Oil Sands Transition: ESG Risk

Where's the Market?

For years Canadian producers have used "ethical oil"[1] or "responsibly produced oil" messaging to differentiate themselves from other producers particularly, those operating in the middle east. As Canadian oil producers start to face a shrinking market there will be a desire to reposition themselves to expand their share of the remaining pie through undeveloped and unknown market mechanisms that put a premium on oil production that scores high on environment, social and governance (ESG) performance criteria. Inherent in this positioning is the notion that ethically sourced oil will make Canada the supplier of choice. However, it is unclear how this will be achieved since oil is a commodity traded in the open market and ESG is not currently factored into market pricing. "Ethical oil" is a subjective term and while work has been completed to create ESG frameworks with objective evaluation criteria there hasn't been consensus on what and how to measure progress within the ESG space. Absent the creation of a market mechanism that can transparently and credibly differentiate ESG oil from "unethical" oil, there will be no pathway to access new "premium" markets.

ESG Market Development Challenges

There are many barriers to the creation of a market that recognizes and rewards "ethical" oil. First and foremost, and from a consumer standpoint, the politics around rising fuel prices suggests there will be little demand for the development of a premium ESG market. Even small increases to retail fuel prices have led to protests and possible policy changes to bring fuel prices down so it's extremely questionable as to whether or not end-users would be comfortable paying a premium for "ethical" oil….and if they won't pay for it who will?.

Further, the creation of an ESG market by its very nature would seek to exclude oil production from "unethical" producers. In a market with slowing or decreasing demand, it's almost impossible to imagine oil producers allowing the development of a premium market they can't access and, given the advantageous market position they currently hold, it's likely they would use their market power to protect and/or expand their share of the shrinking pie. Similarly, the current market is known for being aggressive and price sensitive. Facility choices on feedstock are based on market dynamics and logistics. Refineries currently receiving light oil from the middle east will not be able to utilize Canadian heavy oilsands feedstock without having to spend significant amounts of money to retrofit their refineries to accept heavy crude. Taken together, it is unrealistic to expect the development of an ESG market that will disqualify a significant amount of production and / or require refiners to absorb costs in order to start accepting heavy "ethical" oil.

Is Canadian Oil even "ethical" in the first place?

[1] This term was originally coined by Ezra Levant culminating in a book titled *Ethical Oil: The Case for Canada's Oil Sands*. Levant's primary message is that the Canadian Oil sands performs better than other oil produced in middle east and African nations, on issues of environment, social justice and freedom from oppression (i.e., ESG criteria).

Perhaps this is somewhat of a moot point as even a quick review of Canadian oil production reveals dubious environmental practices and, more concerningly, human rights issues. Tailings ponds are growing unresolved and unfunded environmental liabilities and despite claims of the highest environmental standards linkages to downstream toxicity combined with a recent Environmental Protection Order (EPO) registered against an oil sands producer for a leaking tailings pond make these claims questionable. Canadian upstream projects have, as an aggregate, one of the highest average carbon intensities (CI) among global sources and highest average carbon intensities (CI) among global sources and face significant challenges to reduce emissions relative to peers. Meanwhile oil and gas companies are developing business strategies predicated on downloading environmental liabilities onto the public. Government is now the largest funder of inactive well clean-up, recent court cases demonstrate subversive tactics by companies to bundle and sell marginal high liability wells to shell companies on the verge of bankruptcy, unpaid municipal taxes have resulted in new direction to the Alberta Energy Regulator (AER) to start taking action on these companies and Indigenous lands and rights continued to be ignored the most recent egregious example being the latest tailings spill at Imperial Oil's Kearl site. Taken together, it's unclear how well Canadian oil sands would rate within an ESG framework as, on the surface, these do not appear to be the actions of an ethical industry.