the negotiator

February 2021

Environmental, Social, and Governance *It's Here to Stay*

Part 2 of a 4 Part Series *Deductions Against Overriding Royalties*

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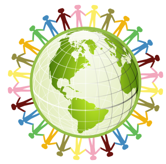

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ESG
It's Here to Stay

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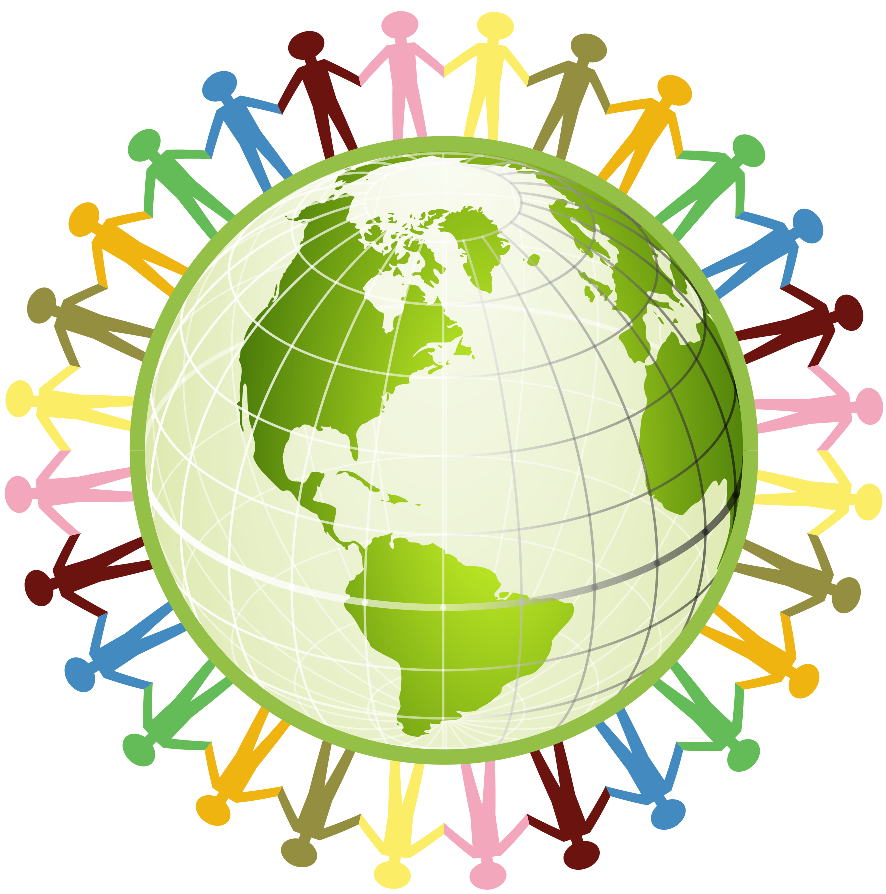


Cue the eye-roll. Outside the C-suite, the three letters ESG can evoke strong emotions, from a positive and salutary feeling that a company is acting responsibly and responding to investors' demands, to contempt for pandering to the uber-woke.

If you dig into reading material on ESG, however, you discover some unexpected truths:

- Many, if not most, Canadian oil and gas producers and midstreamers were already hitting ESG benchmarks before ESG branding arrived, in part because our regulatory environment is so strict;
- There is a burgeoning industry in ESG rating and analysis, but in many cases it's not clear how these ratings are actually determined (i.e. are the ratings based on rigorous science-based analysis, or on more nebulous political premises?);
- Like it or not, ESG is here to stay because investors demand it. Those producers that are highly rated and tell a convincing story about their ESG program will attract more investments than those that treat ESG as fodder for the annual report.

WHAT IS ESG ANYWAY?

ESG is an acronym for Environmental, Social, and Governance. Some institutional investors and pension funds are looking to ESG performance, in addition to conventional metrics such as debt to cash flow or earnings per share, to rate and rank companies in a particular sector. This isn't for virtue-signalling; often, emphasis on ESG is an indicator of other factors, like productivity; operational efficiency and waste reduction; and using energy transition to drive higher margins.

Each of these factors can be broken down into sub-categories (note – this is not an exhaustive list):

ENVIRONMENTAL	SOCIAL	GOVERNANCE
• GHG Emissions • Methane Emissions • Water Management • Spill Release Frequency and Management • Abandonment and Reclamation • Land Use / Minimal Impact • Water use	• Employees: Diversity • Health and Safety • Community Relations • Indigenous Relations • Anti-bribery and corruption	• Board Committee Structure and Independence • Ethical Business Conduct – Board Supervision • Climate Risk

So, for example if a company has health and safety violations, despite actually ensuring EHS compliance and dealing with the regulator, its ESG rating might decrease. This could conceivably make the company less attractive to certain investors who value ESG ratings.

One factor benefiting Canadian oil and gas producers – ESG compliance is required by the very strict regulatory regime that Canadian producers operate under. Environmental and social factors are already part of the cost of doing business in Canada, and so reporting and compliance with an external standard isn't anything new. In fact, some producers may view it as simply repackaging information they already are required to disclose elsewhere. It may be, however, that notwithstanding actual ESG performance, producers and regulators might not have told the story of the regulatory regime effectively enough to investors or rating agencies, and so Canada gets lumped in with other oil-producing nations.

Recently, major producers such as Shell and BP have made commitments to "net-zero" by a date in the future – it's reasonable to expect that these sort of net-zero commitments might be included in the determination of ESG performance going forward.

CORPORATE ESG DISCLOSURE

Companies are not required to disclose ESG metrics and compliance, except as part of other disclosures. Obviously if a spill occurs, a producer would be required to report it to the regulator. But for corporate purposes, a public issuer's continuous disclosure obligations requires that material items be disclosed – of course these can include ESG issues, but there is no separate ESG report that must be filed. Similarly, audited financial statements may be required to contain disclosure of material items, but there is no specific ESG line item.

Some larger producers have chosen to publish extensive ESG reports, voluntarily – possibly as a result of the recommendations of proxy advisory firms. Two examples are Tourmaline and Paramount – these entities' reports can be found here:

https://www.tourmalineoil.com/wp-content/uploads/2020/02/2019-Tourmaline-Sustainability-Report-Final.pdf

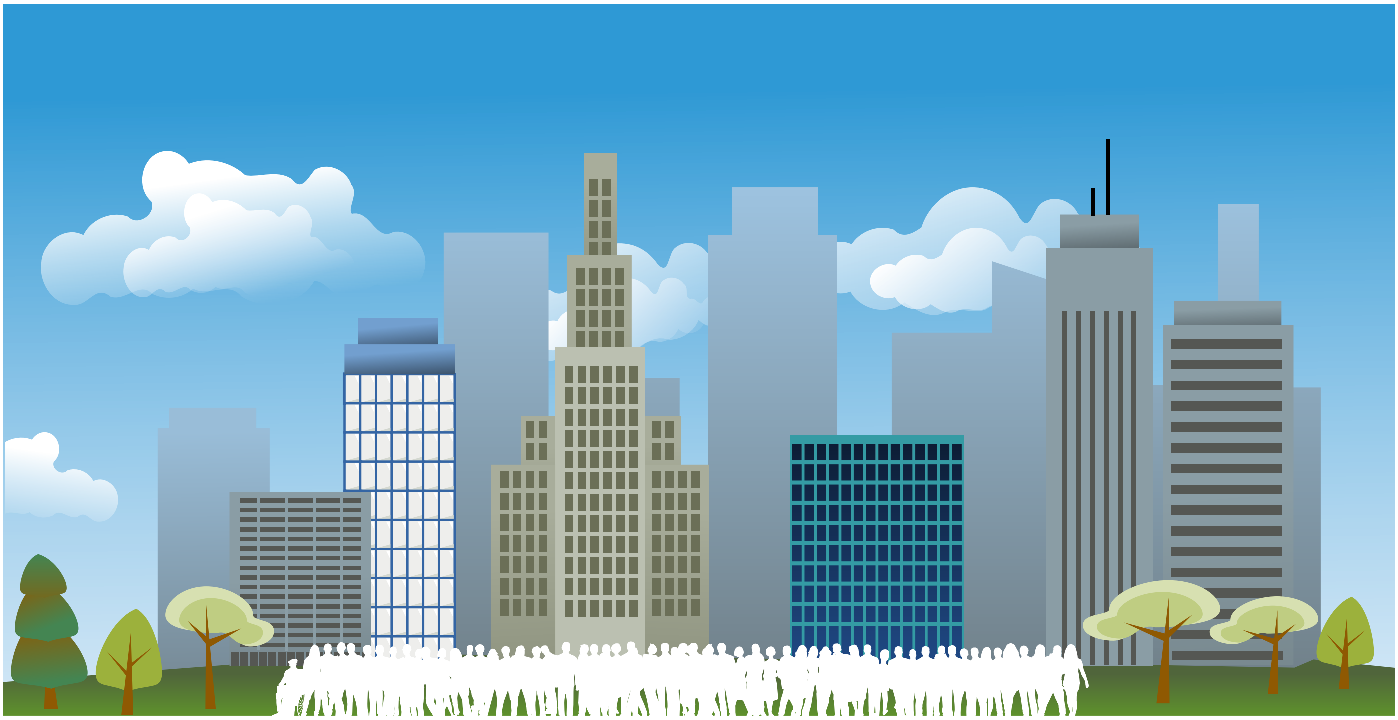
http://www.paramountres.com/upload/media_element/attachments/22/PRL_ESG_Report_2020.pdf

These reports set out ESG data in extensive detail, including GHG emissions, water management, health and safety, and governance. In addition, some producers (such as Tourmaline) have aligned their reporting with reporting standards, such as the Sustainability Accounting Standards Board (SASB), the GRI Reporting Standards, the Taskforce on Climate-related Disclosures (TCFD), and the Climate Disclosure Standards Board (CDSB). There is currently a push for adoption of comparable, common standards.

Of course, smaller companies may not have the resources to undertake the mammoth task of all this reporting when it is voluntary. However, it's reasonable to expect that private equity investors, family offices and even high net-worth individuals, usual sources of equity funds for Canadian producers, will be expecting some sort of ESG disclosure from investee companies, even if not to the granular level undertaken by the larger public producers.

ESG RATING AGENCIES

Many investors use ESG rating agencies to rank companies on their ESG compliance. Two of the most popular are Sustainalytics (https://www.sustainalytics.com/esg-ratings/) and MSCI (https://www.msci.com/our-solutions/esg-investing/esg-ratings/esg-ratings-corporate-search-tool), though there are more than 200 others. These are similar to financial ratings agencies such as Moody's or Standard and Poor's in that they provide an instant "ESG rating" in number form – you can simply type in a name or a stock symbol and the rating pops up.



There are obvious risks in using these rating agencies without more context though, because it's not necessarily clear how the rating number is generated. Clearly, also, because oil and gas producers by their very nature have an environmental impact, their ratings are naturally lower to start with, compared with, say, software companies. In order to offset this, producers' social and governance policies and compliance have to be that much more rigorous. However, the math on how the ratings are determined is in many cases a black box, so the specific steps a company can take to improve its ESG ratings may not immediately apparent.

CONCLUSION

ESG is here to stay, and is another cost item for Canadian producers to absorb, so Canadian producers have to adapt. Some specific disclosure to investors is going to be required.

Here are some modest proposals on ESG to reflect the reality of the Canadian oil and gas producer:

- if the federal government wished to ensure robust ESG disclosure, it could force the rating agencies to disclose how the ratings are calculated. Many do not do so.

- the federal government could also incentivize producers to participate in disclosure— maybe through a tax write-off for costs spent. Otherwise, the producers face all the cost of compliance, but have no idea of how to improve their ratings.

- perhaps most importantly, setting consistent, reasonable standards for disclosure, as is being contemplated internationally, is critical. Otherwise, it's impossible for anyone – investors, regulators, or industry peers, to perform meaningful benchmarking.