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ESG: Leading from the Front

ESG pioneers are shaping the energy transition landscape. Cripps Sears urges companies to act now to secure the talent they need now to lead the charge to Net Zero.

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Foreword

As the UK readies to host the 26th UN Climate Summit (COP26) in Glasgow, companies are jostling to showcase their green credentials. Once this might have been dismissed as opportunistic greenwash but, after a year of apocalyptic wildfires, droughts and floods, there's a growing sense of urgency that words must be matched by real action in order to decarbonise our world.

Carbon-intensive industries, such as oil and gas, mining, shipping and transportation, find themselves on the frontline of the climate emergency and must act now to reposition for a Net Zero world. For these businesses, the energy transition is a potentially existential threat and survival will require decisive leadership in the face of unprecedented disruption, uncertainty and ambiguity. This is a huge ask of typically risk-averse industries and will require an appetite among the senior leaders to innovate, disrupt and make bold bets. The hiring decisions made now could well prove make-or-break and we urge companies to act now to secure the talent needed to navigate the challenges ahead.

Joe Dubbin

Managing Director
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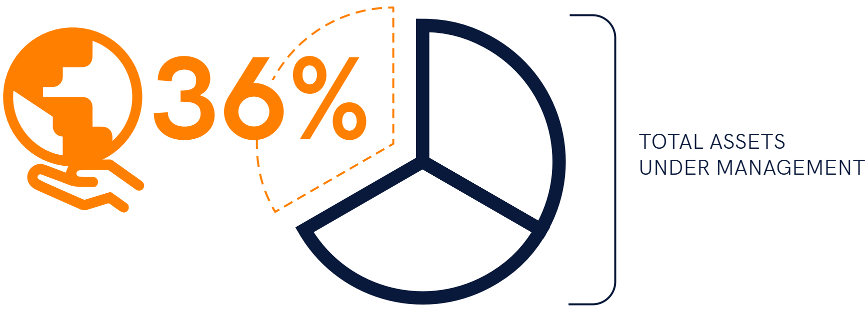
Six years on from the Paris Climate agreement, when almost 200 countries agreed to limit global warming to no more than 2C and ideally no more than 1.5C higher than pre-industrial levels, world leaders are convening in Glasgow to present their plans on how to achieve what many climate scientists fear is now a stretch target.

Many companies have "read the room" and are already fast-tracking their own Net Zero initiatives. Ignoring decarbonisation, along with other environmental, social and governance (ESG) issues, doesn't just carry the risk of public censure and reputation damage. There are also major commercial considerations, with ESG laggards facing funding barriers, an increased cost of capital not to mention lost business and partnership opportunities as entire supply chains and ecosystems seek to decarbonise.

Sustainable investing: mainstream money

ESG has already moved from a nice-to-have niche to a mainstream investment strategy. Global sustainable investment assets under management topped US$35 trillion in early 2020, up 15 per cent since 2018 to represent more than a third (36 per cent) of total assets under management[1], according to analysis by Washington DC-based Global Sustainable Investment Alliance. This wasn't a blip. Research by BlackRock, the world's largest investment manager, suggests investors plan to double their allocations to sustainable products over the next five years[2] as the convergence of political and regulatory pressures, technological change and client preferences pushes sustainability into the mainstream. And this is no longer hair-shirt investing: one recent report by Morningstar found that most ESG funds outperform the wider market over ten years[3]. With investors increasingly incentivised to back ESG stocks to meet their own in-house ethical standards and deliver on ESG-aligned KPIs, they're likely to become more demanding and drive further performance gains.



[1] Global Sustainable Investment Review 2020, published by Global Sustainable Investment Alliance in 2021

[2] BlackRock Global Client Sustainable Investing Survey, December 2020

[3] ESG Fund Performance 2020, published by Morningstar in June 2020

However, it’s not what investors are backing that’s making the difference; it’s what they’re not. Last year, for example, BlackRock completely exited thermal coal production and a number of banks and sovereign funds, including the European Bank for Reconstruction & Development and Norway’s Government Pension Fund Global, have announced plans to desist from funding further upstream oil and gas projects.

Private equity houses are also using ESG criteria to swerve certain investments. More than seven out of ten respondents to PwC’s Global Private Equity Responsible Investment Survey said they always screen target companies for ESG risks and opportunities at the pre-acquisition stage and more than half, 56 per cent, had refused to enter general partner agreements or turned down investments on ESG grounds[4].

Global accounting and auditing standard-setters are also forcing change, stressing that material climate-related risks should not be ignored in financial statements, particularly when making assumptions and estimates about the future. This is a major issue for the extractive industries: portfolios that were once the black gold standard for many pension funds risk becoming stranded liabilities should policy-makers determine the assets must stay buried if the world is to have any hope of meeting its climate change goals.

Stranded assets

It’s largely accepted that the majority of the coal reserves must be left stranded if the world is to have any hope of hitting a 2C scenario, never mind 1.5C. This has already been weighed into the valuation of many coal miners: Bloomberg’s index of global coal miners has slumped 74 per cent over the past decade. Will oil and gas companies go the same way? And what of National Oil Companies, which sit atop vast reserves that sustain their economies?

US$900bn

It’s estimated that around US$900bn — or one-third of the current value of big oil and gas companies — would evaporate if governments took more aggressive action to limit warming to 1.5C[5]. Indeed, if radical policies were introduced post-Glasgow to hit 1.5C, then over 80 per cent of hydrocarbon assets would be worthless. Even less ambitious policies to limit warming to 2C would see energy producers having to write off over half of their reserves.

Shell recently said that 75 per cent of its proved oil and gas reserves will be produced by 2030, with an additional three per cent produced after 2040. It’s a rare admission

[4] Global Private Equity Responsible Investment Survey 2021, published by PwC in May 2021

[5] www.ft.com/content/95efca74-4299-11ea-a43a-c4b328d9061c

that some reserves may be worthless in this new world. Shell aims to cut its emissions to Net Zero by 2050, with a new focus on hydrogen, biofuels and offshore wind as well as carbon off-setting technologies such as carbon capture and storage (CCS) and tree-planting.

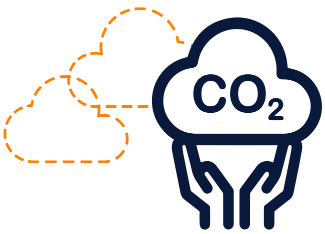
As yet, the jury is still out on the capacity of Big Oil to move quickly and boldly enough to meet Paris Agreement thresholds. According to the IEA, the proportion of capex spent by the largest oil and gas companies on low carbon businesses represents less than one per cent of investment. Smaller companies perhaps have an easier journey: Sweden's Lundin Energy, for example, plans to be carbon neutral from 2023 while Denmark's DONG Energy has already reinvented itself, with the former upstream producer now a wind farm specialist rebranded as Orsted.

This kind of repositioning doesn't happen by accident: it takes vision, courage and relentless research, experimentation, iteration, planning and pivoting over many years. Lundin, for example, began its ESG journey in 2001 and 20 years later produced its first certified carbon neutral oil. Those just getting started will not have the luxury of decades to ready for the Net Zero disruption.

A pipeline of new opportunities

It would be wrong, however, to see the radical energy transition as all downside. The pressure to decarbonise and implement measures across the ESG spectrum can also be a lever for transformation alongside digitalisation, AI and internationalism. This is overdue: it's clear the sector has been under stress for some time with the annual total returns to shareholders from the average oil and gas company lagging the S&P 500 by seven percentage points over the last 15 years[6]. Coal miners, as we have already noted, have also underperformed over the past decade.

There are as many opportunities as there are challenges but companies operating in carbon-intensive sectors, from oil, gas, shipping and mining, need to address these risks now. Carbon pricing and trading is likely to feature – and indeed, may soak up much of the discussion time at COP26 – as an essential bridge to a low carbon world.



US$2trillion

MARKET FOR CARBON CAPTURE

Some companies are already betting big on carbon capture as a means to extend their viable reserve base in a low carbon world. ExxonMobil believes there will be a US$2 trillion market for carbon capture by 2040 and is spending US$3 billion over five years on new CCS projects. Shell expects the oil industry to begin offering "CCS as a service", capturing not just its own emissions but those of other carbon-intensive industries too. This will require a huge expansion of current capacity: Shell's own scenario to limit

[6] www.mckinsey.com/industries/oil-and-gas/our-insights/oil-and-gas-after-covid-19-the-day-of-reckoning-or-a-new-age-of-opportunity

warming to 2C by 2070 predicts 10,000 large facilities over the next 50 years, up from fewer than 50 now. It's a huge capex outlay on a technology still to prove its worth – Chevron's Gorgon CCS plant, for example, has been plagued by problems – and requires a bet on the regulatory and pricing future for carbon.

One thing is clear: from investors and auditors to policymakers and consumers, the pressure is on carbon-intensive businesses to clean up their act. What's more, this high-stakes decarbonisation push has to run in parallel with tangible progress on other ESG issues, from boardroom diversity to anti-corruption policies. Companies must be cognizant of their exposure to the full spectrum of ESG risks and take holistic action to address them all. It does not matter what business you are in, you are now in the ESG business and this should be reflected at all levels of the organisation.

The Cripps Sears View

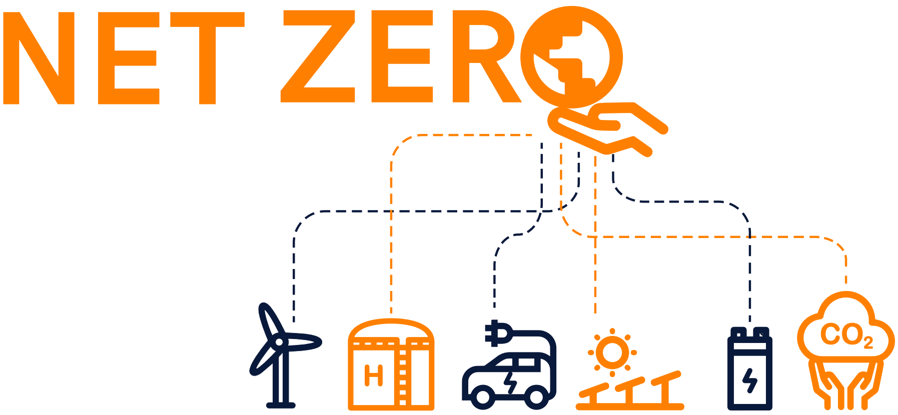
We believe ESG should not be the responsibility of a single ESG director or even a separate division but should be part of a company's DNA. In today's world, ESG is now a core competency. Encouragingly almost half (45%) of FTSE 100 companies now incorporate an ESG measure into their Executive Incentive Plans[7] and we expect this trend to continue.

Already companies are reaching out to find new talent to help them meet their ESG responsibilities and ambitions. This starts at the top. In a VUCA world, in which volatility, uncertainty, complexity, and ambiguity are the norm, new leaders will be needed who have the capacity to pivot and adapt as regulatory regimes, commodity pricing, technologies and public sentiment shift and evolve.

The end-point of Net Zero may be clear but the route-map isn't: companies need to make bets on technologies that may not pay off, whether it's unpredictable public appetite or unreliable subsidy regimes. The knowhow to make those bets will be increasingly specialist, be it the intricacies of battery technology, the new hydrogen economy, clean fuel specifications or carbon pricing regimes, whilst also being unprecedented in breadth, encompassing global policies, complex climate science, shifting supply chains and

[7] www.pwc.co.uk/human-resource-services/assets/pdfs/environmental-social-governance-exec-pay-report.pdf

competing technologies. It will require new attitudes to risk, which for some conservative industries may prove culturally challenging and require recruitment strategies that look outside the usual talent pool to bring in new ideas and new ways of working.



This must include a new readiness to collaborate, network and partner. The scale and complexity of the energy transition means there's no scope to go it alone. Instead, this will be a process of companies across multiple industries working in partnership to scope out opportunities, build out the required infrastructure and discover the future together. From LNG bunkering to hydrogen hubs to electric vehicle charging, the future will force companies out of their comfort zone and into new alliances, ecosystems and markets to effect real world change. Take BP, for example: a recent flurry of announcements reveals the oil giant has signed partnerships with in-car payments provider ryd, Japanese shipping company NYK Line and waste solutions company Brightmark among others. This will require senior leaders who can reach across industry silos, find common ground and forge inclusive partnerships.

We're already working with companies across the extractive industries, shipping and transportation to scope out their ESG exposures and analyse their talent gaps as they seek to navigate this VUCA landscape. We think creatively across our extensive networks to identify people with the vision, creativity, knowhow and leadership to meet the scale of the challenge ahead and help build not only a more resilient and sustainable company but a more resilient and sustainable future for us all.

As more companies wake up to the urgency of the energy transition, there will be an inevitable scramble for talent. This is a problem compounded by the public image of the heavy-carbon industries and the aging demographics of their existing workforce, two converging trends that make it harder to attract the right people to lead these companies into the future. We advise companies act now because the scale of the transformation is unprecedented and disruption tends to favour the bold and the first.

We're proud of the work we're doing with ESG pioneers and we're ready to leverage these learnings to help more companies rapidly adapt to a Net Zero world. As the discussions at COP26 will highlight, there is no work more important.

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