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START SMALL AND SCALE UP – A PRAGMATIC AND NO-FRILLS APPROACH TO INTEGRATING ESG INTO YOUR BUSINESS STRATEGY

Introduction

The energy sector has for many years been addressing sustainability through minimising operational impacts on the environment. This has typically included reducing the risk of hydrocarbon spills, waste and emissions, water use and disposal and direct impacts on biodiversity such as light or noise. On the social front, programs to protect and improve employee health and safety, support gender diversity, employee engagement and community development are certainly not new. Drivers for tackling sustainability issues were typically compliance, cost savings, operational efficiencies and reputation management.

Over the past two years in particular, the energy sector, along with many others, has seen an increase in a focus on sustainability through the lens of ESG – environmental, social and governance. ESG is not new; the term was coined in 2005 with the launch of the United Nations Principles of Responsible Investing, which reflected an understanding that non-financial factors materially impact a company's performance, and therefore should be considered in investment decisions[1].

While some organisations have been embedding ESG into their business strategies for some time, for others, the term ESG, and what it means for their organisation, is still relatively new. This paper considers what integrating ESG into business strategy might look like for those organisations who are starting out on their ESG journey, but may also provide some fresh ideas for those who want to review their current approach to ESG.

Introducing ESG

So what is ESG? There are a range of definitions out there, but for me, the simplest way to describe ESG is as 'sustainability for investors'. ESG is about identifying, measuring, managing and communicating the non-financial factors that could impact organisational performance in a consistent, comparable, and reliable way, using three pillars: environmental, social and governance. The key difference between sustainability and ESG is the measurability and comparability of material ESG risks between organisations from an investment risk perspective.

ESG can be viewed either from the side of the investment sector, including lenders, fund managers and ESG rating specialists, or from the organisations implementing ESG; in this case those in the energy sector. The latter is what I'm focusing on in this paper.

What this looks like in practice is that organisations are increasingly looking outwards, to their competitors, their peers, their customers, and lenders, increasingly acknowledging that their stakeholders matter, and reflecting stakeholder views in their business vision, values and operations. They're embedding ESG into their governance, including Board oversight and risk

[1] Feder, J. (2020). ESG and Energy Transition. Balancing Value and Values in a Post-pandemic World. *Journal of Petroleum Technology*. 72 (06) 17-21.

management approaches, and are developing and implementing the policies, procedures and practices that demonstrate how ESG risks and stakeholder expectations are being addressed. And they're ensuring that their annual financial and/or sustainability reports contain the sorts of information that the financial sector is interested in seeing through the adoption of frameworks and standards.

ESG Drivers and Performance

Given that ESG has been around for 15 years or so, what accounts for the relatively recent focus on ESG? Some of the key drivers include shareholder activism, a focus on climate targets, public discourse around the energy transition from fossil fuels to 'cleaner' forms of energy, a changing regulatory environment, particularly in Europe and the US, and increasingly, lender standards that require companies seeking funding to show how they're addressing key non-financial risks, particularly linked to climate change. It may also be that COVID has played a role, bringing some of the social issues associated with organisation's operations to the fore. In short, our community are declaring that it is no longer sufficient for organisations to talk about 'doing less harm'; they are expecting the conversation to be reframed around 'doing more good'.

Companies that fail to address ESG risks may be more likely to experience reputational damage, reduced revenue, boycotting, supply-chain issues (for example linked to COVID or climate change), missed opportunities for new products, new markets and cost savings, and in some cases litigation. Conversely, the benefits of integrating ESG into business strategy includes increased returns and financial performance, access to new and emerging markets, increased resilience to market fluctuations, improved ability to attract investment, increased employee attraction and retention, and particularly for smaller companies, an opportunity to 'stand out from the crowd' of their peers[2].

So how is the energy sector responding? If we look at what the global majors in the sector are up to, they are investing big in renewables and carbon offsetting projects, while acknowledging that hydrocarbon-based fuels will continue to be important for the remainder of this century, and possibly into the next. To manage emissions they are committing to targets that reduce the carbon intensity of their products, reduce methane emissions and increase investment in low carbon supply chains. These targets are increasingly becoming a focus for their ESG reporting, and absolute carbon emissions and intensity are key considerations in investment and acquisition decisions.

While much of the focus has been on environmental performance, and more recently to climate risk, targets and action, there has also been more attention given to the 'S' in ESG beyond workforce health and safety and land access. The social aspect has increasingly become topical given issues of diversity and inclusion, modern slavery, and Indigenous relations (amongst others), particularly for energy companies with global operations.

Another trend is in the increased quality of ESG disclosure. The Australian Council of Superannuation Investors (ACSI) reports that ESG reporting standards in the ASX200 have improved significantly in the past 5 years[3]. A key focus in reporting has been the adoption of the

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[2] Stutzman, A. (2021). Q&A: Why ESG Investing Will Impact Oil and Gas Landscape in 2021. https://opportune.com/insights/article/qa-why-esg-investing-will-impact-oil-gas-landscape-in-2021/ (Accessed 1 September 2021); and Heinsz, W, Koller, T, and Nuttall, R. (2019). Five Ways That ESG Creates Value. McKinsey Quarterly; and Ramani, V and Saltman, A (2019). Running the Risks: How Corporate Boards Can Oversee Environmental, Social and Governance Issues. Harvard Law School Forum on Corporate Governance.

[3] ACSI. (2019). ESG Reporting by the ASX200. Australian Council of Superannuation Investors.

Task Force on Climate-related Financial Disclosures (TCFD) Framework. ACSI rates the energy and utilities sector as pretty good with respect to ESG reporting, with over 70% of the ASX200 companies in this sector providing 'detailed' or 'leading' reports.

While ESG is undoubtably becoming more important for the energy sector and there is progress being made, MSCI (2020)[4] (a US-based company that provides ESG analysis and ratings) reports that:

- Despite increased investor focus on climate change, companies in general are behind in setting aggressive carbon targets and realising opportunities in low carbon energy.
- Nearly 60% of companies reviewed do not have higher level oversight of climate-related issues (e.g., through a board-level Sustainability Committee).
- Very few company boards have an executive on them with sustainability-related experience.
- The sector has been under-reporting its carbon risks, with only 26% of companies reviewed reporting Scope 3 emissions.

So, there is room for improvement, particularly as demonstrating ESG integration is now critical to securing investment.

A Diversity of Approaches

To get a sense of how energy companies in Australia are approaching ESG integration, I spoke to a number of people from the Australian energy sector and member companies of APGA, and reviewed publicly available Sustainability Reports for several Australian companies to see how organisations are integrating ESG into their business strategy. I found that there are a diverse range of approaches to addressing ESG.

One is to clearly address the energy transition from hydrocarbons as part of an organisation's vision or purpose statement. This might involve ensuring that the company's purpose accurately reflects its interests and operations, which may have shifted from being primarily hydrocarbon-based to incorporating renewables as a significant component of the business. Another is to be unapologetic that the organisation's primary focus is on hydrocarbons, but to commit to produce energy in the safest, most sustainable way possible, acknowledging that we are not going to fully transition to cleaner energy overnight. In both approaches, there is an acknowledgment of the transition and a clear organisational positioning with respect to it.

Organisations are also looking at their policy framework to ensure that sustainability is tightly embedded within how the organisation conducts its business. In some cases, this involves developing a new policy (such as a Climate Change Policy), however mostly it's about 'topping up' existing policies to ensure that ESG material risks and commitments are adequately covered. Some sustainability departments are seeing an increase resources to support an increase in disclosure expectations, and Sustainability Committees have become a common approach to supporting the Board to understand and act on ESG risks and opportunities.

The organisations I reviewed are using a variety of disclosure standards and frameworks, and most have undertaken materiality assessments and report on their material issues. Climate change,

[4] MSCI. 2020. Industry report. Integrated Oil & Gas. February 2020. MSCI ESG Research LCC

health and safety, employees and community, human rights and anti-corruption are commonly disclosed topics. The term 'sustainability' is still widely in use, and most organisations publish a separate annual Sustainability Report disclosing their performance on their material risks. Often reports are supported by a data centre which provides the quantitative metrics. Most companies have set targets, although many of these are qualitative. Several have set 'net zero' targets for greenhouse gas emissions, although the extent to which some of these targets cover all scopes is often unclear.

Our sector has long acknowledged that we can't operate without a social license, and that like ESG, this public acceptance or approval of our activities is shifting rapidly. This makes relationships key to success, and organisations are beginning to integrate meaningful engagement with their stakeholders into organisational culture. In short, sustainability is starting to be viewed less as a 'value' held by some within an organisation, and more as integral to business performance and success.

However this shift is not occurring without its challenges. Smaller companies in particular can find it difficult to source the expertise, human and financial resources to consider what ESG means for their organisation, to begin implementing ESG practices, and measuring and reporting on progress. Stakeholders are demanding more, and without a well-considered strategy, organisations can find themselves constantly reacting to changing customer and shareholder expectations, seemingly keeping no one happy.

The breadth and variety of disclosure standards, frameworks, and terminology available to guide and measure ESG are another challenge, compounded by a perception by some of a lack of leadership and an absence of regulation in Australia (a situation which is shifting in Europe and the US). It can even be hard for larger companies that are relatively well-resourced to tackle ESG integration to know which standards to adopt, as different stakeholders, including financers, ESG analysts and shareholders often demand different approaches.

Focusing on What Matters

In the Introduction to this paper, I described some of the sustainability issues that energy organisations have been managing for some time. These issues are all still important for ESG, but there are new or renewed areas that need to be considered, including workforce diversity, executive remuneration, climate risk, contractor safety, and the supply chain. In particular, the social areas associated with an organisation's operations such as diversity, labour practices, human rights, wage gaps, bribery and corruption, and slavery in the supply chain are becoming increasingly important due to a focus on these issues by our stakeholders. Governance considerations, an area largely overlooked in the past focus on sustainability and selected areas of corporate risk such as bribery and corruption, have become a greater area of focus, with the expectation of greater transparency on shareholder rights, how companies manage risk, hire and pay their boards, measure and report on their performance and how they manage their business ethics, anti-competitive practices and corruption.

Table 1 describes the areas that inform MSCI's ESG ratings and are therefore commonly reported in the oil and gas sector, and Figure 1 highlights some of the broader ESG topics relevant to the energy sector.

Table 1 – Example ESG Areas that Inform Ratings for the Oil and Gas Sector

ESG Topic	Key Performance Area	Weighting
Environment	Carbon Emissions	24%
	Biodiversity and Land Use	14%
Social	Toxic Emissions and Waste	14%
	Health and Safety	14%
Governance	Corruption and Instability	14%
	Corporate Governance	20%

Note: Data sourced from the MSCI (2020)[5].

Figure 1 – ESG Topics

Organisations such as the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), and IPIECA also provide lists of the topics that may be captured in the definition of ESG.

In my mind, a key difference between sustainability and ESG is the concept of materiality. Materiality is about determining which ESG issues are most relevant to a company's operations and therefore, their risk profile. Materiality means that there is no 'one-size fits all' approach, as the risks and therefore topics relevant to one organisation may not be relevant to or appropriate for another.

[5] MSCI (2020). Industry Report – Oil & Gas Exploration and Production. MSCI ESG Research LLC.

Without the application of the concept of materiality, key risks may not be identified and managed, and sustainability reporting could be seen as greenwashing[6]. Materiality gives you the ability to 'focus on what matters' for your organisation.

A Framework for ESG Integration

There are plenty of ESG frameworks out there, mostly associated with standardising the reporting and disclosure of ESG metrics. These frameworks set out the metrics and qualitative elements that an organisation should disclose, as well as the format and frequency of reporting. But disclosure frameworks don't help organisations 'do the work' of embedding ESG into their business. This involves weaving ESG into the very fabric of an organisation, into how they operate and do business, from hiring new employees, to managing the supply chain, to acquiring new assets to how the Board monitors and manages risk.

So how do you go about integrating ESG into your business to ensure your organisation avoids the risks of not addressing ESG, and capitalises on the benefits? Luckily, we've done some of the work for you and have produced a framework to support this (Figures 2 and 3). This framework in no way guarantees you 'ESG success' but provides some logic and structure to support your organisation to commence integrating ESG into your business, and to continuously improve ESG performance over time.

Figure 2 provides some structure to help you evaluate your organisation's 'ESG maturity', so that you can benchmark and test your organisation's current performance and identify where you'd like to be in the future. This matrix can either be used to evaluate organisation-wide performance or for each step outlined in the ESG Integration Matrix (Figure 3).

Figure 2 – ESG Maturity Matrix

No.	Stage	Description
1	Minimal	Solely compliance based. Activities are those required to meet regulatory requirements only.
2	Values-focused	Ethically-motivated. Activities are often siloed and selective, and there is minimal consideration of stakeholder views or priorities or external frameworks.
3	Risk-focused	Understood as a risk management issue. Materiality assessment, target-setting and disclosure are risk-focused and there is some integration of activities across parts of the organisation.
4	Integrated	Understood as integral to business performance. Activities are integrated across the organisation and seek to reduce risk and leverage opportunities. Regular engagement to inform business strategy and decision-making with external stakeholders, the Board and employees.
5	Value Creation	Deeply embedded and a core focus of business strategy. Very high level of transparency (i.e., with strategy and performance) both internally and externally. Focus is on impact and creation of value for the organisation, its stakeholders and society more broadly.

Note: Maturity matrix based on work by Gold (2019)[7].

The ESG Integration Matrix is set out across six simple steps, supported by industry research and benchmarking, engagement with your employees and external stakeholders, and of course ongoing monitoring and review.

[6] Where environmental and social credentials are misstated or exaggerated for marketing purposes.
[7] Gold, A. (2019). Corporate Sustainability (ESG) Reporting Maturity Model. https://drgold.co/2020/06/20/corporate-reporting-maturity-model/ (accessed 15 December 2020).

Figure 3 – ESG Integration Matrix

No.	Step	Description
1	Set your vision	Set a vision or purpose suited to your organisation's strategic priorities, size and operating context to help create a sense of purpose, establish a common language and understanding and set the value, direction and focus of ESG across the organisation.
2	Identify material risks	Engage key employees, the Board and external stakeholders in undertaking a materiality assessment to identify the ESG risks and opportunities material to your organisation's core strategy and performance. Integrate this assessment into existing enterprise risk management processes to support a cohesive approach to risk management across the organisation.
3	Establish your goals and targets	Develop strategic goals and targets that support your vision and address the material risks. It's important to ensure these are relevant and achievable. Targets are supported by key performance indicators and narratives.
4	Implement your ESG initiatives	Ensure that your initiatives are directly linked to achieving your vision, goals and targets. These include ensuring ESG is considered and integrated within company policies, procedures and practices such as strategic planning, due diligence and risk management activities, supplier contracts and procurement, recruitment, training and development, and internal and external reporting and assurance. You may want to capture your initiatives within an annual action plan or strategic document.
5	Measure and disclose your performance	Reporting boundaries provide a clear definition of what will and won't be included when collecting, measuring and reporting data to support key performance indicators. Use standards and frameworks to support consistency of disclosure around your material risks. Include how ESG is being incorporated into business strategy, and don't just describe past performance, look to the future.
6	Engage the Board and Executive	Boards will increasingly be held accountable for managing ESG risks, for setting the direction that guides the organisation's ESG focus and for ESG performance. Strong leadership is essential for accountability, transparency, creating incentives for achievement. Board members may need ESG training, or new members onboarded with ESG expertise.

Benchmark – Take stock of what your organisation is already doing, and look to both your local peers and competitors, and overseas to establish an 'ESG benchmark' relevant to your business.	**Engage** – Talk to your stakeholders to understand their concerns and priorities. Sustainability is not longer the remit of a single department, so ensure your employees are engaged and on board.

Monitor and Review – Regularly review your performance through monitoring industry issues and trends, changes in legislation or industry standards, stakeholder views/expectations, employee engagement outcomes and progress against your targets. Adjust your strategy as required.

By stepping through these two matrices, you're encouraged to:

1. Look externally, to see how your peers and competitors are tackling ESG issues.
2. Look internally, and take stock of what you're already doing, using the framework to consider you organisation's strengths and weaknesses.
3. Talk to your stakeholders to understand their concerns and priorities and engage your employees in your ESG journey.
4. Work out where you want to be positioned in the future.
5. Map out how to get there using the framework and develop an ESG action plan.
6. Keep track of your progress.

My hope is that this framework proves useful in either commencing your organisation's ESG journey or for 'checking in' on how you're doing. It can used to support the development of an ESG strategy and action plan to help your organisation set your vision, implement the right actions to address material risks, and demonstrate your impact to your stakeholders.

Conclusion

Whether you're kicking yourself that you hadn't thought to turn to the end first, or you've read the whole paper and are now ready for the 'so what?', here are a few take-away messages to round out the discussion:

1. **Strategy is about choice.** You can't do everything, so don't attempt it. Be clear what you're about (set that vision and purpose) but build in some flexibility to adapt to the rapidly changing ESG ecosystem and community expectations.

2. **Don’t obsess about targets and measurement.** Yes, they are important, but only to help guide your activities. Getting too caught up in these can bog you down and take focus away from the doing.
3. **Avoid ‘washing’ (unless it’s your clothes or dishes).** Whatever colour you want to call it, people are savvy to it, and it can cause your organisation real damage. ESG isn’t a marketing exercise despite demonstrating a business’s corporate values.
4. **Small steps can make a big difference.** Or as one of our clients commented: “small, measured, honest” is a good way to go. “Rome wasn’t built in a day” is another phrase that comes to mind. There’s no expectation of gold level standards right away, so long as you are engaging in the relevant issues and prioritising actions and can show progress over time.
5. **Help is at hand.** You don’t have to do it all yourself. There are qualified and reputable organisations out there who can help is setting your strategy, developing an action plan, reporting and assurance.

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