Does Energy Belong in an ESG Portfolio?

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The Threat

It's no secret that concerns over climate change are intensifying globally. Numerous forms of regulatory requirements, pledges, alignments, commitments, etc. have emerged across the globe and pressure from governments, investors, and consumers has increased. One of the first industries to be targeted for change was the utility industry. Much progress has been made there in shifting away from coal-fired electricity generation to gas and renewables, especially in Europe and the United States. The falling cost of renewables and batteries appear poised to help this transition continue.

Attention is now shifting to transportation. According to the EPA, greenhouse gas emissions (GHG) from transportation account for 28% of total US GHG emissions, making it the largest contributor to total US GHG emissions.[1] The transportation sector includes modes of transport from light to heavy-duty vehicles, rail, marine, and aircraft - all of which heavily rely on the burning of petroleum-based fuels. The push to move away from fossil-fuel burning transportation is underway. Several countries in Europe will ban the sale of new internal-combustion engines (ICEs) by 2030 and the state of California will ban by 2035. Increased electronic vehicle adoption is also expected globally, notably in China. Auto manufacturers are devoting significant capital to electric-vehicle R&D and production in response. Further, the EPA has fuel emission standards that will require improved fuel-efficiency over the coming years. The Biden administration is expected to take a harder stance on fossil-fuels as evidenced by rejoining the US to the Paris Agreement upon taking office in early 2021.

All of this has significant negative implications for the oil & gas industry. About 25% of oil demand stems from vehicles alone.[2] This is not to mention greening efforts in other end markets such as petrochemicals. For example, the packaging industry aims to reduce the creation of virgin plastic by utilizing more recycled product.

While energy company Scope 1 and Scope 2 emissions can be addressed more easily, it is Scope 3 emissions (emissions created through the use of their product, like in ICEs) that are the largest source of GHG emissions for oil & gas companies and hardest to control.

One might fairly conclude the deck is stacked against oil & gas companies. In fact, the question of investment in energy companies has become a hot topic as investors grapple with the risks and ethics of such an investment. In particular, the issue becomes more contentious when considering whether to include energy company investments in a portfolio designed to meet certain environmental, social, and governance (ESG) standards. Many investors cannot reconcile the idea of a carbon-intensive company in an ESG portfolio and argue energy companies should be excluded from the portfolio construction process based on the sector classification alone. In this paper, we seek to explain why we believe the energy sector should not be excluded even if energy companies do not meet our standards for inclusion yet today.

Transition is Possible

The above headwinds facing the sector have not been lost on management teams of energy companies. Several energy companies have started to outline plans for how they will adapt to the changing energy landscape. We believe there are several levers for energy companies to pull in order to successfully transition their business profile from one that is heavily focused on fossil-fuels to one that is less carbon-intensive, more regulatory compliant and successful in the 21st century. We outline some of these strategies below.

Transition Fuels

While passenger vehicles will be the first to fully transition to electric power, we believe the transition away from oil in heavy-duty trucks, aviation, and shipping will be much slower. The technological solution of electric powered planes, for example, is very distant. If, or until, this type of technology exists for larger forms of transportation, a transition fuel will be needed – and likely for several decades. Transition fuels represent an opportunity for energy companies to diversify away from oil. Some of the most in-demand transition fuels are expected to be natural gas, hydrogen, and biofuels.

- Natural gas – while not completely green, natural gas combustion creates significantly less GHG emissions than oil.
- Hydrogen – greener than oil and natural gas in all forms, and has potential to be totally green.
- Biofuels – fuels produced from organic materials are being developed for use in combination with

traditional fuels. Sustainable aviation fuel is one such area making notable progress.

We believe traditional oil & gas players are well-suited to participate in this burgeoning market due to their strong R&D capabilities, scale, and resources. Some energy companies have already made investments as we detail below.

Capital Investment

Energy companies are making increased "green", or low-carbon, capital investments which includes areas of business like renewable energy projects (BP[3], Shell[4], Total[5]), battery storage (Total[6]), electric vehicle charging (BP[8], Shell[7]), transition fuels (BP[8], Exxon[9]), carbon-capture technology (BP[8], Exxon[9], Occidental[10]), and more. While the current portion of revenues from low-carbon businesses is quite small (generally low single digits), we see material and targeted scaling up in the coming years. In fact, while most energy companies cut overall capex for 2020 & 2021, several did not cut capex allocated toward low-carbon investments thus making low-carbon investments a higher proportion of overall capex. Examples include Total which plans $2bn in annual low-carbon budget for 2021-2025, increasing to $3bn plus until 2030, or more than 20% of total capex[11]. Also in 2020, BP announced plans to increase low-carbon investments to 30% of long-term total capex budget, spending $3-4bn annually by 2025 which is up from only $750mm in 2020[3].

Company	2020 Low-Carbon Capex	% of Total	Low-Carbon Investment Targets
BP plc	$750mm	6%	$3-4bn by 2025; $5bn a year in 2030, as much as 50% of capex in 2030
Chevron Corp	n/a	n/a	n/a
Eni SpA[12]	n/a	20%	€4bn over course of 2021-23, or ~20% of capex
Equinor ASA[13]	$3.2bn	38%	n/a
ExxonMobil Corp	n/a	n/a	n/a
Occidental Petroleum Corp	n/a	n/a	n/a
Repsol SA[14]	n/a	n/a	30% of capex in 2021-2025
Royal Dutch Shell plc[15]	n/a	16%	Increase to 25-30% by 2025, 35-40% of capex "beyond 2025"
Total SE[5]	$2.0bn	n/a	$2-3bn a year by 2030, or >20% of capex

Renewables present a very interesting opportunity. The shift to EVs will require more electricity demand, and oil companies can position for this by investing in renewables to help meet this demand.

Company	Current Renewable Capacity	Targets
BP plc[3]	3.3GW	20GW by 2025, 50GW by 2030
Chevron Corp	0GW	n/a
Eni SpA[12]	0.7GW	5GW by 2025, 60GW by 2050
Equinor ASA[13]	0.5GW	4-6GW by 2026, 12-16GW by 2035
ExxonMobil Corp	0GW	n/a
Occidental Petroleum Corp	0GW	n/a
Repsol SA[16]	3.3GW	7.5GW by 2025, 15GW by 2030
Royal Dutch Shell plc[4]	1GW	$2-3bn in Renewables and Energy Solutions in 2021-25
Total SE[5]	7.0GW	35GW by 2025

Over time, we expect many energy companies will experience a shift in business mix toward more low-carbon revenue streams due to their investments - though notable is the lack of investment among U.S. companies vs European.

Public Commitment and Transparent Plan

We believe a good energy transition plan is threefold: 1) understanding and acknowledgement by management of the headwinds facing fossil-fuels, 2) a credible and public plan addressing energy transition, and 3) measurable targets.

Several large energy companies have taken the first step in energy transition plans including BP, Shell, Total, Occidental, and Equinor who have all committed to net zero by 2050. Occidental was the first US-based shale player to commit to net zero emissions by 2050. While these commitments do not mean the entire plan is in place to achieve such a goal, it is an important step in beginning the process before it is too late. Setting these types of public goals also introduces accountability to investors and shareholders which helps push the progress along. We believe interim targets before 2050 offer additional credibility to the plan.

Positively, oil giants are even targeting Scope 3 emissions which, as discussed above, are the most problematic source of emissions for energy companies.

Company	Targets Addressing Scope 3 Emissions
BP plc[8]	Net zero in upstream operations by 2050; Cut carbon intensity of products sold by 50% by 2050
Chevron Corp	No net zero commitment
Eni SpA[17]	Net zero in Europe (Scope 1-3) by 2050
Equinor ASA[18]	Net zero (Scope 1-3) by 2050
ExxonMobil Corp	No net zero commitment
Occidental Petroleum Corp[10]	Net zero (Scope 1-3) by 2050
Repsol SA[19]	Net zero (Scope 1-3) by 2050
Royal Dutch Shell plc[15]	Net zero (Scope 1-3) by 2050
Total SE[6]	Net zero in Europe (Scope 1-3) by 2050; Cut carbon intensity of products sold by 60% by 2050

Other instances of commitment to energy transition include Total's 2021 announcement to re-name and rebrand to Total Energies, in line with the company's broader energy focus. Shell, BP, Repsol and Eni have all reduced their dividends, at least partially to free up resources for energy transition.[20] In January of this year, Marathon Oil introduced formal GHG emission reduction targets reinforced by compensation incentives.[21]

Important in the success of all this will be access to good reported data from the energy companies so stakeholders can measure progress. We expect key performance indicators (KPIs) to be increasingly demanded by investors. Additionally, we think discussion on progress will be an increasing focus of company earnings presentations and reports.

M&A and Asset Sales

One of the quickest ways to decarbonize is through assets sales. While asset sales do not help solve the "world's" problem of global warming (the asset would need to be decommissioned to do that), they do reduce the company's risk. We see companies increasingly looking toward this as one facet of their energy transition strategy. For example, BP sold all its Alaska assets in 2019 for $5.6bn. The sale was quite meaningful as it allowed BP to report 16% lower Scope 1 and 2 emissions.[22]

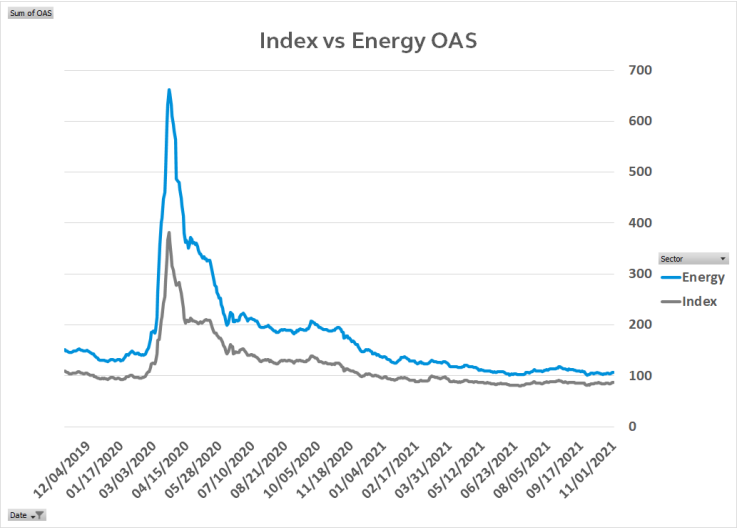
Conversely, energy companies could look to make acquisitions that would change their business profile. An energy major buying a renewable company or even a regulated utility company that specializes in renewables does not seem out of the question.

Summary

In summary, we have laid out the myriad ways in which we think energy companies are looking to transition their business profile from one that is carbon-intensive to one that is low-carbon. We believe an energy company making progress toward an adequately diversified revenue stream cannot only survive, but thrive, in the face of declining oil demand. While the transition timeframe is long, it is also impractical to expect a quick transition to net zero carbon emissions would be possible without tremendously negative economic consequences.

Moreover, there are ever-convincing arguments for why investors should engage with "bad" ESG companies to help them transition vs boycott them altogether. These companies need private-sector funding if they are to invest in the technology necessary to transition. Helping fund the transition while balancing economic stability will make the world a better place for all. In recent months, we have seen evidence of the influence investors have as shareholders at Exxon and Chevron successfully pushed forward agendas addressing climate change. We anticipate this type of engagement will be increasingly common going forward and will likely lead to companies acting more quickly on addressing energy transition than they would under their own plans.

Lastly, because of the risks involved with oil & gas companies' transition, energy bonds generally trade at a premium to similarly rated bonds in other sectors. If we believe certain energy companies have credible plans to decarbonize and adapt to the changing energy landscape, then such investments represent an opportunity and should not be excluded from the investment portfolio.



Source: Bloomberg Barclays US Corporate Index vs Bloomberg Barclays Investment Grade Energy component

It is a fair question whether any energy companies are doing enough right now to warrant investment in an ESG portfolio. However, we believe each energy company must be evaluated on a case-by-case basis and according

to its own merit versus painting in broad strokes. We also expect to see significant strategy changes in the coming years, so energy companies must be constantly reevaluated for portfolio inclusion. As the definition of "energy company" evolves, we intend to remain open to the possibility of including these companies in ESG portfolios.

Risk Considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results

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