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# Peak Uncertainty:

## Evaluating oil company governance at the dawn of the electric transport age

## Executive Summary

Can investors be assured that International Oil Companies (IOCs) are sustainable for the long term? Technological, policy and market trends intended to mitigate climate change threaten permanent displacement of oil demand. The long-term investments of oil companies may prove to be liabilities if future demand falls short of expectations. The potential implications for investors are significant, but uncertain since the likelihood and impact of these trends are difficult to forecast.

In uncertain circumstances, business strategies and practices that historically have served shareholders well may become a hindrance to adapting to new operating environments. The primary risk for oil companies is an inability to adapt to scenarios that fall outside of historical norms.

Given the difficulty of making accurate forecasts in an uncertain environment, the most useful current signal of how well a company is positioned for the long term is its corporate governance. While there is no doubt that oil companies are preparing for the future, the question for shareholders is whether the companies are envisioning a future that looks much like the present or preparing to adapt to societal change that could result in an entirely new operating environment.

As we discussed in our June 2017 piece, "Making Their Voices Heard: Shareholders Vote for Greater Transparency on Climate Change," a majority of shareholders at two IOCs and more than 40% at a few others supported proposals asking companies to disclose an analysis of the impact on their businesses of a global shift to a "low carbon" economy – one in which greenhouse gas emissions are sharply curtailed in order to limit global warming to 2 degrees Celsius. Some companies, such as Shell, Statoil and Total, have done so. Within the past few days, Exxon Mobil has promised to produce a report as well.

While these analyses are important, we believe oil company shareholders should be primarily concerned with whether the company has adopted practices for governance, disclosure and engagement that indicate flexibility and resilience in the face of secular decline for its primary product.

**John Wilson**
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We explore six key questions to guide investors as they engage with oil companies and review upcoming climate risk reports:

- Does the company's reporting include a scenario that envisions disruption to its own production?
- How transparent is the company regarding resilience of its resource base to secular price changes, both in aggregate and by asset type?
- Does the company's strategy provide a realistic path to meeting investor expectations in a low carbon scenario?
- Is the company's board composition and process sufficient to execute its strategy in the case of disruption?
- Would executive compensation plans align shareholders and managers in a disruption scenario?
- What effect does the low carbon strategy have on the company's stakeholder relationships?

## Low Carbon Scenario: A Quick Review

According to the International Energy Agency (IEA), limiting global warming to 2 degrees Celsius—the so-called "low carbon scenario"—requires that combustion of fossil fuels, especially oil, start to decline within the next 15 years and fall by around 60% by 2050. The Paris Agreement of 2015 committed the world's governments to greenhouse gas reductions intended to achieve this goal. However, rising living standards in the developing world and the wavering commitment by the United States have persuaded most analysts that a policy-oriented solution will not be sufficient to achieve "peak demand" for oil.

**Significant disruption becomes plausible when policy goals combine with technological, social and economic trends**

Significant disruption becomes more plausible when policy goals combine with technological, social and economic trends. For example, light duty vehicles, which make up 25% of oil demand, are currently poised to eliminate or radically reduce their reliance on fossil fuels. As the variety of electric vehicle (EV) model choices expands and their quality and price matches or beats those of gasoline-powered options, EVs could reach a "tipping point" of rapid adoption and displacement of existing technology.

While challenges to expanding electrical grids, charging infrastructure and battery supply chains make it difficult to pinpoint the timing of such a tipping point, Bloomberg New Energy Finance predicts that demand for oil could peak by 2025, and a study by the Grantham Institute and Carbon Tracker estimates peak demand by 2020, using updated estimates of technology cost curves for batteries, solar power and EVs that seek to correct the consistent understating of the progress of these technologies.

Meanwhile, despite mounting evidence to the contrary, the base case scenario of the IEA predicts rising demand indefinitely, and most oil companies have not published any demand decline scenarios.

## Uncertainty of Investment

Oil is a core holding of many portfolios despite limited price appreciation over the last decade or so because of the size of the industry and its ability to pay consistent dividends with relatively low volatility. Investors interested in current income will prefer a dividend and share buyback policy that balances current income with capital expenditures necessary for reserve replacement sufficient to maintain free cash flows over time.

**The core competency of an oil company is its ability to replace its reserves with those of equal or greater value while controlling costs**

Reserves, oil companies' most important balance sheet asset, decline as assets are exploited. Therefore, the core competency of an oil company is its ability to replace its reserves with those of equal or greater value while controlling costs. The market values companies primarily on current production, reserves, and near-term replacement of reserves through new exploration. While dividend and buyback policy will also matter to some investors' valuations in the short term, reserve replacement determines a company's ability to meet dividend expectations over the long term.

**The risk of 'stranded assets' is unlikely to affect current oil company balance sheets or to be reflected in near-term share prices**

Company assets that are less likely to enter production, or likely only in the distant future, are discounted and not a major component of oil company valuation. Thus, the risk that climate change mitigation leads to "stranded assets" (assets that never enter production because they have become uneconomical) is unlikely to affect current oil company balance sheets or to be reflected in near-term share prices.

**However, if demand declines faster than supply, the risk to asset value is real**

However, if demand for oil were to fall faster than supply can be shut down, secular commodity price declines would reduce the value of new reserves, especially those with high costs of production. High-cost assets such as arctic or oil sands could be abandoned as too expensive to produce given reduced demand, eroding oil companies' overall asset value.

For context, a recent analyst report[1] indicates that rapid adoption of EVs could displace as much as 3.5 million barrels of oil per day by 2025, an amount greater than the shortfall that caused the price to collapse in 2014. In this case, however,

[1] https://www.cnbc.com/2017/10/05/electric-cars-could-cut-oil-demand-roughly-equal-to-irans-output.html

the decline would be permanent and would accelerate (relative to current expectations) as EV technology improves.

**Energy companies will face decisions about whether they can cut costs sufficiently to maintain margins, meet financial obligations and fund new investments**

Oil companies have been highlighting for investors the ways in which they are reducing the costs of production across asset types to counter this risk. While cost-cutting may provide short-term relief for some firms, on the whole energy companies will face decisions about whether they can cut costs sufficiently to maintain margins, meet financial obligations and fund new investments.

The complexity of such strategic decisions is complicated by the dominance of national oil companies (NOCs), whose strategies are more likely to reflect geopolitical and domestic political considerations that may become more difficult to predict in a changing global demand environment.

For the moment, financial market expectations about the future of commodity prices, and thus oil company share prices, conform to historical norms and mainstream predictions about the future of demand. But if the likelihood of a low carbon scenario materially increases, oil company shares may experience an abrupt selloff as markets correct.

## Uncertainty of the Long Term

**Despite numerous governance concerns, oil companies have maintained a long-term focus that has benefited shareholders overall**

Two traditional problems in corporate governance are "shareholder misalignment," the risk that managers' interests diverge from those of shareholders, and "short-termism," the tendency to manage for the present at the expense of the future. Historically, oil companies have governed these concerns well, providing relatively consistent income over time while managing around the commodity boom-and-bust cycle, political instability in oil-producing countries, and other risk factors beyond their control. Despite numerous governance concerns, especially relating to social and environmental issues, the companies have maintained a long-term focus that has benefited shareholders.

The industry has access to millions of historical data points and leading indicators, analysis of which allows companies to make reasonable predictions about the future that lend confidence to long-term investment plans. However, the value of historical data becomes questionable under conditions of secular change and uncertainty.

**The risk is not that companies and investors are ignoring the future, but rather that they are unprepared for a future that is unlike the present**

The risk is not that companies and investors are ignoring the future by focusing exclusively on the present, but rather that they are unprepared for a future that is unlike the present. A blind spot to outcomes that may lie outside historical experience may hamper its ability to adapt if needed to an unfamiliar operating context. Shareholders who take this risk seriously need tools to manage this risk.

## Climate Risk Reports: A Start, But Not Enough

**In 2017 shareholder proposals for climate risk disclosure received strong support, highlighting investor concerns**

During the 2017 annual meeting season, shareholders of some oil companies voted on proposals for increased disclosure of the potential impact on energy company business models of a global effort to limit global warming to 2 degrees. The proposals received over 60% of the vote at Exxon Mobil and Occidental Petroleum, and more than 40% at several others, despite board opposition.

The proposals differ from most previous shareholder actions on social and environmental issues. They focus on strategy rather than operations; business risk rather than social impact; and specify the scenario that the report should consider. Investors usually hesitate to support proposals that strike this close to the company's core business decisions. The high vote totals in the face of board opposition imply a significant concern among investors about the possibility of the low carbon scenario and the importance of company plans to mitigate risk.

**Reports based on these proposals alone may not resolve shareholders' governance concerns**

In response to shareholder demand for additional disclosures, some of the large oil companies have produced versions of the reports or plan to do so. The Taskforce on Climate Disclosures (TFCD), an initiative of the Financial Stability Board, provides guidance about how companies can create scenarios and model the impact of climate policy on business models. TFCD guidance asks companies to disclose how they intend to govern this issue.

However, reports based on these proposals alone may not resolve shareholders' governance concerns.

At present the low carbon scenario remains hypothetical, and its realization depends on technological advancements, political and policy priorities, and changing market expectations – all of which are difficult to predict with any accuracy. For an industry accustomed to data-driven, quantifiable forecasts, the uncertainty surrounding these factors makes their plausibility difficult to assess.

**Shareholders should view these reports with an appropriate degree of skepticism**

Companies may agree to produce a report solely to fulfill the shareholder request, not because management believes that the threat is plausible. A report could reasonably describe a low carbon scenario, but conclude that no shift in strategy or governance is necessary because it has a low probability of occurring or because the effects would likely fall on other producers. Companies have a strong incentive to produce a scenario report whose assumptions support their existing long-term strategy. Shareholders should view these reports with an appropriate degree of skepticism.

## A More Thorough Assessment of Corporate Resilience

**All of a company's governance reporting should be evaluated in the context of the low carbon scenario**

To assess how a company is positioned to respond, investors should consider more broadly whether its overall corporate governance is well positioned to execute on a strategy that maximizes shareholder welfare in a low carbon scenario. All of a company's governance reporting should be evaluated in the context of the low carbon scenario, assessing how well disclosure about boards, compensation, risk reporting, and other matters align with the company's view on the possibility of disruption. Comparing broader governance and financial reporting with climate risk disclosures will help shareholders to infer how likely the company views the low-carbon scenario to be, and how well positioned the company is to respond under such a scenario. The six questions outlined below are designed to test corporate governance for climate risk resilience.

### 1. Does company reporting include a scenario that envisions disruption to its own production?

The oil industry is known for the rigor of its analyses, applying high standards of quantitative "robustness" to its forecasts using thousands of historical data points. However, industry forecasts have consistently underestimated the forces of disruptive change, including the decline in the cost of renewables or accelerating improvements in fuel economy. Current industry analyses are increasingly inconsistent with the stated plans of important industry stakeholders.

**The coal industry offers a cautionary case study in ignoring secular change**

There is historical precedent for the potential impact on shareholders. A decade ago, coal companies consistently mistook the secular industry decline for a cyclical downturn caused by the global financial crisis. Even as demand for coal was being displaced by cheaper, cleaner and more flexible natural gas, companies refused to write down the value of their assets. Coal companies continued to increase dividends in an apparent attempt to signal confidence in their long-term prospects. At analyst meetings, coal executives consistently predicted a demand rebound, dismissing or ignoring the substitution of their product for natural gas, while few analyst questions addressed competition from other fuel sources. [1]

The result was a waste of capital and eventually the abrupt destruction of shareholder value during bankruptcies in 2015-16. A more realistic analysis and valuation of coal assets may have led to a more orderly and efficient liquidation of these companies through returning cash to shareholders.

[1] See Arch Coal analyst call March 31, 2010, Peabody Energy earnings call 10/20/2010, Alliance Resources conference/presentation call 12/31/2011, et al.

## 2. How transparent is the company regarding resilience of its resource base to secular price changes, both in aggregate and by asset type?

Company disclosure of risk management serves both as a source of critical investment information and as a window into the governance of the company. The choices that companies make about what to disclose may help investors understand management's priorities, perspectives and thought processes.

**Shareholders should carefully consider both the quality of company disclosures and the company's openness to dialogue**

Of course, corporate disclosures are useful only in the context of engaged dialogue between shareholders and management, which can help to illuminate ambiguity and test whether company scenario planning is well aligned with shareholder perspectives. Shareholders should carefully consider both the quality of company disclosures and the company's openness to dialogue as signals of its willingness to take shareholder concerns seriously in its strategic planning.

Investors concerned about the resilience of a company's portfolio of assets in the face of significant price declines will be interested in the company's assessment of these risks, which will drive corporate decision-making around governance, capital expenditure and long-term strategy. Investors should be concerned if companies cannot envision disruption of their own businesses, even if they consider such an outcome unlikely.

**Of interest to investors will be the decisions the company makes about assigning different risk levels to different types of assets**

Of interest to investors will be the decisions the company makes about assigning different risk levels to different types of assets, even if risk levels are described in general terms. (Companies may consider the details of specific assets to be competitive information, but an aggregated analysis sorted by risk level should be possible without disclosing proprietary information.) The risk to an asset may be quite different from the risk to the portfolio, and the stranding of one major asset may have material financial implications for the company even if most of its assets remain productive. Such disclosures could help to establish comparisons between companies, if these risk definitions were reasonably consistent.

## 3. Does the company's strategy provide a realistic path to meeting investor expectations in a low carbon scenario?

In a low carbon scenario brought about by a confluence of technological, regulatory and market changes, investors will be interested in how flexibility will be built into strategic planning, and how companies will leverage competitive strengths to execute on their strategies.

For instance, a company may plan to maintain production by increasing market share in a declining market. It would need to demonstrate an ability to cut costs more quickly than competitors, maintain financial health while making necessary investments, and manage the geopolitical environment. The last will involve managing competition from NOCs, as well as radically altered domestic political contexts (for example, because job growth is concentrated in renewable energy while employment in the oil sector declines). Investors will be particularly interested in how the board and other governance policies emphasize both operational excellence and political skill.

**Management will need to explain how their capabilities will help them remain competitive**

Some oil companies have signaled an intention to shift into either gas or renewables. In past, oil companies have struggled to diversify business lines. Investment in renewables by oil companies has never succeeded at scale, and some oil companies have struggled to profit from gas, or to shift from large scale projects to smaller scale operations such as shale. Moreover, as native shale gas and renewables industries mature, it becomes harder to make the case that oil companies may have core competencies that the native companies do not. Management will need to explain how their capabilities help them compete against native industries with a more directly relevant set of capabilities.

Unlike other industries, such as technology, oil company executives and boards are not accustomed to strategic shifts requiring a radical adjustment to product mix. Investors will be interested in how companies have learned from past failures, and how they intend to build strategic competencies that will enable them to succeed in businesses that may be unfamiliar.

**For companies that lack strategic advantages in a low carbon scenario, managed decline may be in the best interests of shareholders**

Finally, for companies that lack strategic advantages in a low carbon scenario, managed decline may be in the best interests of shareholders. This may be challenging for companies to acknowledge, because it may set off a decline in stock price. However, returning cash to shareholders that cannot be invested properly is a responsibility of corporate management, and would be preferable to the crash experienced by coal company shareholders. The challenge for management is to appropriately identify the market signals that would trigger such a strategy, to allow the company to make investments and operate as a growing enterprise until another strategy is appropriate.

Of particular importance will be how capital expenditures, including investment in new resources, investment in alternatives, dividend policy, buybacks and capital structure (especially debt service) align with the vision of the future outlined in company reporting. Companies that provide robust analysis of low carbon scenarios but little financial preparation for disruption are implying (or stating) that they consider this outcome unlikely.

## 4. Is the company's board composition and process sufficient to execute its strategy in the case of disruption?

**Investors will be interested in whether the board possesses the skills to contribute to the execution of a strategic pivot**

Investors should pay close attention to the composition of the board of directors, specifically what skills and capabilities board members bring to the oversight of execution of the business model envisioned under disruption. Recently, some companies and shareholders have promoted the addition of sustainability expertise to boards. While these directors may bring a greater understanding of the science, economics, or policy implications of sustainability issues, there is a risk that they may not possess the relevant expertise to oversee the execution of strategies that will resolve the business challenges they raise. Investors will be interested in whether these experts possess the specific skills and competencies to contribute to the execution of a strategic pivot.

**Investors will also be interested in the process for board consideration of climate change**

Investors will also be interested in the process for board consideration of climate change. Traditionally, these discussions have taken place alongside other operational topics, such as production emissions or safety. While these topics are important, they take place within an existing corporate strategic framework. If a board considers strategic disruption from climate change to be a material risk, it is more likely to incorporate the subject into strategic discussions, including how best to operationalize a business transformation in response to changing circumstances.

## 5. Would executive compensation plans align shareholders and managers in a disruption scenario?

As with most companies, the compensation plans of oil companies include a mix of financial incentives (such as total shareholder return) and operational incentives (such as production or reserve replacement goals) to align compensation with shareholder interests. Incentives that are commonly used may not serve shareholders well in a low carbon environment, nor encourage companies to pursue a strategy designed to maximize resilience.

**Investors should carefully consider whether compensation plans are consistent with the company's stated objectives for climate resilience**

Compensation disclosures should discuss, even in general terms, how executives would fare under a low carbon scenario, and how compensation incentives are aligned with the company's low carbon strategy. Investors should carefully consider whether compensation plans are consistent with the company's stated objectives for climate resilience. Companies positioning for disruptive change will seek to adapt incentives accordingly. Financial incentives that integrate the risk of specific assets under a low carbon scenario may encourage the development of a more resilient portfolio. Executives should not be incentivized for increasing assets that are at high risk of becoming stranded.

Investors will also be interested in knowing how financial incentives leave room for a strategic pivot towards managed decline, if appropriate.

Operational incentives should include incentives to execute on company strategies to diversify away from fossil fuels, if applicable.

## 6. How does the company evaluate the potential effect a low carbon scenario may have on its stakeholder relationships?

**Shareholders should be concerned that the company has at least considered how changing stakeholder relations would affect its ability to execute its strategy**

A low carbon scenario would change the relationship between the company and most of its stakeholders. A detailed examination of the impact of the company's strategy on its stakeholders might be politically sensitive, and therefore difficult to disclose in detail. Shareholders should be concerned that the company has at least considered how changing stakeholder relations would affect its ability to execute its strategy. For example:

- What could be the potential impact of a low carbon scenario on the company's partnerships with oil producing countries that depend on oil revenues to meet national budgets, provide for their people and maintain political stability?
- What is the impact of declining production on local communities where local people depend on wages, royalties to landowners, and taxes?
- How does the energy sector compete for talent against rising industries such as renewable energy?
- How is the industry working to attract and retain gas station franchisees who may face long-term decline in demand for their services?
- What role do the company's political activities play in its long-term strategy? What is the possibility that its strategies become a liability in a low carbon scenario?

## In Sum

**Investors have an obligation to know whether these companies are ready**

The climate risk reports represent the culmination of decades of dialogue between shareholders and companies on issues of climate change. This dialogue has produced gains in the form of greater operational efficiency, attention to the public positioning, and experiments in alternative business models. All of these are important, but tangential to the IOC's core business and their primary impact on the climate – the sale of hydrocarbons for combustion. In the present moment, the companies are developing business plans and making commitments that may last into the decline of the fossil fuel age. Investors have an obligation to know whether these companies are ready.

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