INSIGHTS FROM THE BDO NATURAL RESOURCES PRACTICE

Fueling the Energy Transition: As Oil and Gas Companies Adapt, Investor Interest Increases

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As the future of energy emerges on the horizon, getting there presents unique challenges in terms of infrastructure and reliability. The energy industry is adapting amid increasing demand for renewables, and oil and gas companies remain vital for driving economic growth, ensuring energy security and supporting the broader energy transition.

A wide range of stakeholders — including shareholders, institutional investors, proxy advisory firms, regulators, legislators, consumers and others — have called on companies to commit to targeting net-zero emissions and addressing environmental, social and governance (ESG) risk factors. Adopting and scaling clean energy will be a long-term endeavor, and traditional fossil fuels are vital to that growth.

Amid a combination of higher oil prices in 2022 and a renewed understanding of the role oil and gas play in energy security, investors are increasingly bullish on the sector. In particular, private equity firms that have faced investor pressure to uphold ESG commitments are reexamining oil and gas investments after diversifying away from the industry in recent years. As investors look to engage or reengage with the industry, oil and gas companies should develop, implement and communicate an ESG strategy that addresses investor concerns. Companies can differentiate from their peers and highlight their competitive advantages to investors.

OIL & GAS IS KEY TO THE ENERGY TRANSITION, AND COMPANIES ARE INVESTING ACCORDINGLY

Despite volatility in oil and gas prices, many companies in the industry have recently seen healthy profit margins. For example, after a pandemic-related drop in early 2020, the price of West Texas Intermediate crude oil roughly tripled between June 2020 and June 2022. The renewed strength in higher oil prices, combined with an emphasis on operational efficiency required during lower commodity price environments of the past, has resulted in strong, sustainable cash flow that attracts interest in the sector.

Whereas some oil and gas companies previously struggled to **raise capital**, many now have funds to deploy. Key areas of investment include digital transformation, cybersecurity and ESG initiatives. **BDO's 2022 Energy CFO Outlook Survey** shows that digital transformation is the top strategy for energy companies this year, while ESG initiatives rank among the top three. Data breaches also stand among their most significant risks. Digital strategy and cybersecurity have been longstanding priorities, and investments in these areas can help companies address ESG considerations and capture technology-related efficiencies. The majority of CFOs surveyed say implementing an ESG program that helps mitigate risk and improve resiliency will have a positive impact on financial performance.

Many oil and gas companies have directed capital expenditures toward growing and supporting cleaner energy as part of their standard operations. This goal can be accomplished through activities such as subsector investments related to power generation, storage and efficiencies, and distribution and transportation. One notable example is the need to address fugitive emissions in the natural gas supply chain, such as by maintaining and replacing valves, installing low- or no-bleed devices and improving monitoring.

Investing in renewables can also be as simple as shifting from gas- or diesel-powered company vehicles to hybrid or electric vehicles. Other examples include harnessing wind, solar energy or biofuel to power operations. Some companies, particularly in Europe, are pursuing growth through M&A in the clean energy space as well.

Fossil fuels also remain vital to ensuring energy reliability through dispatchable power, which can be adjusted to meet fluctuating demand for the electrical grid. During the ongoing energy transition — along with corresponding decarbonization targets and net-zero emissions goals — the stability of energy markets requires the production of oil and gas. This transition requires collaboration among business leaders, investors and legislators on both a national and global scale.

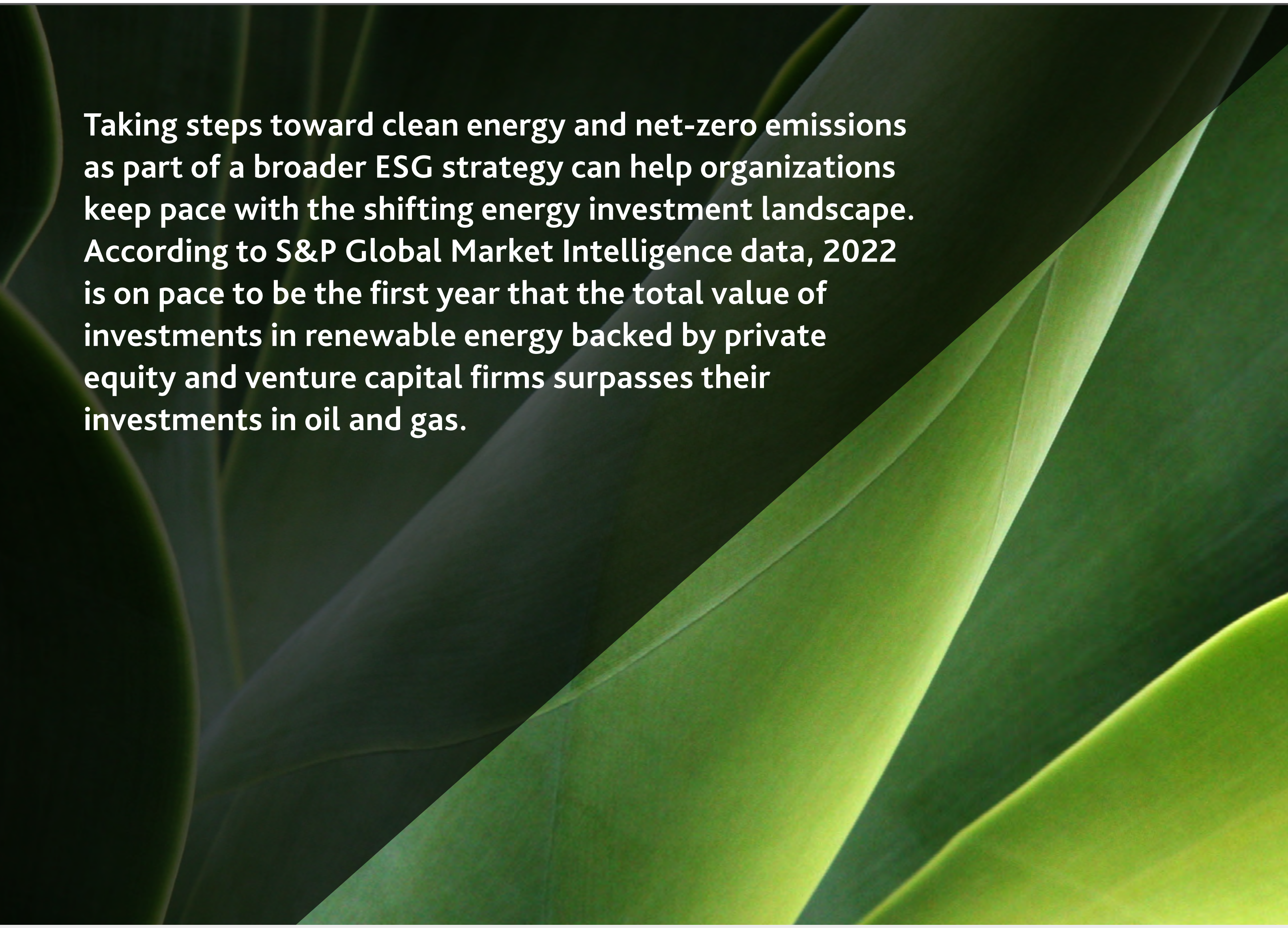
PRIVATE EQUITY FIRMS HAVE AMPLE CAPITAL AND RENEWED INTEREST IN OIL & GAS

As traditional fossil fuel companies make strides to streamline operations, improve cash flow and reduce their carbon footprints, they are attracting renewed interest from investors. To encourage investment from private equity firms and others, oil and gas companies should develop their ESG strategy, or assess their current one, to clarify emissions targets and corresponding timelines. Effective ESG policies lend structure to consistent data measurement and definition to performance outlooks that together mitigate risk and encourage financial discipline.

Some large banks remain committed to investing in oil and gas to help meet consumer demand and economic need, while others have pulled back from fossil fuels. Oil and gas companies with a robust ESG strategy can offer an opportunity for banks and private equity firms to invest in a profitable business with growth potential, as well as meet stakeholder demands related to environmental externalities.

Many private equity firms have deep knowledge of the energy sector and can play an important role in helping traditional oil and gas companies facilitate the energy transition. Some of the largest private equity firms continue to invest in oil and gas companies either directly or through subsidiaries. At the same time, many of them are continuing to build their portfolio of renewables, but oil and gas companies can serve both ends as part of the energy transition.

ESG considerations and risks have also rapidly climbed the list of priorities for private equity firms. According to BDO's **Spring 2022 Private Capital Pulse Survey**, 99% of private equity fund managers have identified an ESG strategy and 95% say they evaluate targets' ESG potential as part of due diligence. Additionally, 50% say they plan to set up impact funds or invest in targets with ESG-focused themes in the coming months.



Taking steps toward clean energy and net-zero emissions as part of a broader ESG strategy can help organizations keep pace with the shifting energy investment landscape. According to S&P Global Market Intelligence data, 2022 is on pace to be the first year that the total value of investments in renewable energy backed by private equity and venture capital firms surpasses their investments in oil and gas.

UNLOCKING NET-ZERO EMISSIONS FOR TRADITIONAL FOSSIL FUELS

As investors and stakeholders continue to push for reliability in clean energy and a net-zero future, the energy transition can take many different practical forms. Carbon capture, utilization and storage (CCUS) stands as a primary example of how the oil and gas industry can use fossil fuels while limiting negative externalities. While carbon capture and other green technologies hold considerable promise for the future of clean energy, they still face some engineering challenges.

There are some examples of fossil fuels producing energy without emissions, such as using natural gas to generate electricity and delivering carbon dioxide in a manner suitable for sequestration. In some cases, existing infrastructure can be leveraged to extract clean energy as well.

Natural gas can also be broken down and used to produce hydrogen and ammonia. Renewable energy, such as solar and wind power, can be used for the conversion process. Hydrogen, however, can be difficult to transport long distances, and it presents some storage issues. Ammonia has properties similar to propane, and it is easier to store and transport than hydrogen, although combustion can be challenging. While both present opportunities in the energy transition, improving and scaling production of clean hydrogen and ammonia will require investment from oil and gas companies and elsewhere.

DRIVING GROWTH FOR CLEAN ENERGY AND THE ECONOMY

Traditional fossil fuels will play an important part in ensuring energy reliability for the future. It is no longer business as usual for oil and gas companies, but there is substantial profit incentive for organizations to adapt with the transition to clean energy. Companies that invest in clean energy can build a long-term growth strategy with commitments to net-zero emissions and ESG principles. Adopting such strategies and adapting to this industry-wide change can help draw interest from private equity and other investors while also helping drive further investment in renewables to the benefit of all stakeholders.

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