How is ESG driving change in the energy sector

On the 15th July 2021, DWF in partnership with the Energy Council, hosted a virtual roundtable to consider, ‘ESG standardisation & demystification – how can ESG goals be achieved?’

The roundtable was attended by leading figures across the energy, finance and investment sectors – each seeking to share their experiences with ESG and each seeking to glean wisdom from their contemporaries. The partners from DWF set the scene, establishing the need to promote the circular economy in regards to ESG developments and the wider energy transition. Underlying the notion that for our global climate goals to succeed, cooperative actions and standardization of frameworks is essential to drive progress.

We would like to thank our attendees from the likes of NatWest, DNB, Deutsche Bank, Kerogen Capital, Triple Point, Suma Capital, Armstrong Capital Management, Chariot Limited, Afentra, Victoria Oil & Gas, Siemens Energy – for taking the time to engage on a topic of timely importance. As with any event hosted by the Energy Council, we operate under Chatham House Rules and no quotes will be attributed to any person or company.
The exception will be to the involvement of our esteemed moderators from DWF: Kirsty Rogers, Managing Partner, Manchester & Group Head of Environmental, Social and Governance; Darren Walsh, Partner & Head of Power, Liverpool; and Brendan Slack, Partner & Head of Real Estate Finance & Energy Finance, London.

The emergence of ESG & its role in the energy landscape

Kirsty, Brendan and Darren began by introducing themselves and the first theme of whether; “ESG is a significant item for the energy sector? And if so, is it just a relabelling of previous concepts such as ‘Diversity and Inclusion’ or ‘Socially Responsible Investments’?” In essence, is there a practical use of ESG as a new framework or is this a case of the ‘Emperor’s New Clothes’.

The consensus affirmed the need for ESG as a conceptual framework to drive better business practices and to futureproof one’s company from impending environmental and social barriers. Yet there remained concerns over the lack of standardization and benchmarking of environmental reporting holding back progress, as well as Western-centric perspectives on ESG in the developing world.

One of the first speakers raised a point that returned regularly throughout – the energy industry has been a leader in establishing strong health, safety and governance principles in years gone by. The introduction of ESG has led to big shifts toward focusing on “E and S” over the past two to three years and is headed in the right direction, with corporate cultures shifting quickly to address these issues. Oil and gas operators are under the spotlight and a general disenchantment has fallen over the industry, leading to capital providers shifting their offerings to accommodate new ESG demands. However, a problem for energy players is to effectively communicate their successes in driving positive ESG-focused change. One attendee operating in the developing world felt their community successes and sound governance on a natural gas project – helping to shift away from coal and heavy oil fuels – succeeded across each criterion. And yet, a cloud hangs over fossil fuel developments.

Darren echoed the broad agreement that irrevocably the ESG strands are intertwined and each aspect should be carefully considered, especially in the context of seeking finance and investment. It is the capital shifts that have provided the greatest influence to change practices, and all attendees acknowledged that these were only going to become more important as climate objectives become more pronounced.

One view felt that "intentions and realities often clash", and that a range of factors are at play; structure and size of a deal, nature of financing, actors involved – all needing to be considered in terms of integration of expectation requirements. Pointing out that innovation and change come from the hard work of individuals within corporates, pushing and working hard to push strong ESG integration.

Evolution or Revolution – the growth of each criterion in the energy transition

The discussion moved to separating each letter into their component parts, drawing one perspective that while the "S and G" aspects have undergone an evolution in recent years, the "E-side" has experienced a revolution. This most important step is that ESG, in all its parts, is now being discussed at board room level.

For the most part, the 'governance' aspect of energy developers, financiers or investors was incredibly sound and allowed the focus to shift to 'environmental' and 'social' responsibilities. Of course, for actors in developing states, the governance side has many difficulties to overcome but they are far from insurmountable. The problem lies in finding a balance between the environmental need to shift to cleaner fuels, and the social consequences of restricting new gas developments on the continent. This returns to the need for improved communication of intentions and actions and for having contextual frameworks.

There was no contestation to this point, only a question as to whether or not to make the "E" aspect its own focus. Each sector has specific challenges and barriers to overcome; retail and manufacturing are vastly different to oil and gas and renewables – therefore creating nuanced and contextual finance and investment offerings, it will allow companies to actively engage in their emissions reduction plan. Moreover, it was questioned if companies should now be looking at "Scope 2 & 3" equivalents in the 'Social' aspect of ESG – insofar as how do companies impact communities across the value chain.

The social and governance work of oil and gas companies is often overlooked in favour of environmental admonishments, but from the 'S&G' side as well as the 'health and safety' requirements, the energy sector is "best in class". However, it is accepted that the role of energy industry in driving change can be enhanced, especially in regards to 'social and environmental' improvements.

For one company that has experienced many pivots in its hundred-year lifetime, it is essential that finance and investment drive the change. In turn, as a global corporate, they will choose the lenders who are placing ESG at the heart of their strategy – as this is what their investors demand. They see the opportunity to lead the change in Europe and the United States, and to reimagine the energy and infrastructure landscape (among others).
One global investor, sought to emphasize the difference between 'Impact' capital and ESG, noting that an impactful biofuels company can 'impact' the energy transition positively but remain far worse than an oil or gas company on ESG.

The investor continued to criticize the pervasive use of "greenwashing", insofar as companies want to appear to be 'doing their part' but not being progressive in their actions. The reality is that the lack of benchmarking creates confusion over what may be genuine action or merely greenwashing PR, although the EU taxonomy holds promise to establishing a benchmark for ESG criteria.

Baselines and Benchmarks – The need for consistency

Kirsty's view was that ESG provides 'a coordination approach to tackle problems together and to plug the gaps', as many issues need collaborative action. And that the "S" factor needs to be taken together with the "E", as they are irrevocably linked – and there are "positive" climate actions that may negatively affect underdeveloped communities. Leading onto the next question, "Will environmental measures within ESG have an impact on the energy transition?"

It is the reporting, standardization and benchmarking of these criteria that remains the biggest barrier to endemic change. As it stands, companies can pick and choose the framework that will suit their business and present a favourable account of operations. Companies are now reporting ESG successes, which makes it easier for finance and investment to understand exposure of assets and pick the "right" clients.

Without sufficient levels of data on each ESG criteria, it becomes difficult to assess company's operations. Often these companies will fall back on permit baseline requirements and this fails to achieve the necessary impact. So it becomes essential to push clients to improve beyond regulatory baselines.

One oil and gas actor simply stating that, "what gets measured, gets actioned". This reflects the need to account for all actions across the ESG frameworks, and present these to capital providers who can compare to their mandates. Those who have thorough examinations of their operations will be far more favourable to banks, firms or funds, than those who merely try to tick the boxes.

A conversation on the need for cooperative actions grew from this point. It cannot only be capital providers mandating change, but there needs to be industry input too. The Majors and Traders will be needed to innovate and uncover decarbonisation technologies, which can be fed to smaller actors. The IOCs are central to innovation in the sector, while the carbon offset solutions need to be disseminated at a far greater rate. The entire carbon offset industry remains one of the nascent peripheral sectors that has huge potential to induce change.

From a lenders perspective, ESG is centrally important to their assessment of risks. However, similarly to how the "environment" aspect has been expanded from Scope 1 to consider Scope, 2 & 3 emissions, the same is beginning to be considered from the "social" aspect. As ESG benchmarks mature, the financial sector will be considering more "social" Scope 2 & 3 impacts, and how a company affects stakeholders along their value chain. They are incorporating a "carbon budget", that analyses the carbon impact of their finance and to what degree their lending is responsible for their client's emissions.

Creating new carbon-conscious corporate cultures

Kirsty then brought us to an important point; how these cultural shifts and changes in attitudes have been key drivers in the explosion of ESG mandates across sectors and within companies. From the financial perspective, companies should try to maximize their efficiencies and better their processes in relation to their expertise. The economic and environmental benefits of a pivot may not be as great as bettering one's own business practices. Board rooms are now discussing ESG issues unlike ever before, with in-country environmental and social officers becoming an industry standard. One attendee pointed to Lundin Energy's CEO who stated his desire to also be Chief Sustainability Officer, and it reflects in how that company operates.

Shifting from coal or heavy oils to natural gas has halved emissions in the US, and can do so in Africa too – all while inducing energy development simultaneously. However, gas maintains a negative reputation from many European perspectives. And if gas keeps this reputation, the financial community must answer the question of how they will resolve the incredibly large requirements to develop an expansive renewables sector across Africa. On the converse side, just like many states in Africa skipped landline telephones and jumped straight to mobile networks, a similar leapfrogging should be attempted with energy by utilizing the most sustainable and efficient infrastructures.

These cultural shifts are driving capital decisions too, as another pointed out. At one stage in recent years, deep sea exploration would have been considered on its merits. For many now, it is discarded out of hand. It speaks to the desire for these actors to be change makers and activists within their own personal and corporate communities. They have the capacity to channel capital to more sustainable projects and should do so, they can influence clients to change and report findings and so they do – but this returns to the need for accurate benchmarking and standardization. Inducing change becomes difficult when everyone labels their company as ESG compliant, despite this distinct lack of ESG clarity.

Conclusion

Our moderators from DWF had five propositions that they asked of the attendees, below are the general consensus from these questions:

- **Is ESG a significant agenda for the Energy sector or could it be seen as re-labelling environmental, social and governance initiatives that are already being adhered to?**

  Undoubtedly yes. ESG has evolved significantly since the Paris Climate Agreement and there are many global initiatives engaged in furthering ESG frameworks. Prior to this, environmental assessments were fit-for-purpose and had very little concern for emissions impacts, or impacts further down the value chain. ESG has developed into its own beast, driven by major institutional investors and international financiers.

  The past five years have led to a wholesale reconsideration of our actions, and ESG is the result of these considerations. Enough was not being done to provide a more pervasive benefit to society.

- **Will environment measures within ESG have an impact on the Energy Transition?**

  Of course. ESG has risen in prominence over the past 2-3 years to become a central consideration for investors, financiers and the boardroom. With government pressures increasing, the onus has been placed on capital owners to drive the energy transition through progressive ESG policies.

- **Energy organisations ESG performance can be seen as a response to the Energy Transition by institutional investors – how can organisations embed ESG processes as to optimise performance and draw investors in?**

  It begins with an honest interrogation of environmental and social impacts across a company's value chain. This will reveal where there is an elevated exposure to risk. Once understood, develop a roadmap that will continually reduce GHG emissions with a hard end-goal, preferably net-zero. Have third-party verification of measurements where applicable.

  For the 'social', a company must exhibit engagement with a broad selection of stakeholders, not just shareholders – and seek to allay concerns in good faith. A company should exhibit an awareness to their 'diversity & inclusion' metrics, seeking to employ a diverse labour force that does not discriminate due to race, sex, gender, religion, ethnicity etc.

  Governance should always be beyond reproach for most investors, regardless. If it is in a bad shape, everything else goes out the window.

- **How do you establish an ESG framework in a multi-national business when there could be major differences in cultural, ethical and environmental contexts between regions?**

  Naturally, there will be barriers in different jurisdictions – the environmental consideration is a global concern and showing improvements in this area will rarely be a problem. One issue is that we should not impose Western perspectives of timelines for the energy transition onto underdeveloped regions with pressing concerns and a dearth of available capital to engage in the energy transition.

  The 'Social' aspect is the most important. A multi-national must respect the communities and stakeholders they are partnering with to have access to the market or resources. To this end, a multi-national should seek the most appropriate and relevant structures that contribute to the development of these jurisdictions. A balancing act is required for multi-nationals where discriminatory laws exist, to not engage with those laws and continue to create a diverse and inclusive workforce.

- **How do you compare the ESG performance of inherently carbon intensive Energy businesses with low carbon Energy businesses?**

This reveals the urgent need for benchmarks for ESG measurements. As one attendee said, “You can have an ‘impact’ investment in innovation technologies that furthers the energy transition but has poor ESG and sits on their laurels. While you can also have an oil company with exceptional ESG that considers their impacts and continually seeks to improve them.”

Few industries are being held to ESG performance like ‘inherently carbon intensive energy businesses’, however they need to and can always do more. Nearly all energy companies seeking finance and investment are developing strong ESG frameworks, with decarbonisation roadmaps to net-zero. They have lost consumer trust and need to exhibit impeccable commitment to improving.

Low carbon energy businesses on the other hand have the advantage of a shorter road to net-zero. However, these low carbon energy businesses need to measure their impacts as closely as any other. While renewables are far better for the environment, they are not faultless in their impact. Any comparisons should be made against benchmarks with independent assessors measuring the efficacy of ESG frameworks.

The core themes of the discussion sought to emphasize the need for embedding ESG in energy companies, finance and investment mandates along standardized benchmarks, and to have these audited openly. Being honest about the impacts on E, S and G is crucial to improving operational efficiencies and overall sustainability.

*This summary was produced by the Energy Council.

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