

Oil & Gas Alert

Update on sustainability



Climate change and sustainability in the oil and gas sector

"Looking ahead, the climate debate will continue to complicate the strategic decision-making of oil and gas companies across the industry."

*– The Ernst & Young
Business Risk Report 2010:
The top 10 risks for oil and gas*

Climate change and sustainability issues are now key components of the corporate agenda. They arouse as much interest and passion in stakeholders as the traditional flashpoints of financial performance or management compensation and have the same ability to influence corporate reputation and culture. Broad challenges that oil and gas companies face today include:

Environmental

The environmental agenda is very broad but is increasingly focusing on the debate around climate change, carbon and other greenhouse gas emissions and energy efficiency. Issues around environmental protection, including air, land and water quality, are heavily regulated and compliance-driven. These regulations continue to evolve. For example, the Environmental Protection Agency's (EPA) greenhouse gas reporting rule was finalized for the oil and gas exploration and production sector on 8 November 2010 and requires companies to report their 2011 greenhouse gas emissions beginning in March 2012. In addition, following the spill in the Gulf of Mexico, there is intense scrutiny around the environmental effects of offshore oil and gas drilling, and onshore oil and gas activity has not escaped the environmental debate. The growing concern over whether the practice of hydraulic fracturing, a key component in the recovery of oil and gas resources, particularly unconventional gas, contaminates water supplies has emerged as another important issue for the industry. Thus, oil and natural gas companies face the potential of new regulations that may limit the use of hydraulic fracturing as well as increased regulation of offshore drilling.

Social

Social challenges include a range of issues, from providing fair wages and healthy, safe working conditions to respect for human rights and a commitment to community development. For oil and gas companies, acting responsibly also encompasses consideration of the broader economic benefit to society that can be achieved through improved employment, procurement and investment practices in developing countries.



Ethical

The primary ethical challenge for oil and gas companies interested in sustainability is to create an honest and transparent business environment between and among competitors, suppliers, partners, employers and employees, customers, governments and society. Many oil and gas companies have extensive international operations, which has led to questions concerning transparency. For example, under the Dodd-Frank Act, publicly traded oil and gas companies will be required to disclose payments to foreign governments related to the commercial development of oil, natural gas or minerals. Potential issues include the required project-specific reporting detail, as well as the broad definition of the terms “payments” and “resource extraction issuers,” all of which could create public relations, compliance and administrative challenges.

Why is interest in sustainability issues growing?

A number of forces have combined to increase interest in sustainability, including:

- ▶ Better public access to information, particularly the media coverage of issues, and greater expectations of corporate transparency.
- ▶ High profile incidents involving oil and gas companies, including oil spills, safety incidents and human rights allegations.
- ▶ Shifting consumer and shareholder expectations and behavior.
- ▶ Business partner expectations and competitor activities – market conditions require that companies keep pace in this area.
- ▶ The introduction of more stringent regulations, including non-financial reporting requirements.
- ▶ Greater engagement by the investment community, including the publication and popularity of international indexes, for example, the Dow Jones Sustainability Indexes and Carbon Disclosure Project.
- ▶ Employee expectations – workers increasingly say that it is important that their employer is “responsible” to society and the environment.

What can oil and gas companies do to manage sustainability risks?

Our work with clients in the oil and gas sector on the sustainability agenda has highlighted a number of specific issues that are currently taking on greater importance for senior management.

Acting sustainably and responsibly

Oil and gas companies are under pressure to operate in a sustainable and responsible way. This has typically made it more difficult for them to operate in countries with poor human rights records or countries where violence to personnel is a real threat. This applies to a broader range of non-financial issues other than just health, safety and environment (HSE) issues, which have been the historical focus. The growing need for oil and gas companies to gain and maintain a social “license” to operate means senior management oversight should extend to issues such as, access to land, community engagement, socioeconomic investment and human rights.

Performing on a global stage invites the attention of a global audience, including potential partners, competitors, domestic and host governments and capital providers. All of these constituencies demand a level of transparency and commitment to sustainable and responsible behavior in international locations, particularly when operating in a geography where there may be shareholder opposition and political resistance. A common challenge for organizations when managing these issues across multiple jurisdictions is the need for robust internal controls and systems that are scalable on a global level. Establishing or retaining adequate oversight over international operations is a key challenge for companies.

Ernst & Young’s sustainability professionals have extensive experience in reviewing and assessing the non-financial governance mechanisms of leading global companies in the oil and gas sector. We work with clients who are at the leading edge of thinking not only on HSE issues, but also on community impacts, diversity and inclusion, stakeholder engagement and human rights.

Our teams examine processes and outcomes of non-financial risk assessments to confirm whether non-financial risks appropriate to the business have been identified and whether adequate controls have been established to mitigate these risks. We review internal monitoring and reporting mechanisms to test the adequacy of management information and internal reporting. A common challenge that we have seen is the use of multiple assurance mechanisms for managing non-financial risks, which leads to duplication and gaps in coverage. We, therefore, work to understand existing internal oversight for key non-financial issues, highlighting strengths and identifying potential areas for improvement. We can also provide sustainability assurance readiness assessments and assurance reporting on sustainability.



While most jurisdictions do not currently require third-party assurance, sustainability reports are being more closely monitored than ever before. As this trend continues, users of sustainability information will come to expect that the information has been validated by a reliable third party. Companies are likely to migrate to accounting firms to obtain sustainability assurance because of the rigor the accounting profession applies to financial and non-financial assurance services and the efficiencies gained from having one assurance provider.

Assurance sends a message that the sustainability report is relevant, reliable and free from bias.

Working with third parties

Effective health, safety and environmental management is recognized as a fundamental requirement for successful oil and gas companies. HSE issues affect both operational costs (e.g., health care, employee turnover, fines, compensation) and operational risks (e.g., downtime, regulatory investigations, unplanned capital investment). Oil and gas companies are feeling pressure to manage HSE issues both within their own operations and within their extensive contractor networks.

Oil and gas companies expanding into new markets rely on the assistance of a range of partners, be they joint ventures or a contractor network. Partners are increasingly insisting that minimum expectations are met across the sustainability agenda related to social, ethical and environmental issues, and are taking this into consideration when making investment decisions. Many companies now set out their expectations in this area within a set of business principles (or their equivalent).

Ernst & Young has worked with organizations to help develop global systems of controls and assurance to identify, mitigate and monitor material risks of non-compliance with business principles. This type of work is designed to help support an improvement in contractor performance in relation to non-financial risk.

Climate change

A fundamental shift in how carbon emissions are accounted for and reported is coming, driven by a rapidly evolving fiscal and regulatory environment that will see carbon emissions move from a fringe issue to the balance sheet. Companies are feeling both market and regulatory-driven pressures to provide non-financial information to satisfy stakeholders' demands for a more rounded and longer-term picture of their activities and performance. As a sector that

is particularly energy-intensive, oil and gas companies recognize the need to be prepared for this. Involvement of government stakeholders, such as the EPA, the Securities and Exchange Commission and the Federal Trade Commission, is adding to the pressure to monitor, measure and report accurate and complete data. The reporting requirements are not only on a federal level; many states are beginning to require large emitters to report their emissions under various state and regional programs, such as AB32 in California. Companies also need to be in a position to set credible reduction targets, to be able to track which parts of their business will make material contributions to this reduction and be in a position to develop, execute and monitor programs to deliver this change. Companies must develop processes and controls to measure, monitor and report carbon emissions. For some oil and gas companies, disclosure of carbon emissions will be a new process.

Climate change and sustainability performance is becoming an increasingly important factor in evaluating potential acquisition targets or when a client is positioning itself for a divestiture or sale. Executives are starting to factor in climate change risk and exposures, such as potential issues related to water usage and waste, as well as reputational issues associated with the overall carbon footprint of a merger target. These and many other factors can affect how a deal is valued and have an impact on the post-merger integration and costs.

We help clients think through the implications of climate change for their organization by identifying the potential issues and which aspects of their business may be affected, as well as advising on appropriate actions. This includes recommendations on the development of an effective climate change strategy and the processes and controls required to implement that strategy; review of the adequacy of climate change plans and the mechanisms used to track the benefits a company is getting; guidance on developing compelling and credible external communications on climate change that management can rely on; help preparing the company for regulatory requirements; and providing assurance over a company's disclosures on climate change, including statements of performance and claims about the positive effects of products or services. We provide management with a basis for confidence that the actions they are taking will help them meet the challenge, that their internal systems will deliver the information that they need; and that their external communications will have greater credibility. We also provide carbon emissions verification services.

A checklist of next steps

If your company does not report on sustainability issues, greenhouse gas emissions or releases only a brief summary of its operations' environmental impacts, here are some questions to consider:

- ▶ Are we prepared to start reporting our greenhouse gas emissions?
- ▶ What feedback are we getting from our stakeholders?
- ▶ Is there pressure from our stakeholders to report?
- ▶ How are we perceived externally?
- ▶ Do we have a good understanding of the risks associated with sustainability?
- ▶ What are our peers and competitors doing?

If your company currently issues a sustainability report and wants to take it to the next level, management should be asking the following questions:

- ▶ Have we clearly identified our material sustainability issues?
- ▶ Are we engaging and responding to our stakeholders?
- ▶ Do we want to be a leader in this area?
- ▶ What level of assurance do we currently obtain?
- ▶ Do we want a more rigorous process to ensure that our reporting is credible?

Additional information can be found in our recently released report, *Seven questions CEOs and boards should ask about 'triple bottom line' reporting*. This report and others can be found online at www.ey.com/climatechange.

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Ernst & Young LLP's Climate Change and Sustainability Services help organizations manage the risks and the opportunities created by regulations and other developments relating to climate change. We assist clients in achieving measurable results by leveraging our leading knowledge of the economics of climate change and environmental sustainability, the global resources of the Ernst & Young organization, and our deep financial insight. We help clients identify the right approach to climate change during each phase of their business from vision, planning and execution to monitoring, measuring and reporting results.

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