National Oil Companies and the ESG Framework

BY MAJID AL MONEEF

The recent focus on companies' environmental, social and governance (ESG) or how they serve the natural environment, workers, communities, customers, vendors and shareholders, has been gaining momentum. Companies investments into these three pillars are increasing remarkably, and benchmarking their relative performances in ESG indices is moving from being optional to essential. ESG reporting has been challenging to policymakers, boards and executives, and it is forcing companies to revamp their corporate strategies. ESG regulations have the potential to raise the cost of capital of oil and gas producers as well as the marginal cost of production, which will ultimately impact markets and prices.

Oil and gas contribute 50% of global carbon dioxide (CO2) emissions, with oil alone contributing around 30%. Oil and gas industry faces different challenges than others, especially when it comes to the 'E' pillar of ESG. With around half of the world's oil and gas production, and 40% of capital investment, National Oil Companies (NOCs) are especially impacted by the energy transition and ESG framework. Their performance in the three ESG pillars and their strategies and responses to the global energy transition will shape their future roles as well as the energy transition itself.

However, the ESG metrics and disclosure requirements have largely been from the perspective of developed markets and publicly listed companies. They have been driven by national and stock exchange listing regulations, shareholder and stakeholder pressure, and by pressure from international capital and equity markets to disclose data and strategies for future climate scenarios, including net-zero emissions. While NOCs have been historically insulated from this framework, their increasing access to the international capital markets exert further pressure on them to report and disclose ESG data and targets. However, the level of disclosure and transparency from NOCs is currently far lower than that of IOCs, reflecting different stakeholder pressures outlooks of future oil and gas demand, the scale of reserves and the costs of production. Their governments are also responding to the fiscal pressures of relying on hydrocarbon revenues and reforming the state-NOC relationship, including taxes and oversight. In addition, these governments are not mere bystanders, but increasingly engaging in the global climate change framework.

All NOCs play significant roles in the economies of their home nations. However, they are not monolithic: they differ in respect to their hydrocarbon reserves and production, the roles they play in their economies, the diversity of their assets and markets, and their levels of vertical integration. They also differ in the trade-offs they face in the energy transition, the flexibility they have to reshape their mandates, their relations with their governments, their technical skills, risk management, engineering capacity, balance sheets, and so on.

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Despite the growing consensus that the global growth in hydrocarbon demand will slow, with variations among regions and economies, the role of the oil and gas industry and NOCs in their home states will likely not abate. However, the way in which the industry operates and its contribution to economies and society most certainly will be transformed irrespective of the speed of the energy transition. There will likely be two responses by NOCs: those that will move away from hydrocarbons and those that will optimize the use of their hydrocarbon reserves. Generally, the low-cost, low-emission NOCs, especially in the Middle East, will be the last ones standing.

To start with, each oil and gas company must define where it stands within the ESG pillars and metrics and tailor its policies accordingly. Each company should identify its own priorities, driven by regulations, customer demand and debt financing requirements. NOCs, in particular, should align their respective strategies with their respective country's climate commitments and energy goals, including those for renewable energy. They need to conduct rigorous risk analyses around capital allocation decisions to target investment effectively and focus on projects that generate returns, given the constraints of energy transition and ESG framework. They need to emphasize public communication and develop shared national narratives on the energy transition to adjust the public's expectations of the hydrocarbon sector.

NOCs may pursue a variety of strategies to increase their resilience. Companies with greater technical capacity, access to capital, and project management skills, could become central actors in their countries' climate ambitions. Some may focus on staying competitive in their core businesses, or invest in clean technologies that can prop up demand for oil and gas. The low-cost, low-carbon intensity producers can invest in new technologies that will help decarbonize their production, such as carbon capture, utilization, and storage (CCUS) and direct air capture (DAC) of CO2. Others may redirect their investment portfolios to emphasize gas, which requires strong corporate governance and decision-making procedures. Needless to say, there are risks associated with each option, including diverting financial and human resources from the NOC's core business and the potential conflict between fossil fuels and renewable investments.

For the governments of NOCs, the transition might entail changes in the financial trajectory of the country's economy and its fiscal budget, as well as its domestic energy policies and subsidies. The prevailing hydrocarbon development and economic diversification models might witness changes. This will impact the role of safeguards such as foreign exchange reserves and sovereign wealth funds, as well as the role of NOCs in their economies and globally, including their engagement with and standing in the ESG framework and metrics.

There are wide differences in the number of quantitative non-binding corporate and environmental reporting frameworks that provide guidance to corporate ESG and environmental metrics. Differences in the way in which individual metrics are calculated and weighed contribute to the wide variance of scores. However, most ESG metrics for the environment pillar are focused on the impact of companies' operational performances regarding emissions and flaring reduction from operations (scopes 1 and 2) and from their products (scope 3). Most NOCs have set operational targets of the first two scopes but expanding such commitments to scope 3 will remain problematic for many of them.

Issues of particular importance to NOCs, such as the carbon intensity of hydrocarbon production, the Circular Carbon Economy (CCE) and CCUS investments, have not been weighed adequately in the 'E' metrics. For example, KAPSARC developed a (CCE) Index that covers G20 countries, and the top-20 global oil-producing countries, to quantify and compare countries' performances and potential in developing CCEs. In the 2021 index, Saudi Arabia ranked sixth among oil producers, with higher-ranked economies Norway, the United Kingdom, the United States, Canada and China not as oil dependent.

Needless to say, NOCs usually follow national environmental agendas. For example, the Saudi government's recent green initiative, including its announcement to be carbon neutral by 2060, will certainly impact its NOC's corporate strategies and investment portfolios. How this might impact the future valuation of majority state-owned Aramco is uncertain. Needless to say that the current valuation of IOCs is tightly correlated with oil prices, and the size and lifespan of their proven oil reserves. This suggests that financial markets are not yet reflecting the transition plans of these companies, whose investments in low-carbon technologies or renewables still represents less than 2% of their total capital investments.

The social pillar of ESG, focusing on diversity, equity, anti-corruption and inclusion, are shared concerns for all industries. However, social issues vary significantly across geographies, especially between mature and emerging markets and between IOCs and NOCs. Currently, many ESG metrics address the economic development, diversification and employment issues in the home countries of the companies from their tax contribution angle . NOCs, by definition, have a national mission and differ in their historical, cultural and regulatory contexts. For most NOCs, their human resource development, contribution to the national economy and local community and provision of energy products to the local market are essential, and for many, are government-mandated.

For example, Saudi Aramco has been a leading force within Saudi Arabia's human resource development, technological innovation, industrial development and the promotion of locally sourced goods and services for its operations. Its programs such as the College Preparatory Program (CPP), professional development programs (PDP) and the Home Ownership Program have had a profound impact on its workforce, its communities and on the nation at large. Its In-Kingdom Total Value Added Program (IKTVA) has been a leading example of the country's national diversification strategies. None of these have been weighed in the 'S' metrics of ESG benchmarks.

The governance pillar of ESG focuses on policymaking, the distribution of rights and responsibilities of the board of directors and managers, and the oversight of executives. The successful pursuit of these areas has been critical to NOCs' with potential impact on the execution of environmental stewardship and social responsibility. Generally speaking, the quality of NOCs' governance, including their relationships with their governmental shareholders, and with other stakeholders in their home states, often determines their success. Needless to say, strong corporate governance, transparency, a clearly defined mandate, well-qualified and independent boards, and strong management accountable for measured performance against clear benchmarks will be essential tools for managing the challenges of the energy transition. Currently, ESG metrics for good governance are framed from a publicly listed company perspective. Issues such as board structures and relationships with governments do not take account of the shareholding structure of NOCs. In the case of Aramco, its governance has evolved over the years, with the most recent evolution being the process that led to its initial public offering (IPO) in late 2019. To prepare Aramco and the country for that IPO, the state promulgated a new hydrocarbon law, changed the hydrocarbon royalty and tax regimes, and renegotiated a new concession agreement with the company. To this end, the company's bylaws were redrafted, its business lines and assets restructured and its financial disclosure enhanced.

There are currently numerous efforts to develop a set of global sustainability ESG standards, including the Sustainability Standards Board of the International Financial Reporting Standards (IFRS), which aims to complement the International Accounting Standards. The other effort from the World Economic Forum's International Business Council identifies a set of 21 core ESG and 34 expanded metrics and disclosures. Of the NOCs, only Aramco and Equinor were engaged in developing these metrics. Aramco was often a lone voice in challenging the relevance of specific metrics to a developing market context, especially the predominant focus on emissions, and the disregard of the contribution of reliable and affordable energy in supporting social development. The latter is a critical measure of stakeholder value both within NOCs' home states and in global markets.

The existence of multiple ESG measurement and reporting frameworks and a lack of consistency and comparability of metrics hinder the ability of NOCs to meaningfully and credibly demonstrate the progress they are making on sustainability, including their contribution to the United Nations Sustainable Development Goals (SDGs). They face the challenges of prioritizing a growing list of reporting frameworks and initiatives, and their relatively lower internal understanding of and capacity to implement these frameworks. NOCs' organizational maturities, their internal capabilities, global breadth, market power, and their engagement in the development of new standards, such as IFRS and WEF, will shape their ability to develop new assets, diversify their portfolios, enhance their efficiency and improve their ESG guidelines.