CLIENT ALERT

ESG, Capital Access, and the Future of the Oil & Gas Industry

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How Did We Get Here? From Shale Revolution to Capital Discipline to COVID-19 and the Oil Price War

Over the past few years, oil and gas investors have demanded that U.S. exploration and production (E&P) companies prioritize capital discipline over growth (i.e., value over volume). As capital retreated from the “growth-at-all-costs” philosophy of the energy sector during the shale revolution, stock prices were pummeled. E&P and oilfield service and equipment (OFS) companies saw stock price declines ranging from 30% to 75% or more through the end of 2019. Meanwhile, over the same time frame, the S&P 500 was up over 60%.

E&P and OFS companies got the message. They tightened their belts, cut capex budgets, and many started generating free cash flow. But there were still significant headwinds, especially with West Texas Intermediate (WTI) oil prices stuck in the mid-$50s. Many shale E&P companies only break even at that price point and many others still lose money. So the capital markets remained largely closed to the E&P and OFS sectors and stock prices remained under downward pressure.

What the U.S. oil and gas industry needed was for the global oil supply to tighten and global demand, especially for U.S. oil exports, to grow. Welcome to 2020. The one-two punch of the COVID-19 pandemic and the Saudi-Russian oil price war generated the exact opposite result – concurrently destroying global demand and oversupplying the markets, both at unprecedented levels.

Beginning in March, much of the global economy was shut down due to COVID-19 and oil demand collapsed. The International Energy Agency (IEA) forecasts that global oil demand will plummet a record 29 million barrels per day (bpd) in April (approximately 30%). And for 2020, IEA predicts demand will drop by approximately 9 million bpd, down to an average of 90.5 million bpd, which effectively returns global oil demand to 2012 levels. The stunning level of demand destruction is clearly seen in the surge in inventory builds. Last week, the U.S. Energy Information Agency (EIA) reported the largest weekly oil inventory increase in history, eclipsing by almost 30% the record increase set just the week before. Based on current projected fill rates, storage facilities in the U.S. will be full by mid-May.

On March 8, 2020, after the OPEC+ alliance broke down over proposed oil production cuts in response to the COVID-19 pandemic, Saudi Arabia announced significant and unexpected oil price discounts to customers in Europe, Asia, and the United States. Two days later, Saudi Arabia also announced it would increase its production from 9.7 million bpd to 12.3 million bpd and Russia indicated it would also increase its production levels. OPEC+ eventually reached an agreement in early April to cut production beginning in May by almost 10 million bpd, but the oil markets largely shrugged off this cut, viewing it as “too little too late.”

Oil prices started to turn over at the beginning of year and then went into free fall, dropping from the low $60s in early January to the low $20s by the end of March. Then, never-before-seen demand destruction, coupled with global supply increases and U.S. producers’ inability to shut in wells fast enough, created a severe strain on U.S. storage capacity, which caused oil prices to plunge again in April. WTI crude futures dropped below zero this week as traders dumped contracts for May delivery in the final days before trading for those contracts expired. Setting aside the unprecedented pricing action in oil futures contracts, cash prices in the physical market in many U.S. basins are currently in the single digits and some market participants are seeing negative pricing. June futures contracts are still trading in the $19-20 range and contracts expiring in Q4 and in 2021 are currently priced in the mid-$30s but, again, most E&P companies are simply not profitable at these price points.

So Where Do We Go from Here? There is Optimism in Restructuring, Recalibrating, Demand Recovery, and Energy Transition

U.S. E&P and OFS companies are slashing capital expenditures; reducing labor costs through large-scale layoffs, furloughs, and early retirement program;, and cutting dividends to conserve cash and hold on until year end. But a tsunami of debt is also looming over energy companies, with scheduled maturities of $20 billion in 2021, $41 billion in 2022, and $59 billion in 2023. And many companies can’t even service their debt loads in the interim. The simple, painful truth is that many E&P and OFS companies will not survive this downturn. Prolonged, significant demand destruction combined with overflowing oil storage facilities means oil prices will stay depressed for some time. Many companies have already filed for bankruptcy. Many more will file in the coming weeks and months.

That said, we see a lot of reasons to be optimistic about the industry in the long run:

- Restructuring and Consolidation

  The impending surge of bankruptcy filings and out-of-court restructurings, together with other merger and consolidation activity, will enable companies to recalibrate their balance sheets – reducing debt and improving asset bases, both in size and quality.

- Innovation

  The growing industry-wide focus on sustainability initiatives and opportunities, including significant continued investments in technology; the ongoing replacement of coal with natural gas for power generation, especially in China and emerging markets; and other energy transition strategies, will drive new revenue streams and increase profitability.

- Communication and Collaboration

  Industry movement towards coordinated, robust, and transparent disclosure about (i) sustainability issues; (ii) the progress the industry has made on concerns about the environment, diversity, safety, and community impact; and (iii) the industry’s benefits to modern life, is starting to slowly improve investor and public perception about the industry.

- Demand Recovery

Whether the industry will experience a V-shaped recovery or a more U-shaped recovery is up for debate, but most oil demand estimates show a return to 2019 demand levels in Q4 2020 or Q1 2021 and potentially increasing demand throughout 2021 – a great environment for the resurgence of a leaner, more efficient industry.

Even if there is another demand destruction event like COVID-19 (which is a real possibility in our global economy), we believe there is a profitable and prominent place for the U.S. oil and gas industry in the global energy markets.

Financing the Future of Oil & Gas: Capital Reallocation and the Rise of ESG

We believe that this bright future is dependent on robust equity and debt capital investment in the industry and that investment interest will be significantly impacted by environmental, social, and governance (ESG) factors. The industry has learned during the COVID-19 pandemic that many of the key ESG focus points, including worker safety, supply- chain diversity, community impact, and the like, have been key to their survival over the last several weeks. So let's take our successes in these areas, combine them with continued, focused efforts and progress on environmental and governance issues, and make sure investors know the great ESG story for our industry.

Sustainable investing (and other socially responsible investing strategies focused on ESG factors) has grown exponentially in recent years. U.S. sustainable investing assets under management now exceed $12 trillion. Record numbers of sustainable exchange-traded funds (ETFs) and mutual funds have been launched in recent years and have enjoyed net inflows year after year. And private equity funds are also participating in the trend as institutional investors continue to commit themselves to ESG principles. And with the vast majority of millennials interested in sustainable investing, ESG's influence on capital access is here to stay. Ignoring ESG-focused capital sources would be unwise and unnecessarily hamper the industry's recovery.

As Larry Fink of BlackRock noted in his latest letter to CEOs discussing sustainability, "[i]n the near future – and sooner than most anticipate – there will be a significant reallocation of capital." We believe the COVID-19 pandemic and the oil price war will greatly accelerate this capital reallocation for the oil and gas industry.

So how do we, as part of this great industry, prepare ourselves for this fast-approaching "reshaping of finance"? We must become ESG-friendly and do so quickly. We should be proud of our industry's contribution to modern life. But we must also embrace ESG principles to ensure future access to sufficient and cost-effective capital. To ensure our people are employed and thriving and that our local communities flourish. To ensure that we can keep providing energy to the world in the safest and most responsible ways possible.

The Oil & Gas Industry's ESG and Capital Access Playbook: Our Recommendations

1. <u>Increased Board Role: Tone, Strategy, and Oversight</u>

   Boards of directors should clearly message to their corporate stakeholders—investors, employees, customers, vendors, and local communities—that their companies are committed to ESG principles. There is no one-size-fits-all approach to this stakeholder engagement. Each board will need to determine its own best path. Direct communications, written and oral, from the chairman and other directors may be appropriate depending on director skill sets and stakeholder demands, but the executive team will typically be best suited to deliver the message. And board policies, governance guidelines, codes of ethics, and compensation practices (see more below) should reflect this ESG commitment. There can be no doubt, the board must set the tone at the top by both word and action.

   Strategic planning must actively consider ESG principles. How can new technologies and innovation improve the environmental impact of our existing businesses? How can we restructure our organization to improve our workplace, contribute to our communities, and maximize the health and safety of our people? What is our ideal supply-chain configuration? How do we allocate our capital to existing business lines and new ventures with an eye towards a low-carbon future? Boards must actively ask these questions and many more. One thing is clear: business as usual is no longer an option.

Boards should critically review their existing director skill sets. Does the board have the right composition? Do we need new and/or diverse directors that are ESG-savvy and can spearhead our sustainability oversight? Do we need to establish a special committee focused on ESG-related matters? Effective board oversight and management accountability will be necessary to success and to capital access.

2. C-Suite Leadership: Building the Right Team

Senior management must incorporate this new strategic directive into their business plan execution. The CEO, CFO, GC, VPs of Finance, Corporate Development, Marketing, HR, HSE, Supply Chain, Investor Relations, Public Relations and Government Relations, and other key management personnel must understand, value, and implement ESG principles. ESG success depends on execution of a coordinated, multi-disciplinary game plan. CEOs should evaluate their current team and its bench strength. Do we have the right people in each role – with the right business skills and who share the company's ESG vision?

3. Industry Collaboration Through Trade Associations and Other Industry Organizations

The industry must start rowing together and in the same direction. Collaboration through industry trade associations, such as the American Petroleum Institute (API), the International Association of Oil & Gas Producers (IOGP), the IPIECA, the Independent Petroleum Association of America (IPAA), the Petroleum Equipment and Services Association (PESA), and others, is key to achieving the industry's ESG goals. These associations are each proactively working on and developing ESG resources for their member institutions and providing networks for sharing information and ideas. And cross-vertical organizations, like the newly formed Energy ESG Council, are creating forums for companies in the upstream, midstream, service, downstream, and renewable sectors to work together on industry-wide ESG objectives, such as common-sense measurement and reporting frameworks (see more below) to help the industry communicate a cohesive and positive ESG message. Many larger companies are active in these organizations, but participation and financial support must deepen and more senior level executives within every member institution must get involved.

4. Agreeing on Industry-Sensible ESG Framework(s) and Coordinating our Message

Investor complaints about the lack of consistent and comparable sustainability reporting and other ESG related disclosures are valid. And investors are pushing hard for standardization. For example, BlackRock is currently promoting the frameworks from the Sustainability Accounting Standards Board (SASB) and, for climate-related risks, from the Task Force on Climate-related Financial Disclosures (TCFD) (of which BlackRock was a founding member). And while investors, through investment decisions and voting policies, will certainly influence framework selection, the oil and gas industry is in the best position to determine the most appropriate framework(s).

Organizations like IPIECA, working with API and IOGP, have been working on sustainability reporting guidance for years and have considered the approaches and content from a broad range of other frameworks besides SASB and TCFD, such as the Global Reporting Initiative (GRI). We believe continued collaboration through industry trade associations on reporting frameworks, measurement and disclosure, and encouraging senior level executives within your company to engage with those associations on these topics, is key. We must develop and deploy industry-sensible framework(s) consistently as possible across the industry so that we can effectively communicate our ESG efforts and successes, including advances in technology. Inconsistent and conflicting messaging leads to investor confusion and resistance and will only hamper the industry's capital-raising efforts.

5. Continued Focus on Technological Innovation and Energy Transition

The oil and gas industry must continue to invest significant capital into technological innovation, including technologies that will help it transition to a low-carbon future. These new technologies and alternative business lines will be key to our ongoing success. And they will attract capital that can help sustain existing oil and gas operations as the transition continues. European banks, institutional investors, and sovereign wealth funds have already largely exited fossil fuel financing. And many U.S. banks and investors appear to be headed in a similar direction. Therefore, industry focus on innovation with an eye on the inevitable transition to a low-carbon future will be critical.

6. Prioritizing Human Capital (Now and Going Forward)

During the COVID-19 pandemic, the industry has been intensely focused on the health and safety of its people. The industry needs to continue to prioritize its human capital, especially as the country starts to reopen and as our industry recovers and begins to rehire. Human capital factors are critical ESG metrics and, even with significant technological advances in recent years, the industry's people are still a key to its success. It's the right thing to do and many capital sources will avoid companies that do not make their people and their communities a top priority.

7. Incentivizing ESG Success

The industry must adjust its compensation programs and policies to incentivize and drive ESG success. ESG metrics must become a key performance indicator and a significant component of our incentive programs, together with strategic, financial, operational, and other traditional performance metrics. Compensation committees and the CEO must define and track ESG goals and hold management teams accountable. Appropriate metrics and goals will vary among companies and, within companies, among the various members of management. Compensation committees should start actively working with the CEO, the HR team, and compensation consultants to incorporate ESG objectives into both their short-term and long-term incentive programs. As the board sets the tone at the top and develops the corporate strategy, it must follow through with incentives that will motivate and encourage the desired ESG-related behaviors. Failure to do so will permit competing incentives to potentially derail or postpone ESG success and unnecessarily divert needed capital.

We believe that the oil and gas companies that survive and thrive going forward will be focused on ESG principles and continually evolving their businesses, strategies, products, and services in response to energy transition issues driven by ESG factors and changing market demands. And we believe these companies will need, at least to some degree, ESG-focused investors to meet their capital requirements. The above recommendations should ensure that oil and gas companies are headed in the right direction. We work with all of our clients on these critical ESG and energy transition issues. If we can assist you and your company in becoming an ESG success story, do not hesitate to reach out to us.

View all of our COVID-19 perspectives here. Contact a member of our COVID-19 Legal Task Force here.

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