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Ratings: Is it too risky to invest in the O&G sector?

By Tan Zhai Yun / The Edge Malaysia

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“Companies that pursue carbon capture and storage (CCS) may face technological, financial, policy and stakeholder perception risks. As such, their forward-looking credit health is not ‘rewarded’ for claiming CCS as part of their strategy.” Ng (Photo by IEEFA)

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The question of whether oil and gas (O&G) companies should exist in an ESG (environmental, social and governance) portfolio almost always incites heated debate.

The sector is a major contributor to greenhouse gas emissions and despite its investments in renewable energy (RE) assets in recent years, new fossil fuel projects are still in the works. Instead, carbon capture and storage (CCS) technology is often cited as the solution for decarbonisation. This does not sit well with a group of investors who prefer to divest from the sector. The International Energy Agency (IEA) said in 2021 that to stay within the safe limits of global warming, no new fossil fuel developments should be built.

On the other hand, there are investors who want to support O&G companies that are transitioning to become lower carbon. They see a potential for returns by investing in such companies and believe they can have more impact by encouraging companies to go this route.

Regardless of which camp one is in, however, the risks of investing in the O&G sector will have to be acknowledged.

“The O&G industry is seen as a sunset industry in the mid to long term. While gas, in particular, has been touted as a transition fuel, investors see that demand dynamics for O&G are changing from energy production to petrochemical products, and this has serious implications for the industry,” says Christina Ng, debt markets research and stakeholder engagement leader at the Institute for Energy Economics and Financial Analysis (IEEFA).

One major risk is the loss of funding from institutional investors who believe that O&G companies are not doing enough to halt climate change.

“Short-term equity players are expected to be interested in the near-term upside of the O&G industry. However, shareholder activism is growing and sustainability-focused investors hold the view that a real transition needs to happen,” says Ng.

She gives the example of the Church of England Pension Board divesting from Shell, BP and other O&G companies in June for failing to show sufficient ambition to decarbonise in line with the goal to limit global warming to 1.5° Celsius.

“Furthermore, IEEFA research found that leading financial actors are increasingly choosing divestment from the O&G industry to protect their investors from the loss of value. Many found themselves better off in the process. As of 2022, funds worth more than US$40 trillion have committed to some form of divestment,” Ng says.

Other than investor pressure, the commitment by countries and companies to reach net zero emissions may result in O&G companies having stranded assets as they are forced to transition. Carbon taxes that are being introduced will add to the cost of doing business.

"The industry operates often in markets with limited social and environmental safeguards. This exposes the businesses to higher risks and increases expectations for [the companies'] environmental and social policies and practices," says Daniel Klier, CEO of data provider ESG Book.

"Physical risks from extreme weather events also have a disproportionate effect on the industry, with both production sites and transport routes heavily exposed."

As the adoption of renewable energy and electric vehicles (EVs) accelerates, the demand for O&G will be impacted as well.

The IEA projects growth in world demand for oil to slow in the coming years and for oil for transport fuels to decline after 2026 due to the expansion of EV usage, growth of biofuels and improving fuel economy.

"The IEA's outlook has shown that a slowdown in demand growth could put large natural gas projects in jeopardy, thus increasing the risk of stranded assets for exporters," says IEEFA's Ng.

Delayed decarbonisation could result in O&G companies facing rising global policy pressure and consumer substitution risk, which will increasingly influence O&G companies' creditworthiness in the long run, she adds. Therefore, companies that are overly reliant on O&G assets as their main sources of revenue in the near term are particularly susceptible to transition risk.

ESG ratings of Malaysian public-listed companies (PLCs) in the energy sector

TOP 25% AMONG FBM EMAS PLCS (4 STARS) BY FTSE RUSSELL	SUSTAINALYTICS RISK RATING (0=NEGLIGIBLE, 40=SEVERE)	TOP 26%-50% AMONG FBM EMAS PLCS (3 STARS) BY FTSE RUSSELL	ESG BOOK PERFORMANCE SCORE	SUSTAINALYTICS RISK RATING (0=NEGLIGIBLE, 40=SEVERE)
Bumi Armada Bhd	20.4 (medium)	Dialog Group Bhd	58.34	24.2 (medium)
Deleum Bhd		Hengyuan Refining Company Bhd		
Hibiscus Petroleum Bhd	38.1 (high)	Icon Offshore Bhd		
Malaysia Marine and Heavy Engineering Bhd		Petron Malaysia Refining and Marketing Bhd		
		Velesto Energy Bhd		21.7 (medium)
		Yinson Holdings Bhd	53.17	16.6 (low)

**Sustainalytics categorises Hibiscus Petroleum as an oil and gas producer, while the other companies are in the energy services category*

***Not all PLCs are given ESG scores by rating agencies*

SOURCE: BURSA MALAYSIA, SUSTAINALYTICS, ESG BOOK, DATA TAKEN IN AUGUST 2023.

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O&G companies judged on how they manage risks

Last year, Tesla CEO Elon Musk questioned how ExxonMobil could be kept in the S&P 500 ESG Index while Tesla was dropped. This highlighted several common misunderstandings about ESG ratings. Companies are rated against their peers in the same industry, and the scores often reflect how they are managing their risks and not their impact on the world.

“ESG ratings scores do not necessarily measure whether a company is an actual leader in reducing its impacts on people and the planet or whether it is working to build a more just and sustainable world,” says Bertrand Jabouley, sustainable finance analyst at S&P Global Ratings.

“But it does typically highlight a company’s exposure to industry-specific material ESG risks and how well a company is managing those risks.”

ESG scores for O&G companies, therefore, could be useful only to compare against peers in the industry and for investors to identify companies that are best at managing their risks.

For O&G companies, S&P pays specific attention to the risks of transition, including physical risks, pollution and regulatory risks. On the social side, it looks at safety and the community where the companies operate.

How will the ESG scores of two O&G companies differ? Jabouley gives the example of Ecopetrol SA and Repsol SA, the two O&G corporates it scores and whose ESG evaluation reports are available online. The Spain-based Repsol has a score of 68, while Ecopetrol is at 58.

“The key differentiator between the two is that Repsol has been increasing more decisively its focus on biofuels, chemicals and renewables to reduce transition risks and [make it] part of the energy transition,” says Jabouley.

What other factors will increase an O&G company’s ESG scores? Those that set credible targets, says ESG Book’s Klier. “A credible net zero target requires transparency, management incentives, initiatives that are aligned with the target and a track record of delivery.”

Companies that go back on their climate pledges can be viewed as a transition risk and it could impact their ESG score. “We also see companies like Repsol, Shell and Total [that] link executive remuneration to emissions reduction measures. Disclosing this usually signals good governance and can impact the governance pillar,” adds Ng.

O&G companies that are over-reliant on CCS as a decarbonisation strategy may pose a red flag. CCS has been criticised for underdelivering on its promises and encouraging more oil and gas extraction, which does not result in net emissions reductions.

"While it is an expensive technology, CCS is considered financially viable for large O&G companies but not transformational. Companies that pursue CCS may face technological, financial, policy and stakeholder perception risks. As such, their forward-looking credit health is not 'rewarded' for claiming CCS as part of their strategy," says Ng.

Investors have been urged to scrutinise CCS projections associated with the net zero transition plans of Asian companies by the Asian Investor Group on Climate Change, as the deployment of CCS across Asia will likely undershoot industry claims and scenario projections. The Intergovernmental Panel on Climate Change has also expressed similar concerns.

In Malaysia, Petroliam Nasional Bhd (Petronas) is the biggest O&G player. Ng observes that the company has a significant dependency on O&G for revenues and "while its plans for revenue diversification include investing in RE, it appears to be largely adopting a wait-and-see approach compared to global peers and is, instead, investing in CCS for the processing of natural gas."

This is concerning, she says. "Because CCS is yet to be a credible decarbonisation solution and its CCS projects are in early stages, how CCS contributes to Petronas' emissions reduction plan is questionable for now."

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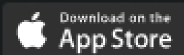

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