increasingly attracted to companies where they can make an impact on the welfare of all stakeholders
- **Expands partnership opportunities** — ESG standards adoption expands the universe of potential business and investment partners
- **Broadens the investor base** — Investors are increasingly narrowing their portfolios to include only companies that lead in ESG

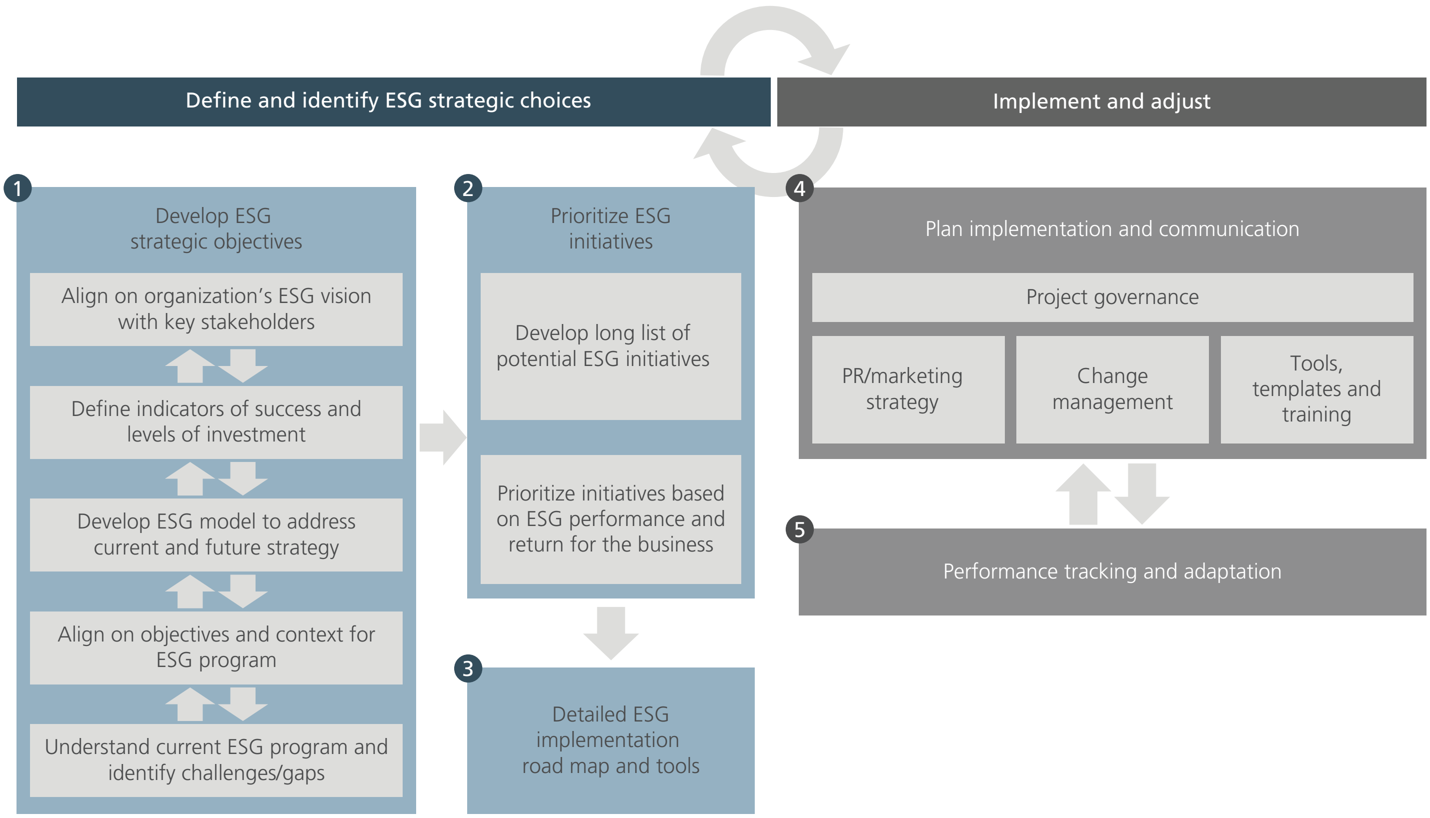
All of these results are achievable if the ESG program is built to do exactly that. Building such an ESG program requires a systematic approach integrated at all levels of the business, from leadership to operations, and often in coordination with multiple regional business units (see Figure 1).

ESG programs, like other strategic initiatives, should be actively managed

Once targets are set, the ESG program needs to be managed — and targets need to be met. The ESG will have to be balanced

Figure 1

Best-practice model includes strategic choices, an ESG road map and tools, and plans to implement and adjust



Source: L.E.K. analysis

against other strategic priorities, and business discipline is required if the ESG program itself is to succeed.

The ideal program is one that achieves the highest financial impact with a clear and measurable societal impact at the minimum cost and effort. In the real world, no program will accomplish all of that. Managing the program means managing trade-offs. Ask yourself:

- How should the impact of the initiatives be measured?
- How much weight should be given to financial return vs. societal value?
- What are the quick and easy initiatives we can implement today?
- Which initiatives should be prioritized?

Savvy leaders will prioritize initiatives carefully. They will understand both the direct and indirect financial benefits involved and will grasp the complexity around initiatives where the indirect benefits are not always clear. Take social programs that support education in communities where the business operates — this support can create a feedback loop that offers the business access to a new and robust talent pool, and may also result in an engaged community that will support the business's operations in times of political unrest. This social initiative lowers recruitment costs, improves employee engagement and business productivity, and offers risk mitigation value.

Avoid these ESG planning pitfalls

Both while planning and during the implementation, there are pitfalls to avoid:

- **Don't try to be comprehensive.** Do not commit to too many initiatives — choose the most strategic and impactful.
- **But don't operate in just one dimension.** It is tempting to focus only on environmental concerns — or to play to factors that are already in the company's wheelhouse. Remember that ESG goals all need to be addressed. In fact, companies heavily engaged in overseas markets may benefit from social and governance initiatives most of all.

What is your ESG type?

Who are the leaders in ESG in oil and gas? Some companies have stood out — Shell, Equinor and Total are generally recognized as best in class.

But what suits one company may not suit others. Know your ESG type:

- **Best-in-class companies** are those that have made significant investments over a long period of time. Companies like Equinor, Schlumberger, Shell and Total are high performers in each dimension of ESG, leading in a wide range of factors, from green technology to production sustainability to worker safety to ethical best practices.
- **Category-specific leaders** outperform their peers in select initiatives. Repsol has invested $2.5 billion in alternative energy initiatives and plans to be carbon neutral by 2050, and it has committed to making sure 30% of its leaders and directors are women — this year. BP has addressed safety by piloting a wearable heat exposure management technology and is pushing further on areas of alternative energy and energy efficiency.
- **Emerging adopter**s are making investments across the ESG spectrum but are not yet producing best-in-class outcomes. Eni, Chevron, ExxonMobil and Oxy are spending heavily, but their initiatives have yet to yield outstanding results in emissions reductions, social initiatives or transparency.
- **Transparent reporters** report their ESG initiatives but trail competitors in investments and outcomes. These are largely international companies such as CNOOC, Rosneft and PetroChina and have not invested heavily. Their basic worker safety programs have not generated improvements, and they meet government transparency requirements but do not go above and beyond. Many independent E&P companies fall into the transparent reporter category.

The differences underscore that implementing an effective ESG program is complicated. Many initiatives fall under the broad heading of ESG, and the most effective ones are those that are linked directly to the business. Matching the program to the organization’s state of ESG development is essential to success.

- **Don’t shirk on metrics.** Business unit and asset leaders need to understand and be accountable for the full range of ESG results, and must be given the tools to track and report performance.

ESG is here to stay

Regardless of the industry’s earlier environmental history, in spite of past programs that were little more than marketing and publicity, and despite the current pressing challenge of the COVID-19 pandemic … ESG is not going away. Instead, it is likely to grow in significance, becoming continually more integral to operations and results.

The way to approach ESG is to develop programs that are tied to operations and that are authentic and achievable for your organization. A handful of major players such as Shell, BP, Total and Schlumberger have staked a claim to ESG leadership. The answer is not to follow them but instead to be true to your own organizational culture, marketplace realities, and state of play in the environmental, social and governance arena.

If you do that — if you take a systematic, strategic approach linked to business goals and targets — results will follow. You will be on the path toward becoming an organization that is more closely tied to its investors and stakeholders — and that delivers superior results as well.

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[1] https://www.forbes.com/sites/tamarathiessen/2020/04/10/how-clean-air-cities-could-outlast-covid-19-lockdowns/#212fe04c6bb5

[2] https://www.washingtonpost.com/weather/2020/04/09/air-quality-improving-coronavirus/

[3] https://www.wsj.com/articles/coronavirus-got-rid-of-smog-can-electric-cars-do-so-permanently-11586532988

About the Authors

Nilesh Dayal is a Managing Director and Partner in L.E.K. Consulting's Houston office. Nilesh is head of the firm's Oil & Gas practice and is also focused on the energy and chemicals sectors. He has more than 20 years of experience advising clients on growth strategies related to acquisitions, divestitures and new business venture launches; corporate restructurings; supply chain management; public sector and regulatory strategy; profitability and operations improvement; and post-merger integration and planning.

Clare Chatfield is a Managing Director in L.E.K. Consulting's Paris office. Clare has more than 25 years of consulting experience working for both French and international corporate clients. She covers a broad range of industrial sectors, including energy and environment, infrastructure, transport and mobility, logistics and distribution, and business services. Clare has particular expertise in the rapidly growing areas of energy efficiency, smart power, energy storage and the circular economy.

Amar Gujral is a Principal in L.E.K. Consulting's Houston office. Amar is focused on growth and commercial strategy, M&A, and due diligence in the energy sector. He has supported strategy engagements and M&A processes with major and midsize E&Ps, oilfield service companies, utilities, equipment manufacturers, private equity firms, and other financial institutions. Prior to L.E.K., Amar was on the energy deals team at Strategy& and covered oilfield services at Guggenheim Partners.

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