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Thought Leadership:

Can ESG Engagement Have Unintended Consequences?

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Companies only really have two ways to increase their profits: increase revenues or lower costs. On a per unit basis, revenues can be substituted for price in the profit equation, but in a commodity market, such as oil and gas, prices are set externally by market demand, not by the company producing the product. This means companies in this sector can only control profits by lowering their costs per unit. A little more than a year ago, when I was still in business development position in the oil and gas industry, it wasn't uncommon to hear people say, "Geologists used to be the kings of the industry, but now it's supply chain." The phrase was in reference to an attempt by the industry to move towards cost discipline, and get spending under control, rather than focus on growing production or acreage positions. If we take a lesson from Goodhart's Law (Charles Goodhart), sometimes actions can have unintended consequences.

(Note: to learn more about Goodhart's Law, listen to NPR's Planet Money Podcast #877 with @radiomalone and @GonzalezSarahA.)

Goodhart's law essentially states that "when a measure becomes a target, it ceases to be a good measure." In this case, when management measures something, employees will find a way to make the numbers look good even if it doesn't benefit the organization as a whole. This happened in the oil and gas industry after the downturn, and is still occurring today. When so much pressure is applied to companies and employees in an effort to lower costs, quality is often the first thing sacrificed. In an industry with a propensity for safety hazards and environmental issues, extremely negative impacts are all but guaranteed to result. Take waste management for example: if a company who is transporting its waste to a landfill suddenly finds the need to lower costs, on-site burial of its wastes becomes a viable option. It's essentially free disposal, it's legal (in most states), and it can save more than $100,000 per well in some cases. Most importantly, it's not being measured, and therefore doesn't reflect poorly on the individual, the company, or the industry as a whole.

ESG data is an extremely important aspect of investing, not only because it allows us to invest responsibly, but also by the simple act of measuring ESG metrics, we can fundamentally change the behaviors of companies and people. However, we must also be vigilant to understand that what we measure, and what we don't, may have unintended consequences. Currently, "waste" is not considered a material ESG issue for oil and gas companies by any major reporting organization, including SASB, GRI, and IPIECA. Companies' water usage and emissions, though, have been under scrutiny for the past several years. It's only natural, following Goodhart's Law, that they will find a way to reduce costs while meeting these stricter standards, but possibly at the expense of something that isn't currently being measured, such as waste.

Clearly, it's easy for us to understand the importance of waste management. In fact, even though SASB doesn't consider "waste" to be a material issue for the financial sector, many companies within the sector report on their wastes and waste reduction programs anyway. And if office waste is a significant enough issue to warrant disclosure, isn't drilling waste? The volumes of drilling waste rival that of coal ash each year in the U.S.; however, drilling waste contains potentially hazardous compounds that coal ash does not. If we do not engage with companies and communicate to them the importance of proper waste management, they will inherently choose what they perceive to be the most cost effective method. This is especially true if regulations are lax, and certain methods were designed to systematically mislead them to not take into account all of the relevant costs.