RISK in Focus

Oil + Gas

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Background

Investors and other stakeholders across all industries are holding businesses accountable not only for their financial performance, but their measurable impact on people and the planet.[1] Specifically, they're scrutinizing companies' actions and policies related to environmental, social, and governance (ESG) matters. These categories are quite broad:

+ **Environmental** issues are related to protecting the earth and conserving its resources.
+ **Social** criteria reflect how the company relates to the people in its sphere – from employees to business partners to the communities in which it has a presence.
+ **Governance** refers to the company's practices regarding legal compliance and whether it's operating in accordance with ethical principles.

Recently, major credit rating agencies like Moody's Investors Service and S&P Global Ratings have zeroed in on ESG and especially the environmental records of oil and gas companies. They're also increasingly skeptical about the industry's ability to operate as it has in the past in the face of likely:

+ Future public policies to address global warming.
+ Liability suits from climate activists.
+ Shifts to alternative energy.
+ Shareholder suits regarding ESG matters.

Specifically, Moody's warned in September 2020 of long-term risks within the oil and gas industry related to access to capital as well as related risks regarding insurability and litigation.[2] Similarly, early in 2021 S&P downgraded its credit ratings for major U.S. oil companies, citing future stricter regulation and declining demand for oil and gas.[3]

Independent rating agencies aren't the only ones analyzing these matters and energy companies' ESG performance. Customers, investors, insurers, banks, news media, and the general public are reviewing these matters carefully. Scrutiny is shifting from the major energy companies to the independent oil and gas organizations. As such, it has now become commonplace to see ESG commentary in public filings and investor presentations of companies of all sizes.

Hazards that Contribute to this Risk

Hazard 1: Failing to take Appropriate Environmental ESG-Related Actions

Energy companies may be tempted to push back against the environmental improvement expectations within ESG. After all, energy recovery and transportation are complex and environmentally invasive. Additionally, oilfield service (OFS) companies and others in the energy value chain that have been suffering from declining margins may not see this as the best use of capital. Many companies have also already gone to extraordinary lengths to minimize the environmental impact of their operations and feel that these efforts have been enough.

But if these companies don't take additional, visible steps and demonstrate continual progress in this area, they'll be subject to criticism within their communities, targeted by policymakers and activists, negatively impacted by higher cost of capital due to declining Moody's and S&P ratings, and further constricted by lending institutions and insurers that are looking to scale back their exposure in industries that score lower in ESG ratings. All of these factors are expected to have an inflationary impact. This is becoming increasingly important in the insurance marketplace. Lloyd's, the world's biggest insurance market, announced in 2020 to pull out of the fossil fuel business altogether by 2030, bowing to pressure of outside activists. It is imperative that companies focus on ESG initiatives and actively promote their achievements as insurance capacity will likely flow to higher performing ESG campaigns.

With commodity prices significantly recovered in 2021 from the historic lows 12 months prior, upstream and midstream oil and gas companies and their suppliers have an opportunity to invest additional time and resources in this kind of incremental environmental progress – for example by making additional investments in solar power at the production sites, upgrading their fleets to EAVs, or incorporating additional pollution mitigation and containment systems.

Hazard 2: Failing to take Appropriate Social and Governance ESG-Related Actions

It's all too easy for companies across the energy value chain to only zero in on the environmental side of ESG – it's the area the public tends to think of first for this industry. But if these companies neglect to address society's concerns about their social and governance activity, they'll be open to criticism and lawsuits on these matters as well, and institutional and private investors will look for opportunities elsewhere. Even though many companies have already taken measures to address these concerns, it is likely the industry will continue to face close scrutiny.

With regard to social issues, currently there are several good reasons to review employee compensation schedules and benefits as discussed in the workforce section below. Additionally, energy companies should take a fresh look at how they support community priorities.

The companies should also review their governance policies and performance. Are they being accurate and transparent in their public disclosures, treating their employees and shareholders fairly, and maintaining productive and diverse boards of directors?

Hazard 3: Viewing ESG as an Onerous Intrusion

The principles behind ESG are good for business.[4] Strong ESG performers have better access to capital. Companies, insurers, and investors generally prefer to partner with companies with strong ESG records compared to those that do not.

Further, operating with transparency, building and maintaining a diverse workforce, reducing pollution, utilizing alternative energy, and adhering to other ESG initiatives are good business practices. Taken together, they reduce worksite hazards, stimulate innovation, attract investment, reduce local opposition, minimize staff turnover, and decrease costs.

Hazard 4: Failing to Measure and Promote the Company's ESG Performance

In order to reap the full benefit of a robust ESG program, a company needs to ensure its achievements and progress are broadly recognized. A variety of stakeholders – the public, public officials, lenders, insurers, investors, activists, and others – want to see tangible, data-driven evidence of progress within each of the three areas of ESG.

When companies don't take a strategic and thoughtful approach to informing these stakeholders about their ESG activity and commitment, they're missing an important opportunity. Covering these ESG issues with a page or two in the company's quarterly financials and investor presentation is just the first step. Proactive community outreach, creative social media messaging, and building relations with local news media are important as well.

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Cyber Security and Ransom Attacks

Background

On May 7, 2021, Colonial Pipeline was targeted by international cybercriminals who hacked its IT network. Out of an abundance of caution and to minimize the scope of the intrusion, the company immediately shut down its 5,500-mile pipeline, disrupting fuel deliveries for several days in much of the country. The company paid the hackers approximately $5 million in ransom.[5]

This seemed to be a wakeup call for small to midsize oil and gas companies across the U.S., in spite of the fact that ransom attacks were already one of the fastest-growing forms of cybercrime. They were up 139% in the third quarter of 2020 compared to the same timeframe the year before.[6] The largest demand in 2020 was $30 million. One of the most potent malware versions, Maze, averaged $4.8 million per ransom incident in 2020, which is significantly higher than the average ransom demand of $847,000 across all ransomware types in 2020.

Hazards Contributing to the Risk

Hazard 1: Failure to Train Employees about Cyberattack Risks and What to Look For

Employees can be the weak link in any business cybersecurity setting. Most are well-aware of the risks of clicking on a suspicious link. But it just takes one employee in one careless moment to let a hacker into the system.

Unless training and reminders are continually offered, the likelihood of this happening creeps up over time. Some companies go so far as to send test “phishing” emails to their employees periodically to measure vulnerability and provide important training moments.

Hazard 2: Maintaining Poor Firewalls and Failing to Review and Optimize Security Access Protocols

In other cases, poorly maintained systems are to blame. Joseph Blount, Jr., CEO of Colonial Pipeline, admitted to a U.S. Senate Committee that the company believes the hackers gained access to the company’s shared internal drive through a virtual private network (VPN) profile. It was password protected but wasn’t utilizing multi-factor authentication, which was the company’s standard.[7] Multi-factor authentication is becoming the norm and not the exception and companies may be held liable by shareholders and other various stakeholders for potential losses. In the new world, where work from home and other heavy IT dependent activities dominate companies’ systems and processes, optimization of IT security is key to reducing risk and vulnerability.

Labor Shortage

Background

As COVID disrupted the global economy and caused energy prices to sink in 2020, more than 107,000 workers were laid off from midstream, refining, and chemical companies in the U.S.[8] However, by midyear 2021 prices had recovered stronger than many expected, and once again the industry needed to staff up.

Unlike with other cycles, though, the downturn in 2020 felt much different. This time it was accompanied by a more concentrated societal focus on global warming. As a result, many employees who left the industry in 2020 are more hesitant to come back.[9]

Energy companies will need to invest in new employee training to bridge the knowledge gap as well as make a strong effort to retain current employees with enhanced benefits and other inducements.

Hazards Contributing to the Risk

Hazard 1: Failure to Learn from Previous Downturns

During the energy industry downturn in the 1980s, employment in the energy extraction sector fell by 30% and many firms discontinued their recruiting and hiring programs. This led to a generational gap of talent in the industry when markets recovered, and it left companies scrambling – forced to hire and train younger and mid-career workers.[10]

If companies take these same steps at this time and scale back their recruitment efforts, their longer-term talent pipeline will dry up. This is especially significant given that the median employee age in the industry today is more than 44.[11] Neglecting recruitment will also diminish their opportunity to establish a more diverse workforce.

Hazard 2: Neglecting to Offer Competitive Benefits

The labor shortage has increased the competition for all levels of oil and gas workers. The most talented and experienced employees are in a prime position to explore options that would increase their compensation and other benefits.

Oil and gas company owners that don't take a Total Rewards approach to employee compensation are at a greater risk of losing out in the competition for workers. Total Rewards includes the thoughtful balance of:

- Base wages
- Incentives
- Benefits
- Work-Life Balance
- Training and Career Growth

Hazard 3: Inability to Appeal to a New Generation of Workers

The struggle to attract new workers to the oil and gas industry is in large part a challenge of perception. Despite the fact that the industry offers high-paying jobs, not many young workers planning their education consider this field because it's too often stigmatized as unappealing and destructive.

In fact, the energy industry, including oil field service companies, are digitizing their services at a rapid pace. Much of their hiring is for less labor-intensive positions. University petroleum engineering programs are significantly recrafting their curricula in this direction.

Similarly, there's a perception that the oil and gas industry will disappear within a decade or two. Experts disagree and believe that full careers are still available for young people just starting in the industry.[12]

If companies fail to demonstrate this new technology-driven face of oil and gas operations and the fact that viable, long-term careers are still possible, they'll continue to fall behind in recruiting the new generation of employees they need.

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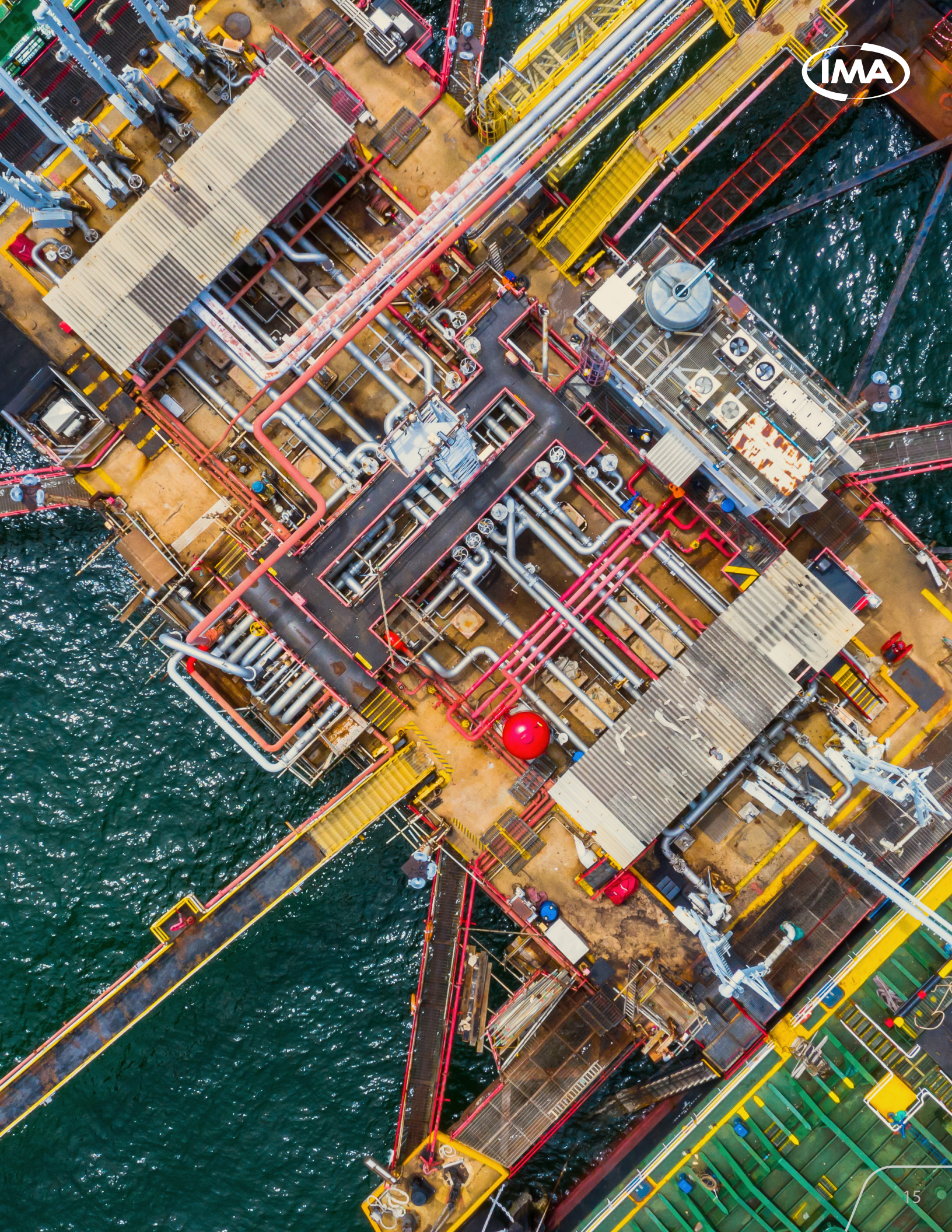

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IMA is an integrated financial services company specializing in risk management, insurance, employee benefits and wealth management. It is the sixth-largest privately-held and employee-owned insurance broker in the country and employs more than 1,200 associates.

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