The ESG Chess Game (Transcript)

From *Power Hour* with Alex Epstein (recorded 3/11/20)

Alex Epstein:

The next topic I want to talk about is what I call the ESG chess game. And I'll bring in Don in a few minutes. He's still standing by, but I want to give you a little bit of background on this. And this is, again, an issue that industry is thinking about a lot and it's sort of an industry issue, but it's really an issue for everyone to understand. And I think that there're certain mistakes we believe people in industry are making will be harmful to all of us.

So here's the background. I'm using this term ESG, so I should talk about what it means. In the last several years, there's been a massive push toward what's called ESG investing and it's often used synonymously with sustainability or sustainable investing.

So ESG stands for Environmental, Social, Governance. So Environmental, Social, Governance. And you can think of those as these are considered the three aspects of sustainability. So they're looking at companies and saying, "Okay, how sustainable are you in terms of your environmental impacts and then your social impacts and then your governance practices?"

Now I **mentioned it's important to define ESG and sustainability for that matter, and one of the things that you notice is that they're not clearly defined or they're defined in many different ways.** And that's always a flag I think that we should be concerned about something being put over on us.

But I think the most legitimate sense of it, the way that most people think of it even if they don't define it this way, is sustainability, people think of as **long-term value creation**. So versus trying to create value or get money in a way that's short term, people think of sustainability as long-term value creation. And long-term value creation is a great concept and one thing I advise companies on and I'll advise anyone listening is that's a good concept to use and that's a better concept to use than sustainability. **If I was creating a report and it was up to me, companies wouldn't be creating sustainability reports, they'd be creating long-term value reports.** I think that would be much, much better for a whole bunch of reasons that we'll get into.

But the value creation part of it is very important and almost never even discussed under sustainability. It's usually just focused on... as I'm sure Don will elaborate on, it's focused on, okay, what are the negatives that you need to do less of, but not focusing on, okay, what's the value you're creating and how does that compare to the value that others are creating or not creating? So sustainability, the way it's thought of is in the best sense as long-term value creation. And then ESG you can think of as these are the best practices for long-term value creation. So you'll say, okay, these are best practices for how to structure your board of directors. And these are the best practices for what people call diversity policy.

And these are the best practices for let's say, methane emissions, that's a certain type of emission associated with oil and natural gas. And so there are these best practices. And in practice why companies care about this so much besides insofar as it's a good idea, which we'll talk about to what extent that's true.

If companies are not evaluated as sufficiently ESG compliant, at least two bad things can happen to them. So one is that certain investors won't invest in them. And so that's a very big concern, particularly if you're a public company, but even if you're a private company or are fund raising money. So if you're not viewed as ESG compliant or ESG friendly, certain investors won't invest in you.

And then two is that shareholders may pass a resolution against the management of the companies. They may say, "Well, we disagree with management," and it can ultimately mean we want to fire the CEO, we want to fire people on the board. And understandably, CEOs and boards are not super happy about that. And for that reason and other reasons, they often give in to different kinds of demands. And so what's happened is that these companies have this very strong incentive to comply with ESG, different kinds of requests. And these come from different sources. Some are more kind of activists, often it comes from the large, what are called passive investors, which are people like Vanguard and BlackRock.

They have much of our 401(k) and because of what I believe are problems in the law actually, they're required to participate in all kinds of different shareholder votes. And in recent years they've been advocates of ESG and said they'll vote against management if management goes against certain kinds of ESG practices or demands. And so as you might expect, when there's all this ESG pressure, there's this huge industry that has sprung up to help fossil fuel companies become more ESG compliant. And in the last several years, it's been really astounding, I think to people everywhere. **Just that ESG three, four years ago, you barely heard of it at all. Now you're hearing about it at the CEO level, at the board level.**

And it's just the thing to do is to be more ESG compliant, to improve your ESG. And one interesting thing is that many executives have thought of it as a good thing despite the sense that I'll talk about where much of the ESG movement is obviously hostile to the fossil fuel industry, but many executives have thought of it as good. And I think the reason is because some of the ESG, but I emphasize, *some* of the best practices are reasonable. And so they think that's like, okay, well, I can do this thing that's reasonable and then I can get points for it. I can get a good letter grade or I can... they'll often say, "I can check the box."

And then sometimes companies even think it helps them because they can tell about these good best practices that they're doing that they might not have told about before. So there are a lot of examples of this, but one example is companies will say to me, "Well, we have good policies on methane emissions and we already had those, but we weren't telling our story very well. So now with ESG we can check off that we have a better methane emissions policy or we have a good corporate governance policy and what the ESG people are asking us is pretty reasonable." Or sometimes they'll say... maybe ESG has some charitable component and they'll say, "Oh, we're helping build a school in some country and that's good. And so we get to tell our story."

It's interesting that ESG is viewed as an opportunity. And then even with things that you might think a fossil fuel company should be concerned about, such as ESG demands that they lower their greenhouse gas emissions because greenhouse gas emissions are inherent in fossil fuel production and use, I still hear from many people, "Oh no, this is okay. It's good for us to commit to this." And one argument I hear, this happens with refiners certainly is they'll say, "Yeah, we have agreed to reduce our greenhouse gases. But that's okay. That just means we'll use less energy to produce the same amount of refined fuel and that'll make us more efficient. And so that's good."

So there's this general view that yeah, it's good. We want to follow the ESG guidelines, we want to agree to the ESG demands and it's going to be... that might even help us and it might even lead us toward better practices and it's reasonable.

And so my view is that this is not a strategic way of looking at it. So I want to share with you what I think is a more strategic way of looking at it. And I believe that whenever one is presented with a significant new change in conditions, whether it's an economic change or a change in economic environment or physical environment or intellectual environment in terms of this big movement that's affecting a lot of the company's policies, **one should really think about what is this movement's goal and then what are the steps it's telling us to take to get there?**

And so one way to think of ESG as a framework, it's a new structure for thinking about your company and its long-term value creation. So I'd ask executives to think about two questions. Do you agree with the ESG definition of value creation and do you agree with the best practices to get there? So do you agree with the definition of value creation and do you agree with the best practices to get there or do you agree with all of them? And if you don't agree with some of them, what are they and how important that is.

And so I want to start out the best practices and then I'll go to what they mean by value creation. So one thing we've observed is that some of the best practices are beneficial or benign, but others are clearly not beneficial for fossil fuel companies, but they're still endorsing them. They're still being asked to do them under ESG.

And I want to bring in Don because Don worked with me very closely on... we wrote a mini white paper that we've been sharing with certain people who read our newsletter. So far we're only sharing it with people in industry who are dealing with ESG challenges. **So if you're interested in seeing the current version, just email me alex@alexepstein.com, subject white paper.** Again, if you're actually dealing with these challenges, we'll at some point reduce a more, rather release a more public version. But I wanted to bring in Don. And Don, can you talk about cases where... we call this the ESG dilemma where things that companies are being asked to do in the name of ESG clearly are not in their long-term interests.

Don Watkins:

Sure. I mean, just to set a little context for it, I think there's often the straw man view of companies that what they do to pursue profitability is they only look at economics. They only look at finance and they don't think about the broader picture. But the broader picture of how a company operates…business leaders have always known that every element of their company and every kind of action or market condition can affect them. And so there's many kinds of impacts that a company has or that they face which they take into account when making decisions, and then investors take into account and want to think about if they're trying to figure out: is this company creating long-term value or is this company in a path that long-term is going to harm them?

And so as you mentioned, there are certain common sense things that companies are being asked to disclose and companies are often eager to talk about. If you're an energy company, it's relevant to how you're performing in the long run, for example, how much water are you spilling? How much oil are you spilling? How much water are you using? What kinds of pollution does your product create or do your operations create and what are you doing to rein that in?

But some things companies are being asked to disclose are really conditioned by this assumption that you talked about in an earlier segment that we are in an energy transition—that we're moving away from fossil fuels towards renewables. **And so a lot of the inquiries are set from this question of: how will your company be able to cope with this coming energy transition?**

And so just as one example to start off on that, the question will be put to companies: We want to see how your company will perform in a case where we follow the Paris Climate Accords and take the policy actions and achieve the technological and competitive transformations that will allow the globe to keep temperatures from rising above two degrees Celsius. And **this is called two-degree scenario analysis. And, in effect, what companies are being asked is if we go through an energy transition, won't your company be destroyed?**

And indeed, the shareholder activists who really conceived of and initially started pushing these requests were people whose explicit goal was to convey to investors and to the public that fossil fuel companies were overvalued because they weren't going to be able to survive as we rapidly got off of fossil fuels.

And these, I don't know how much detail you want to go into them, but I'll say just at a high level, that is a very dubious starting premise in which to be able to communicate your long-term prospects, because it essentially says, what will happen to your company if your industry tanks?

And the larger question is, is your industry set for long-term value creation or not, rather than just these two degrees scenario analyses, which are assuming that your industry is set to tank. So I think that's one example, but it's one major example, and we can definitely talk about others if you're interested.

Alex Epstein:

Yeah, I think that's good for now. We might bring up a couple of others as we go through this. So you talked about this best practice of two-degree scenario analysis. And let me add just one other best practice, which is a real best practice that companies are getting lauded for, which is commitment to dramatically reduce greenhouse gas emissions. I mentioned the refinery case of that, but in the even the exploration and production, you have companies such as BP and Shell saying yeah, we're going to dramatically reduce our emissions. Sometimes even saying we're going to get to zero. And even the zero, not just the production of our product but the use of our product, which is where most of the emissions come in, doesn't come in from producing the oil. A little bit is from that, but it's mostly from using the oil. And those get lauded. So that's considered the more that you can see the extinction narrative, the more ESG friendly you are considered, and **the more you commit to the extinction of the fossil fuel industry, the more ESG friendly you are.**

And this points to then the answer to my question of, **what does ESG, or what does sustainability really mean? How is it really defined in the end? And it's really defined as a non-fossil fuel.** So ultimately, sustainability, sustainable energy, in today's discussion, that means non fossil fuel energy.

And that is something where people are trying to get around that, they're trying to think, we can be a sustainable company and we can also be a fossil fuel company. Depends what you mean. **You can be a sustainable company in the sense of actual long-term value creation, but not as conceived of by the mainstream ESG movement. By that movement, by the leading definition, or implied definition, fossil fuels are not considered sustainable.**

And as you mentioned, if we look at the history of the movement, the growth of this movement is largely a deliberate strategy to do two things. One is to stop investment in fossil fuels, and then two is to manipulate fossil fuel companies into getting off fossil fuels. So by promoting these anti-fossil fuel conceptions of ESG and sustainability, they push investors away from fossil fuels. And then other investors who either have to remain invested because they have to own a certain amount of the market, or they choose to remain invested, those investors are in effect, managing, pressuring, manipulating the companies to go off fossil fuels.

So if you think of this as, **I'm calling this the ESG chess game because I think most people who are playing in it, most executives and boards of directors are not fully familiar with the history and goals of this movement. And it's really important to know that this is largely a strategy of the anti-fossil fuel movement to destroy the fossil fuel industry. And so the actions that they are taking are conceived of as chess moves on the way to get there.**

And so that doesn't tell you exactly what to do in response to those chess moves, but you need to understand the game that they're playing, and the moves that they're making, in the context of their goal. And part of the cleverness of the chess game is that many of the moves they ask you to do seem reasonable, but you still need to understand the game that they're playing. So you can decide, how do I do the reasonable things without doing the unreasonable things?

Don Watkins:

Can I say something about that, Alex?

Alex Epstein:

Oh yeah, of course.

Don Watkins:

Yeah. Just to lay out that, because it connects to what I was saying out about the two-degree scenario analysis. So the way that it typically works is, we'll share with the public how our company is going to operate in this sort of scenario. But that becomes a foundation then for anti-fossil fuel activists to start saying, “Well, are you really doing enough to plan for this transition?”

And so what happens is the next shareholder resolution, or the next pressure from shareholders will come and say, “Well, now we want you to set greenhouse gas targets.” And so the company, as you pointed out, might say, you know what? There are actually some economic things we can do to lower our greenhouse gas emissions. And so they'll do that, and they'll say, look, our goal is to lower greenhouse gases, and we've successfully done it.

And the anti-fossil fuel activists will say, “Look, but that’s is not enough to reach the Paris targets, which you guys have already at least implicitly conceded we should be pursuing.” And so then those targets need to be increased.

And then if you're not keeping up with them, then there's going to be more shareholder resolutions that say, “Look, you need to tie your executive compensation to those greenhouse gas and other ESG targets. And then to make sure that that's taken even more seriously, we need to hold the board members accountable. So we need to have board members here who take ESG seriously, who take climate seriously,” which really means, who view fossil fuels as an industry that should be out of business.

So there's an escalation and continuing moving of the goalposts. And the more that you can see it and comply, the more vulnerable you are when they demand that you be consistent with what you've already said is your goal, which is to lower your impact on the planet.

Alex Epstein:

Great points. I want to share a note I got from an executive, he's of a private company but familiar with a bunch of this. And I thought it was just, he read our white paper on what we call the ESG dilemma and what we call the full impact messaging solution. Here’s some of what the executive wrote, which I thought was really, really insightful, and it motivated me to create this segment.

So he said:

> There are consultants springing up to help craft a message on ESG. From what I have seen, those messages kind of fit the popular narrative [that is the extinction or transition narrative] but they lack a long-term strategy or well thought out framework.
>
> Implicitly, they seem to tacitly admit some sort of guilt, and that the industry must be dismantled and that the future is unquestioned and clear regarding the replacement technologies.
>
> I think the consultants often believe this.
>
> I believe it all rests on the assumption that if we play along we will be liked again, that investors will like the industry again, and we'll viewed as part of the solution with the group of people driving this.
>
> I think that is just not a path truly available to these companies with that group of people [as in the leaders of the ESG movement].

And then he says later on regarding public boards of directors,

> This is a chess game that they need to think through many moves ahead.

And that's really the biggest theme of this segment. **This is a chess game that you need to think through many moves ahead.**

And I just enjoyed this email where it just made a lot of good points, including that there's just the assumption that the industry must be dismantled, that the technologies to replace it exist, that the consultants involved saying to companies, Oh, I'll help you with ESG. They believe this. Now I should say, full disclosure, we do consulting on ESG as well, although a very different approach. So you can call us biased if we disagree with, in a sense, our competition. But we're not at all a full, we do very I think important, but narrow in terms of helping with certain kinds of messaging, and in particular, helping with the strategy of it and understanding the chess game. So it's not like our goal is to become the dominant ESG firm, but nevertheless we do have some, I just wanted to disclose any competitive bias I had. But this was his comment, that consultants often believe this.

I believe it all rests on the assumption that if we play along, we will be liked again and viewed as part of the solution with the group of people driving this. Yeah, I think it's that, viewed as part of the solution.

People think, yeah, we can be part of ESG, we can be responsible. And it depends. You can be actually responsible by your own definition, and by the definition of many investors, but the mainstream definition of it, or implied definition of responsible, equals non fossil fuel. You cannot agree to that if you want to stay in existence as a fossil fuel producing company.

So Don talked about one of the big moves that the ESG movement wants the companies to make, is to endorse this transition or extinction narrative. And I want to point out how that's exactly the opposite of what the strategy needs to be. If you think about your investor messaging strategy…so I think of it, there's an investor messaging strategy and then part of that is the ESG messaging strategy. And you need to think about how those integrate.

So the value of your company, if you think about what justifies investment, it depends on, I mentioned this earlier, how much of a market will there be for oil and gas? And then how good are you at producing it? **So if you concede that there's going to be a dramatically smaller market for oil and gas, then you're almost certainly not a good investment, and you're certainly a much worse investment than you would be if there was a better market. So it's a very dangerous thing, investor wise, to concede that it's going to be a much smaller market.** And I don't believe it's a justified concession.

So now companies are trying to agree with the ESG terms and say, Oh yeah, we agree with the two degrees scenario, or this is a likely possibility, but we'll be fine. So it's almost humorous where you see all these companies have these sustainability reports and they all say, yeah, even under a two-degree scenario we'd be totally fine. **But two degrees scenario means really near elimination of fossil fuels. Just the idea that all these companies are going to be totally fine, we're even seeing with contraction of demand, even on today's scale, but not from economics directly, but with Coronavirus. You're even seeing these companies be in jeopardy. So imagine what it would mean for most companies if we weren't allowed to use fossil fuels, for the vast majority of instances in which we use them today.**

So the narrative about the future of your industry, that is a key thing that the investor messaging strategy must control. And the way to do it is to say, the way to do it proactively is to say, look, we are committed to long-term value creation, and we believe that hydrocarbons, fossil fuels, oil and gas, that those are going to be of crucial value, and even expanding value to billions of people for decades to come. And then there are a whole bunch of points to make in terms of how to make that narrative, how to address all these different things like renewables and EVs, and claims of climate catastrophe. But that's part of the job, is to be able to have really locked in all the specifics of your narrative, and then have all the answers to the opposite narrative.

But you can't have the expansion, long-term value creation narrative in your investor messaging overall, if your ESG messaging concedes the extinction narrative. Nor can you have the right investor messaging, or the right strategy, if you're committing to reducing greenhouse gases as a first step. You could say we reduce it as we're doing something else. Like, I don't know, we have more natural gas because that's a good strategy for us. But if you're saying we're committing to reducing greenhouse gases, that is a very dangerous path to be on. So I would really think of it as anyone thinking about this, but particularly if you're involved in these issues, certainly if you're at the board level or the CEO level, be really aware of what concessions are you making and what commitments are you making or being asked to make and how do those affect your investor messaging and its prospects including ultimately investment? Then how does that affect your long-term actual value creation?

Because if you're conceding the extinction narrative, you can't do investor messaging properly. If you start committing to real cuts in emissions that are inherent in your product, that is not consistent with long-term value creation, at least not with hydrocarbons. Those are the kinds of things to be really aware of. The high level idea is this is a chess game and are you really prepared for the chess game?

Number one is need to understand what is the opposition's goal? What is their strategy? Then how are the moves they're forcing you to make, or trying to get you to make, part of that strategy? I should say that in terms of if you want to know more about how we address, there's the investor messaging overall, which is really important. Then we have this mini white paper on the ESG part of it in particular, but it has to go into the overall narrative of long-term value creation. You can email me alex@alexepstein.com. Just put white paper in it.

Again, if you're actually dealing with these issues in some industry. Then I'll be happy to send that to you. You'll see that one of the things we talk about in the white paper with regard to ESG and doing that in making that a more legitimate thing is we do what's called full impact messaging. **Traditional ESG is tending to ask for just negative impacts of what you do and have you say, "Oh, we're doing less of them than we used to." We're saying, "No. If you're really talking about your impacts in these areas, you need to talk about positive impacts as well, including the value you're creating for the world."**

A recent example I saw of a way that I disagree doing it, what I call negative impact messaging, where all you're doing is looking at negative impacts…where you're basically saying, "We're doing a little. We're less bad than we used to be or we'll do better in the future," but not anything really positive is one of the best and most innovative and most admirable companies in the world called EOG Resources. I've met different generations of the leadership there and have tremendous admiration for all of them including the current ones. But if you look at their sustainability report, it's pure what we call a negative impact messaging.

There's not one sentence in that about the value that they create in the world. There's some stuff about charitable stuff that has nothing specific to do with oil or gas, but it's all about, "Hey, we are going to use less water. We're going to have less emissions." But it implies, "Hey, our basic business is unsustainable. We agree with that and we're going to jump through all these hoops, but we're being less unsustainable as we used to." Then you can imagine while investors are, the activist will just say, "Well, it's not enough to be less unsustainable. You need to actually move into sustainability. What are you doing to get involved with solar? What are you doing to actually get off this stuff?"

That's just an example of that's a really smart, admirable company. But you can take my opinion for what it's worth, but I don't think that they are, and I don't think most companies are really understanding the chess game that they're in. I think **if you do understand the chess game, it's not that you can 100% make it easy for yourself, but what you can do, which we talk about in the white paper, is you can comply with the most legitimate parts of ESG and improve your scores in that way, but you can avoid the most damaging things. At the same time you can create much, much better investor messaging that actually brings investors toward you.** That's what we advocate in terms of the strategy and the execution.

I hope that's helpful. I hope it's helpful to other listeners who are outside the industry for you to just see this is a really important movement. Because what it's doing is it's the financial world, which that's kind of the industry that fuels every industry. Then the energy industry is the industry that powers every other industry. **What we really do not want is a finance industry that's taking capital away from the productive forms of energy and putting it toward the unproductive forms of energy. Because that means the energy is going to be higher cost. When energy is higher cost, then everything is higher cost.**

This is really a humanitarian issue globally and in future segments we'll be talking about how to fight back against it as citizens, but today I wanted to focus on how companies can fight back against it. I know that some people listening to this will be, particularly if your exploration and production, not so much if your pipelines and certainly not if you're refiners, but you're going to be focusing on the oil crash and there's lots of difficult choices to make.

But this idea of your overall investor messaging, that's still a really crucial thing to be thinking about because it's the extinction narrative that is contributing. It's not the sole cause by any means, but it's contributing to all of these problems in your industry in terms of investment. Then also just it's contributing to all kinds of bad policies including to the popular or semi-popular policies of people who say, "Oh well, let's go 100% renewable." That's all based on the extinction narrative. That's all I had, Don. Did you have any final thoughts you wanted to add before we wrap up?

Don Watkins:

I just want to reinforce something from a slightly different perspective, which is one of the justifications given for ESG is the idea that we want to make sure investors are informed. Certainly to the executives in the industry that I've spoken to, they really care about being honest and informing their investors. I think part of the theme of what we're laying out is that ESG as it's currently constituted is misinforming investors. If you comply with it by just highlighting your negative impacts, you're doing your genuine investors a disservice as well as your company.

I think it really is a moral obligation to you or company and your employees and your investors to really think about how to give them the full picture of all your impacts**. Because ESG was not created by people who sat around scientifically investigating what are the best long-term value creation strategies. It was people who sat around and thought about how do we minimize the impact of companies on the planet?** That included some things that are actually good for companies and some things that are very bad for companies and all of their customers.

I think it's up to companies to think first-handedly about how can we really communicate the value of what we do, both the positives and the negatives so that our investors come away with a clear and accurate picture?

Alex Epstein:

Awesome. Thanks for joining me today. Thanks everyone for listening today. I'm definitely curious to see what you think about the first episode. If you have any questions, comments, love mail or hate mail, you can email me at alex@alexepstein.com. I want all kinds of comments, positive and negative and certainly suggestions for any kinds of shows in the future.

Also, if you are ever interested in bringing in a speaker or in getting some kind of advice or consulting or message creation from us, we like to help organizations with that. You can just email Don at don@industrialprogress.net. You're welcome to include me as well. He can tell you about all the different ways we can empower your organization.

That is it for this week. I'll be back, I expect next week. I hope you enjoyed this episode. Until next week, I'm Alex Epstein. This has been *Power Hour*.