Assessing Oil: A review of Sustainability Ratings Evaluation of Oil Companies

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Abstract

As oil becomes scarcer and its extraction more complex, the social and environmental risks of exploration and production progressively intensify. The sustainability indexes and ratings are an increasing popular tool to assist investors in making decisions about these risks in oil and gas companies. The swelling importance of ratings in the investment decision-making process combined with increasing risks of the O&G business requires a rigorous analysis of the criteria used to classify companies in the industry.

Using Deepwater Horizon accident as a backdrop, the aim of this study is to identify the differences in methodologies of selected sustainability indexes and how that reflects in their raking of the oil and gas companies. A literature review and document research was performed and found that categories varied depending on the objective of the agency: whether it focused on materiality issues or seeks to be encompassing. A ranking comparison is not trivial, mainly due to irregular assessment intervals and lack of transparency. Total is the only company included in all ratings followed by Shell, Repsol, Petrobras and ENI. It is noteworthy to mention that BP ranked above fifth place before the Gulf accident in all reviewed ratings; however, only one maintained the position after the Deepwater Horizon incident. Operational safety may be diluted among the other criteria; thus, a company that has a low score in safety may still score high in the overall mark. Investors and society must understand the limitations of the methodologies of the rating before making an investment decision.

I. Introduction

The demand for socially responsible investing (SRI), despite the crisis, is growing and resources under management reached € 5 trillion in Europe and USD $ 3 trillion in the United States at the end of 2009 (Eurosif, 2010 and SIF, 2010). Investors use a variety of methods to assess the social responsibility of companies, among them, are indexes. Note that indexes can be investment vehicles, but they can also be tools for investment. For example, they could be

used as part of the investment process for identifying risks and opportunities, or for measuring a sustainability impact (UKSIF, 2010).

Investors are increasingly looking at sustainable indexes, for both products and performance measurement, to help them achieve both financial and social and environmental value (UKSIF, 2010). The first sustainable index was the Domini 400 Social Index launched in 1990 followed by the Dow Jones Sustainability Index in 1999 (Fowler and Hope, 2007). Despite its short history, according to SustainAbility (2010b), there are over 100 ratings, indexes, and awards to assess, compare or reward corporate sustainability performance, with new ones emerging constantly. A common goal among these ratings is to measure and compare sustainability performance by informing decision makers; investors, consumers, employees; and encouraging an increased disclosure of information.

The ratings are currently one of the signs considered most relevant about the environmental performance of companies to the general public, which does not track all activities of companies and have no access or expertise to analyze the relevant data (Lyon and Maxwell, 2006). Investors, in turn, have a limited ability to analyze information about social and environmental performance of companies, therefore, demand tools adapted to their needs (Avetisyan, 2010). Thus, the indexes are a crucial link in communication between companies and investors, especially those who have concerns about the social responsibility of companies in which they are investing (GES Investment Services, 2007).

BP had a better reputation than its peers in terms of social responsibility (Steverman, 2010). However, on April 2010 there was a hydrocarbons leakage from the well of Macondo operated by BP in the Gulf of Mexico, resulting explosions and fire. Eleven people lost their lives and seventeen were injured. The fire lasted 36 hours until the rig, the Deepwater Horizon, sunk. Oil continued to leak for 87 days, causing a spill of international significance, the largest in US history (BP, 2010). When the accident occurred, BP was part of the Dow Jones Sustainability Index, and had led the energy sector in 2003 and 2004. In 2007, BP was first in the most responsible companies ranking developed by Fortune magazine and the NGO AccountAbility. In 2009, the Spanish consultancy Management & Excellence considered it the most sustainable among its peers, and in 2010 Tomorrow's Value placed BP on the top spot.

At the time of the accident, funds and indexes that seek only the most environmentally friendly companies held millions of dollars in BP shares (Steverman, 2010). Several issues, however, are being raised about the credibility and role of ratings and indexes. Some concerns include lack of transparency of the process and criteria, inadequate focus on material issues, difficulty in comparing industries, conflicts of interest of the organization offering the service of classification, and divergences among the ratings (SustainAbility, 2010). The Deepwater Horizon accident was a fatality that could happen to any company that operates a high-risk industry? Were corporate sustainability analysts looking at the wrong indicators? (Sverjensky, 2010)

The purpose of this paper is to analyze how environmental and social performance of oil & gas companies is evaluated by investors. Although there is limited literature on sustainable indexes, the phenomenon offers considerable promise for academic researchers studying potential link between sustainability and corporate performance. The increasing importance

of the ratings in investment decisions combined with significant amount of capital used for socially responsible investment and the growing exposure to social and environmental risks of the O&G industry makes necessary a careful analysis of the ratings used by leading investors to evaluate companies in such sector. Using the case of BP as a backdrop, the objective of this study is to analyze how the rates and classifications consider issues relating to environment, social responsibility and governance of oil & gas companies. Can an ESG analysis identify which companies are more prone to accidents? Are these ratings sending messages credible and relevant to investment decision makers? How similar or different are their approaches (criteria and weights)?

The work begins with a brief overview of SRI, its roots, meanings and strategies. Then it goes on to discuss the behavior of certain SRI funds in function of the Deepwater Horizon accident. Subsequently, an analysis of SRI ratings is presented, ending discussion of possible implications of the BP accident to the SRI community.

II. Socially Responsible Investment and Sustainability Indexes

The roots of the movement of socially responsible investors (SRI), also called ethical or sustainable investing (Renneboog et al., 2008) are religious, dating back many centuries (Statman, 2010). This movement, however, gained momentum over the past decade, as evidenced by membership of 855 institutions, representing around U.S. $ 22 trillion in assets to the Principles Responsible Investment of the United Nations (UN PRI, 2010). The concept of socially responsible investment is growing in popularity, and thus, gaining an increasing interest from academia in recent decades (Van den Brink and Van Der Woerd, 2004; Finch, 2005; Zorraquin and Schmidheiny 1996, O´Rourke, 2002; Fowler and Hope, 2007; Ziegler and Schröder, 2010).

There is no consensus on this new investment movement, on what are its main features, and what are the main issues to be integrated into the decision making process. For purposes of this paper will adopt the definition Eurosif (2010): "*a generic term covering any type of investment process that combines investors' financial objectives with their concerns about Environmental, Social and Governance (ESG) issues.*"The different strategies available consist mainly of ethical exclusions, best-in-class, thematic funds, and engagement and integration, often in combination with one another.

Pension funds, universities, as well as a large number of individuals who invest on ethical financial market instruments seek to identify the stocks they want to own or avoid through labels or ratings. Specialized agencies issue these labels and ratings, such as SAM, KLD, Oekom, Management & Excellence, Vigeo, Avenzi, among others. Negative screening or exclusions is considered a primary approach (Fowler and Hope, 2007). A more advanced strategy is positive screening, such as best-in-class, which creates an index with a selection of the best companies from each industrial sector based on a number of different criteria. The inclusion in such stock indexes is regarded as an indicator of excellent corporate sustainability performance (Ziegler and Schröder, 2010).

For some critics, given that oil is not a sustainable energy source and the risks inherent in their exploration, production and consumption are high, these companies should not be part of

social responsibility funds (Sverjensky, 2010). However, oil companies are enjoying record profits with high oil prices and are preferred by pension funds and institutional investors. On the other hand, many in the sustainability field see SRI to have the potential to shift corporate behavior towards more sustainable patterns of production and consumption (O´Rourke, 2002). The risks of exploring in ever more remote areas are seen as having material impacts, but it is unclear how this impact can be calculated in financial terms (Goldman Sachs, 2007).

The socially responsible "performance" of companies is difficult to measure and, in many cases, one has to rely on what is reported by companies. The criteria on which these ratings are built on defines how companies will be classified, and thus, reflects their social and environmental performance.

III. SRI Indexes and Ratings

In 2005, BP ranked among the 20 companies most often found in European Ethics Funds. Ten percent of the companies in this list are O&G (De Keuleneer apud Avanzi SRI Research and SiRi Company 2005). IW Financial argues that large oil companies are leaders in energy production and supply and, thus, investing in an SRI perspective helps influence these companies to move towards more sustainable energy sources (Matthews, 2010).

According to Eurosif (2010), environmental and social crises have acted as a wake-up call for many investors; the risks and liabilities of the BP Deepwater Horizon case clearly illustrates how environmental and social risks have significant and long lasting financial consequences. BP stocks, which were trading at near US$60,00 a share, fell to US$27,00 during the accident, and despite high oil prices, have not fully recovered at the time of this paper.

According to the literature, the reactions of SRI funds to the Macondo Accident were mixed. Some, recommended divesting BP stock based on the reassessment of the risk factors and actual environmental performance of the company during the accident (Matthews, 2010 and Burstein, 2010). Others have elected not to divest in order to engage in shareholder advocacy (Matthews, 2010). A third group of SRI fund manager had elected not to hold BP prior to the accident (Matthews, 2010 and Burstein, 2010)

Many funds base their investment profile in the recommendation of ratings. The sustainability ratings are prepared by a number of reasons, including ethics, risk quantification, and prediction of long-term performance. The goal of the index affects the methodology of collecting information and criteria applied.

The ratings were selected using the following criteria with the aim of understanding how BP stocks were treated before and after the Gulf of Mexico incident:

- Industry specific, oil and gas sector.
- Global scope.
- Analyze social, environmental and governance issues.
- Target audience mainly investors and companies.

Well known and respected ratings, such as the Carbon Disclosure Project, were excluded due to their focus on one issue: in this case climate change. In addition, excluded were ratings compare companies from different industries, such as Forbes' 100 Most Trustworthy Companies, or with a regional focus, e.g. Corporate Sustainability Index of Bovespa which only includes Brazilian listed companies.

Thus, the following ratings/indexes were selected:

- Dow Jones Sustainability Index developed by Sustainable Asset Management (SAM). The DJSI, based on the cooperation of Dow Jones Indexes and SAM, was the first global index to track the financial and sustainability performance of companies. SAM is a global investment firm focused exclusively on sustainability investing, offering comprises asset management, indexes and clean tech private equity.

- GS Sustain developed by Goldman Sachs, a full-service global investment banking and securities firm.

- Oekom Industry Focus - Oil & Gas developed by Oekom research AG, which is a global rating agency that provides services to the segment of sustainable investments.

- Tomorrow's Value Rating (TV) developed by Two Tomorrows. Two Tomorrows is a international corporate sustainability agency which provides assistance to companies worldwide.

- World's Most Sustainable Oil Companies developed by Management & Excellence (M&E) . Management & Excellence S.A. (M&E) is a research and rating company in the areas of ethics, sustainability, corporate governance, transparency and corporate social responsibility (CSR) specialized in Latin America, Spain and the global oil industry.

- FTSE4Good ESG developed by EIRIS, a global provider of independent research into the environmental, social, governance (ESG) and ethical performance of companies. FTSE4Good ESG Ratings seek to measure the ESG risk and performance of companies worldwide, based on the companies listed in FTSE.

The selected ratings differ significantly in their goal and the main product of the agency that develops them. For instance, the DJSI, FTSE4Good and GS Sustain select their sustainability criteria with a focus on materiality. Alternatively, Oekom, M & E and TV aim to be as comprehensive as possible on ESG issues. The main product of both the FTSE4Good and the DJSI is the financial performance of their indexes. GS Sustain, instead, was created seeking to research how ESG issues were reflected in stock prices. In the case of Oekom, M&E and TV, the ratings are the flagship product of research and evaluation of companies, where customers demand a detailed understanding of the company´s performance.

Table 1. Characteristics of the Selected Ratings

Ratings		DJSI	GS Sustain	OEKOM	World's Most Sustainable Oil Companies	Tomorrows Value	FTSE4Good ESG
Agency that Developed		SAM	Goldman Sachs	Oekom	M&E	Two Tomorrows (TT)	EIRIS
Frequency		Annual	sporadic (2002, 2003, 2006)	sporadic (2010)	sporadic (2004-2009)	sporadic (2010)	Annual (first 2011)
Country of Origin		Switzerland	England	Germany	Spain	England	England
Analitical Strategy		Materiality	Materiality	Broad Scope	Broad Scope	Broad Scope	Materiality
Source	Public information	Yes	Yes	Yes	Yes	Yes	Yes
	Application	Yes	Yes	Yes	No	No	Yes
Consultation	Company	Yes	No	Yes	Yes	No	No
	Suppliers	No	No	No	No	No	No
	Third Sector	No	No	Yes	No	Yes	Yes
Public Disclosure	Ranking	Partial	Yes	No	Yes	Yes	No
	Criteria	Partial	Yes	Partial	No	Yes	No
	Weights	Partial	No	No	No	No	No
	Indicators	Partial	Yes	No	No	No	No
Exclude BP after the accident?		Yes	No	No	**	No	Yes*

Another point that deserves attention is the practice of an advisory committee consisting of independent experts coming from the academia, NGOs, and the market. This practice is present in three of the ratings: Oekom, FTSE4Good and TV. Note, the DJSI has third-party audit by a specialist company.

The comparison between the ratings of the classification is complicated primarily by the lack of regularity and transparency of information. On Table 1, we can observe that only the FTSE4Good and DJSI have a routine annual disclosure. FTSE4Good ESG, however, does not disclose companies listed in the index.

It was not possible to perform a comparative analysis of the criteria and weights used by the ratings due to the unavailability of information. Only the GS Sustain discloses in detail all the indicators that comprise its index, which is probably because Goldman Sachs does not use the GS Sustain directly for commercial purposes.

Table 2 presents the latest available ratings of companies in the last five years. Total is the only company included in all indexes, followed by Shell, Repsol, Petrobras and ENI.

Note the low participation of American companies in the indexes. This may reflect the origin of the rating agencies, all European (as per Table 1).

Table 2. Company Ranking

Year	2006			2007		2008		2009		2010		
Rating	DJSI	GS	M&E	DJSI	M&E	DJSI	M&E	DJSI	M&E*	DJSI	OE	TV
BG Group	L	1	NL	L	NL	L	NL	L	NL	L	NA	NL
BP p.l.c.	L	5	2	L	4	L	3	L	1	NL	9	1
BHP Billiton	NL	4	NL	NL	NL	NL	NL	NL	NL	NL	NA	NL
Cairn	NL	9	NL	NL	NL	NL	NL	NL	NL	NL	NA	NL
Chevron	NL	14	8	NL	NL	NL	9	NL	4	NL	NA	7
Conoco Phillips	NL	NL	10	NL	7	NL	10	NL	NL	NL	NA	4
EnCana	L	NL	NL	L	NL	L	NL	L	NL	L	NA	NL
ENI	NL	12	12	L	6	1	6	L	5	L	NA	6
ExxonMobil	NL	11	9	NL	NL	NL	NL	NL	6	NL	NA	3
Gazprom	NL	21	14	NL	NL	NL	16	NL	9	NL	NA	8
Lukeoil	NL	NL	13	NL	10	NL	14	NL	NL	NL	NA	NL
Marathon	NL	10	NL	NL	NL	NL	13	NL	NL	NL	NA	NL
MOL Hungarian Oil	NL	NL	NL	NL	NL	NL	NL	NL	NL	L	NA	NL
Nam Rete Gas	NL	NL	NL	NL	NL	NL	NL	NL	NL	NL	2	NL
Neste Oil Ou	NL	NL	NL	L	NL	L	NL	L	NL	L	NA	NL
Nexen Inc. Canada	L	NL	NL	L	NL	L	NL	NL	NL	NL	NA	NL
Norsk Hydro	NL	7	7	NL	NL	NL	NL	NL	NL	NL	NA	NL
OMV	NL	15	NL	NL	8	NL	8	NL	NL	NL	1	NL
PEMEX	NL	NL	11	NL	9	12	NL	NL	NL	NL	NA	NL
PDVSA	NL	NL	NL	NL	NL	NL	20	NL	NL	NL	NA	NL
Petrobras	L	6	3	L	2	L	1	L	2	L	NA	NL
Petrochina	NL	24	NL	NL	NL	NL	17	NL	10	NL	NA	9
Repsol YPF S.A.	L	17	6	L	5	L	7	L	NL	L	NA	NL
Royal Dutch Shell	L	2	1	L	1	L	5	L	7	NL	NA	2
Santos	NL	13	NL	NL	NL	NL	NL	NL	NL	NL	NA	NL
Sasol ltda	NL	NL	NL	NL	NL	L	NL	L	NL	1	NA	NL
Saudi Aramco	NL	NL	NL	NL	NL	NL	19	NL	NL	NL	NA	NL
Sinopec	NL	26	NL	NL	NL	NL	NL	NL	8	NL	NA	8
S-OIL COR	NL	NL	NL	NL	NL	NL	NL	NL	NL	L	NA	NL
Statoil Norway	1	3	4	1	NL	L	3	L	NL	L	10	NL
Suncor Energy Inc	L	NL	NL	L	NL	NL	NL	NL	NL	NL	NA	NL
Total AS	L	8	5	L	3	L	2	1	3	L	3	5
Woodside	NL	16	NL	L	NL	L	NL	L	NL	L	NA	NL
NUMBER OF O&G COMPANIES LISTED	**11**	**26**	**14**	**13**	**10**	**13**	**20**	**12**	**10**	**12**	**10**	**9**

NA = Data not available, Listed, NL= Not listed , DJSI = Dow Jones Sustainability Index, TV = Tomorrow Value, OE = Oekom, GS = Goldman Sachs Energy Sustain, M&E = Management and Excellence

TV and M&E conducted the last rating a few months before the accident at BP, where BP configured in the first position in both of them. TV released a statement that BP earned its classification due to its overall performance and that the accident is inherent in the activities of P & G.

The M&E 2009 report is no longer found in their website and no official statement about BP of the Deepwater Horizon accident was located (M&E, 2009). However, on the official communication on the occasion of the release of the 2009 rating, BP was commended for having the best investment portfolio in alternative energy. Hence, if SRI seeks to stimulate O&G companies to invest in more sustainable fuel, as argued previously by Matthews (2010), then an investment in BP is coherent independent of its risks in current operations.

DJSI index withdrew BP assessment in 2010. FTSE4Good CSG did not exist at the time of the accident, but the FTSE4Good indexes (without ESG) also excluded BP from their portfolio. Oekom published its first rating after the accident in the Gulf of Mexico. We found no statement of the GS Sustain on the subject.

IV. Conclusions

BP stocks belonged to several sustainability indexes before the accident in April 2010. Several of these ratings disqualified and removed the company from their lists after the Gulf of Mexico disaster claiming the long-term consequences of the accident. However, none of the ratings analyzed had placed BP below the fifth in terms of sustainability performance compared to its peers before the blowout.

Nevertheless, many did recognize the safety problems the company had in the last few years, such as the Texas Refinery and Pudhoe Bay leak. A possible conclusion is that the weights used for each criterion are not adequate, placing only a small emphasis on operational safety. For example, Oil&Gas companies must fill out for the DJSI contains 80 pages and 25 criteria, only two of which address aspects of operational safety. M&E reports that companies must score on 387 criteria, not specifying how many are security-related. When analyzing a company in a high-risk industry, the sustainability ratings should make operational-safety criteria more relevant; ensuring it will not dilute in the middle all ESG requirements. It was not possible to compare the criteria and weights as a consequence of lack of available information.

Another possibility for the neglect in the safety records and still scoring high across the board in sustainability is the favorable alternative energy portfolio of the British company compared to its peers. Macondo's accident reveals that BP had serious problems regarding risk management, but does not mean that it is worse than its peers. These ratings are assembled such that it does not mean that the company scored well in all requirements. For example, a company score poorly on community relations, but obtain a high mark in environmental management. Thus, its total score can be high, even with low scores on some aspects.

We suggest a complementary study including interviews with the rating agencies to supplement the information. The ratings will always vary in their classification. They are designed with different goals and scopes, thus investors and society must understand their limitations when investing in the recommended stocks.

A potential problem is that the ratings studied provide services to both investors and companies, which may create a conflict of interest and bias the evaluation. Rating must be mechanisms that drive the progress of corporate sustainability. The criteria of these instruments should be more transparent, focused and robust. The information collection mechanisms should be enhanced to better capture the aspirations of society. Most of the ratings is based on data from annual questionnaires, or forms and documents sent by the companies themselves. The practice of an independent review committee adopted by Oekom, TV and FTSE4Good is a move in the right way.

No society, rating or company is perfect. A best-in-class approach intents, however, to select the best companies within their industries. Market instruments of corporate sustainability do not replace the role of supervision and enforcement of government and society. In the wake of the accident in the Gulf, regulators should push companies to invest more in health and operational safety.

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