

Upstream investment: a contrarian strategy

Social risk should not be eliminated from the planning process.

Jim Sisco and Bryan Bloom, Enodo Global

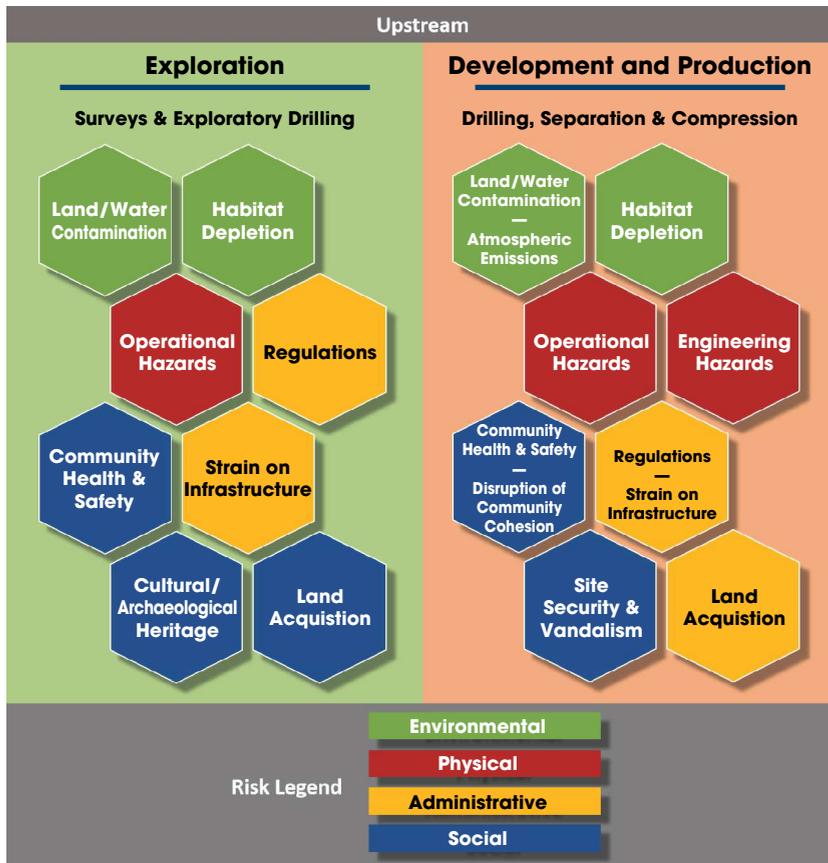
Actions by oil and gas firms to divest from upstream assets are short-sighted. Upstream investments present a golden opportunity for companies when social risk analysis is applied to their risk portfolios. Social risk (e.g., strikes, protest, litigation, sabotage and violence) are increasing in frequency and magnitude. They cause production disruptions and stoppages up and down the supply chain, especially in frontier markets where upstream investments are more prevalent. Social risk analysis enables firms to introduce systemic improvements to

their business models, safeguard operations throughout the life cycle of the project, reduce their risk exposure, take advantage of short-term depressed upstream asset prices and position themselves to increase market share when commodity prices rebound.

The 2014 commodity downturn significantly accelerated an industry trend to divest from upstream assets. Today divestments are employed as part of a strategy to address short-term cash flow gaps, remove riskier assets from balance sheets and stabilize cash flow with more reliable downstream operations. In addition, firms have employed traditional financial methods (e.g., capital structure adjustments, employee layoffs and dividend

payment reductions) to stop the bleeding. This approach is rational for firms focused on maintaining quarterly profits and reducing short-term risk. These measures have failed, however, to deliver a sustainable solution to protect profits. For example, Exxon Mobil not only missed its profit projections for the quarter ending June 30 but also reported its weakest earnings since 1999. Yet even in the face of continued lackluster earnings, firms have doubled down on traditional methods.

Oil and gas majors, hit hard by the commodity downturn, have taken traditional financial methods to the extreme. Chevron's cash flow declined from \$31.5 billion in 2014 to \$19.5 billion in 2015. Instead of plugging the difference with a reduction in its \$8 billion of dividends, Chevron raised new debt, sold assets and executed unprecedented layoffs. Changes to higher levered capital structures are evident across the industry. Exxon Mobil, Royal Dutch Shell, BP and Chevron have more than doubled their debt in the past two years. BP more than tripled its divestment program from a normal rate of \$2 billion to \$3 billion a



Social risk dominates upstream operations and intensifies environmental, physical and administrative risks. (Source: Enodo Global)

year to \$10 billion in 2015 in an effort to manage price volatility. Chevron is executing a plan in 2016 to cut 8,000 jobs, which comprises 12% of its workforce, and BP is cutting 4,000 jobs or 16% of its upstream workforce. ConocoPhillips has tightened the belt on equity investors through a dividend reduction from \$0.74 per share in the last quarter of 2015 to \$0.25 per share in first-quarter 2016. Even this drastic approach, by industry standards, is only a short-term fix.

Social risk analysis

Social risk exists throughout the entire oil and gas supply chain. It dominates upstream operations (E&P and development phases) and intensifies environmental, physical and administrative risks. Innovative technologies saturate the industry to improve investment decisions. They provide companies with unprecedented data to reduce traditional risks but fail to pinpoint, forecast and mitigate social risk. During upstream operations firms are especially exposed to this gap in their risk portfolio. The cost can be enormous. Extreme losses associated with black swan events and multiyear delays often are the result of unidentified or unmitigated social risk.

Proliferation of communication technologies has made traditional risk analysis obsolete. Moreover, geopolitical, country and security experts employed by companies to help navigate region-specific challenges offer only part of the solution. Today's dynamic environments, where most upstream investments are made, require social risk analysis. Populations, specifically the communities in the vicinity of production facilities, have more power and influence than ever before. Activists, environmental groups and criminal networks use communication technologies (e.g., social media, cellphones, etc.) to amplify existing hostility and create grievances within a society. These groups shape perceptions through powerful narratives that instigate protests, strikes, litigation or violence.

Energy Transfer Partners' Dakota Access Pipeline offers an example of disruption caused by social risk. The pipeline is designed to transport 570,000 bbl/d of crude over 1,770 km (1,100 miles) from the Bakken Shale, Montana and parts of Canada to oil refineries along the U.S. Gulf Coast. The Standing Rock Sioux Tribe sued in federal court to block the pipeline, claiming it would destroy important cultural sites and ancestral lands and endanger their water supply. They lost their case in court, and events turned violent. Company reports describe organized protests, individuals chaining themselves to equipment, and burned and vandalized construction equipment resulting in more than \$3

million in damage. In the face of mounting public outcry, the federal government halted construction of the \$3.8 billion pipeline in September, which was due to be completed by year-end 2016.

Events like these are becoming more frequent and the new industry norm. Resistance to pollution, land use and infringement on local livelihoods has led to defiant actions that damage company property, halt production and negatively impact profitability. Other examples include protests by landowners over royalty agreements with Exxon Mobil in Papua New Guinea, environmental campaigners' occupation of Infrastrata's site on Dorset's Jurassic Coast and months-long work stoppages at Petrofac's gas plant in Tunisia due to labor disputes. Without a way to forecast and mitigate social risk, these events make upstream investment cost-prohibitive and reinforce divestment strategies.

Identifying, mitigating social risk

Social risk analysis delivers a solution. It measures how oil and gas operations impact populations and how populations impact oil and gas projects. Open source information (e.g., social media, local and regional news outlets) combined with advanced data analytics enable firms to leverage quantitative and qualitative data to pinpoint, forecast and mitigate social risk. This not only enables firms to understand the true risk level of an investment but also serves as a baseline to monitor for anomalies and deviations. For example, will 10,000 angry tweets over low wages translate into a protest at a facility? With a baseline assessment established, firms can determine if this is cause for concern and, more importantly, develop mitigation strategies to proactively quell any potential work disruptions.

Social risk analysis provides utility across the entire oil and gas business model. Integrating social risk analyses into upstream due diligence investigations allows firms to proactively quantify the potential for extreme losses. During operations companies can lower the risk of work stoppages that affect project timelines and cash flows through active engagement. The additional layer of analysis enables firms to better understand total risk exposure, creating opportunities to strategically acquire mispriced assets or to more effectively manage operations at current facilities. In today's market where many oil and gas firms are divesting upstream assets, social risk analysis provides a unique opportunity to not only acquire relatively cheap assets but also to create an enduring upstream portfolio to protect long-term profits. For companies with a more strategic financial strategy and long-term outlook, upstream investments offer incredible upside potential. **ESP**