KBRA KROLL BOND RATING AGENCY

Midstream Energy Companies and ESG Risk Management

Corporates | ESG Research

This Kroll Bond Rating Agency (KBRA) report is a follow-up to a recent publication on how environmental, social, and governance (ESG) factors are considered in KBRA's credit rating process across corporate, financial, and government (CFG) ratings. While our previous publication provided a broad overview of KBRA's ESG integration process, this report serves to detail the credit-relevant ESG factors that may be evaluated when rating midstream energy companies.

As stated in our **Credit Ratings Deserve ESG Risk Analysis, Not ESG Scores** report, while many ESG factors play an important role in how we manage our business and a growing role in helping investors preferentially allocate capital, we believe the role of analysts at a credit rating agency is to remain focused on ESG factors that are material to credit. Further, KBRA believes that the distinction between ESG factors that are credit-relevant or not is best accomplished through fundamental, bottom-up credit-by-credit risk analysis, rather than through the collection of often irrelevant ESG data and/or the creation of ESG scores that are burdensome to analysts and issuers. In our view, ESG scores based on subjective metrics that are not correlated to credit risk have no place in the credit rating process. Instead, KBRA analysts identify and integrate credit-relevant ESG factors through the lens of risk management analysis. We believe this process contributes to a goal of improving meaningful disclosure of ESG issues that are impactful to credit.

KBRA uses a two-step process to identify credit-relevant ESG considerations. First, KBRA identifies and evaluates ESG factors that have a direct impact on the given transaction. KBRA defines direct impact as those factors that have a clear, tangible effect on credit, are typically quantifiable, and the assessment of which is generally rooted in existing methodologies. The second step is to evaluate an issuer's strategy for identifying and mitigating ESG risks, as well as planning for opportunities. KBRA also reviews the affordability of an issuer's management plan to address ESG risks and opportunities and whether it is achievable at the given rating level. Assessing management performance and capability has long held a prominent role in many of KBRA's rating methodologies, meaning it is a natural extension to integrate certain ESG issues into the analysis of management teams. KBRA's management review also includes an evaluation of an issuer's exposure to changes in stakeholder preferences and how that may influence its reputation and creditworthiness.

Understanding stakeholder preferences and potential changes in demand is also a key feature of KBRA's analysis of ESG issues. As ESG gains momentum and public sentiment continues to shift on issues like climate change and racial justice, it is crucial for an entity's management team to understand their own reputational risk and exposure to changes in stakeholder preferences. During our analysis of stakeholder preferences, KBRA assesses whether constituents' policy preferences on environmental, social, or governance issues present risks or opportunities for an entity and how the entity is managing (or utilizing) that risk. Stakeholders in the midstream energy space refer to regulators, investors, employees, customers, communities in which the company operates, or other relevant constituent groups.

Though KBRA evaluates the management of ESG issues, we do not make value-based, subjective judgments around ESG impact as this is inconsistent with objective credit analysis. Instead, we seek to illuminate, through our rating reports, how ESG factors may drive changes in the credit profile of the entity under consideration. As the relevance of ESG factors continue to evolve, KBRA's analytical process aims to be bespoke and dynamic, capturing all the credit-related factors that may affect the risk of default for a given transaction.

ESG and Midstream Energy Corporations

KBRA defines midstream energy companies as those that principally engage in the transportation, storage, processing, and marketing of crude oil and its derivates, natural gas, and natural gas liquids. Midstream operations include, but are not limited to, gathering and processing plants that collect gas at the wellhead and prepare them for long-distance transport; long-haul pipelines that move oil and gas from the production site to a designated market area or to storage facilities; terminals that provide distribution, storage, and blending of the oil and gas products; and liquefaction and regasification plants that convert the physical state of natural gas to allow for effective transportation or commercial usage.

Managing Environmental Factors

The impact of environmental factors on midstream companies generally varies by sector (i.e., processing, storing, transporting) and can be idiosyncratic at the company level or a systemic sector risk. The impact of environmental factors on corporate ratings can occur over the short, medium, or long term. As such, KBRA's credit profiles consider the mitigation plans that companies have in place—or are planning—to reduce their exposure to environmental risks, as well as how their strategies manage these risks and build resilience.

The global shift toward a lower-carbon economy and changing stakeholder preferences toward investments with a positive environmental impact may lead to the capital markets becoming less receptive to the midstream energy industry due to its reliance on fossil fuels and high level of greenhouse gas (GHG) emissions. However, some midstream assets may be viewed more favorably given their role in procuring and delivering natural gas, which is increasingly replacing coal as a cleaner source of electricity production and will likely be crucial in the early stages of a low-carbon transition. Further, if the global response to climate change continues to push technological developments in the capture and storage of carbon dioxide, midstream assets may play a role in the long-term transition plan. Though it is unclear how midstream assets will be viewed over the longer term, KBRA sees the management of stakeholder preferences around environmental issues as crucial for any midstream entity.

Other key environmental factors that may influence a midstream company's credit ratings include climate change, land use and natural resource allocation, and pollution, which we describe below.

Climate Change

Where relevant, KBRA analysts examine both physical and transition risks related to climate change. Physical risks such as extreme weather, sea-level rise, or drought, directly impact assets or business operations. In contrast, transition risks are indirect and relate to an entity's ability to shift to a lower-carbon economy because of potential changes to environmental regulations, supply and demand changes, and/or increased reputational risk.

Regarding physical risks, KBRA analysts will often request an issuer's analysis of the potential impact of climate change on its physical or financial assets such as operating facilities, revenue generating assets, or financial assets (e.g., insurance policies, business loans, etc.). In addition, when appropriate, KBRA seeks to understand the process through which an issuer determines its exposure. Though there are exceptions, KBRA believes this line of inquiry is increasingly relevant across most CFG issuer and issue types. In addition to the obvious importance of any insight into the potential timing and costs of mitigation efforts, KBRA also believes the process an issuer uses to analyze its exposure to climate change is credit-relevant because it provides insight into the robustness of its risk management practices.

KBRA considers climate change to be a material risk to midstream companies as it may result in reduced demand for downstream products, which could have an immediate effect on the need for midstream services. As the global economy shifts to cleaner energy sources to combat climate change, the demand for oil and gas pipelines is expected to fall. While this dynamic is likely to affect some crude oil pipelines, KBRA believes the demand for natural gas transportation networks will continue. At present, natural gas accounts for 40% of all power generation in the U.S. Although this percentage is likely to decrease as renewable energy continues to expand in the country, it is unlikely that natural gas production will be eliminated over the short and medium term. Furthermore, the planned expansion of liquefied natural gas (LNG) export facilities will potentially result in additional demand for some pipeline systems.

As climate change intensifies, natural disasters and extreme weather events such as earthquakes, flooding, wildfires, and drought are projected to increase in frequency and severity. Consequently, the risk of technological accidents triggered by natural disasters (natech) are expected to increase, which can cause damage to some midstream assets and the downstream facilities that rely on their services. However, climate change is likely to affect different assets in various ways, creating opportunities for some issuers and risks for others. Some companies may benefit as weather patterns change, while others could experience a reduction in operations and productivity. For instance, climate change-driven water shortages and droughts could make it more difficult for some power generating facilities to operate. Although drought conditions will likely affect many industries, it could be beneficial for certain assets as the demand to store and transport water may increase over time. This dynamic illustrates the critical need to understand how management teams identify, prepare, and adapt to climate-related risks and opportunities and their response to natech events. It also shows how unique these can be for a specific issuer or asset, which is why KBRA's bespoke approach to credit analysis is so important.

KBRA favorably views companies that are actively investing in reducing their exposure to climate change risk and natural disasters. Those without capable management teams that are not planning for future ESG risks will likely face decreases in productivity, reductions in operations, increased capital costs, and in some severe cases, the complete loss of assets. While hurricanes often garner the most attention, landslides, floods, and lightning can cause the most damage for some pipeline systems and it is important for at-risk companies to have business continuity plans in place to combat this exposure.

Land Use and Natural Resource Allocation

Natural resource allocation and land use can be critical credit considerations in the rating analysis when the effective management of these factors is required to maintain sustainability and efficiency of business operations. KBRA recognizes that land use and its effect on a midstream company can vary depending on the environmental cycle, the resource being utilized, and the geographical footprint of assets. KBRA's evaluation of land use and natural resource allocation includes the sustainability of finite resources, the extent of dependency on natural resources, vulnerability to resource price volatility, and the efficiency of resource exploitation. Land use evaluation may be important when a company is particularly dependent on a globally traded commodity, such as oil, especially if the retrieval of that commodity requires mining or other invasive processes that may affect the surrounding environment. Notably, corporates that rely on finite natural resources during their production process may experience declining revenue as the resource begins to deplete. This could be the case for some midstream companies, especially those operating in the storage and transportation sectors.

Environmental Pollution

Environmental pollution can be important credit considerations in the evaluation of midstream companies. Forms of pollution include nuclear plant leaks, oil spills, toxic waste, smog, and soot. Companies with pipeline systems that leak oil or other foreign substances into inland water bodies or land may have to pay fines or fees associated with remediation and civil penalties, and will likely face some reputational risk. These companies will also likely experience revenue declines as the asset typically needs to be taken offline for corrective maintenance and preventive measures after a spill.

Air pollution is also a concern as some assets release GHG and other contaminants. New regulations that limit or provide financial penalties to assets that exceed a predetermined threshold could impact the financial performance of some midstream companies. KBRA believes that management teams that proactively plan for these events will likely have a competitive advantage over companies that are not actively planning for such cases. Companies that do not invest in innovative monitoring and mitigation technologies are vulnerable to regulatory changes that may reduce the value proposition of some of their assets.

KBRA believes that a responsible operator with a proven track record of managing midstream assets can reduce some of this risk exposure. An assessment of a company's historical performance coupled with its maintenance strategy and community engagement can provide insight into the likelihood of declining financial performance due to pollution. While it is possible that effective management could mitigate some of these risks, others (e.g., regulatory changes) can be out of a company's control. For example, midstream companies that deliver fuel to power plants may experience revenue shortfalls if new environmental regulations prompt some facilities to be retired.

Managing Social Factors

In the midstream energy space, social issues are most likely to be incorporated in KBRA's analysis of stakeholder preferences. Labor management, employee health and safety, and community relations (among other potential social issues) can affect a company's reputation—and revenues. For example, community opposition to oil and gas pipelines has been a common occurrence in recent years and can delay or even halt project development for some midstream companies. Surrounding communities have raised concerns about the negative ecological impact that pipelines may have on water quality, wildlife, and the outer environment. In the event of significant community backlash, KBRA believes it is critical for corporate management teams to interact with the community and have clear plans in place to manage their concerns and mitigate any potential adverse risks. For many companies, effective communication and ongoing community engagement may be needed for long-term project success. Likewise, proactive labor management that prioritizes emergency preparedness and the health and safety of employees is important for midstream companies, given the industry risk.

Managing Governance Factors

Governance issues have historically been important considerations in credit analysis as good governance practices are frequently a driver of financial stability and creditworthiness across sectors. For KBRA, a capable management team that can plan for and mitigate the unique challenges (ESG-related and otherwise) it faces, which is crucial for financial stability.

KBRA believes it is important for issuers to demonstrate awareness of and disclose the ESG preferences of their key stakeholders, and how these preferences may impact the issuer's operating, capital, and financial strategies. As KBRA analysts interact with management teams, one guiding question we might use to initiate inquiry into an issuer's management of stakeholder preferences and related reputational risks is: Do your investors, customers, employees, regulators, voters, or other key stakeholders have environmental, social, or governance goals or policy preferences that present risks and/or opportunities to your enterprise?

Stakeholder preferences on governance issues can be an important consideration when analyzing a midstream energy company. Stakeholder views on a company's governance profile, such as its executive compensation policies, supply chain management, tax strategy, or cybersecurity systems, have the potential to affect a company's reputation and its ability to access capital, which is a key credit risk.

Cybersecurity

Cyberattack risk continues to increase as most companies have become more reliant on technology. However, the impact of these attacks varies greatly across industries and some of the most at-risk companies are in the energy sector. A cyberattack focused on the manipulation of a pipeline network or gathering system could result in explosions and environmental damage, endangering civilian lives and potentially causing billions of dollars in damages.

KBRA believes that an effective management team should, at a minimum, have an effective security response plan that can quickly identify breaches to its internal networks. The ability for midstream companies to swiftly adapt to security lapses is critical, considering the impact that technological breaches could have on the operations and financial performance of a midstream company. Management teams that do not spend a substantial amount of time and resources on a comprehensive cybersecurity plan and infrastructure are exposing the company to significant risks. In some cases, these risks could have a severe, negative impact on operations. Without proper cybersecurity systems in place, KBRA believes these risks increase the probability of default, and in turn, will likely have a negative impact on creditworthiness.

Conclusion

ESG issues, and especially environmental considerations, pose significant challenges to a midstream company's management team. Throughout the rating process, KBRA seeks to understand how management identifies and manages ESG-related risks and opportunities. While it is important for a management team to develop a plan to identify and mitigate ESG risks, affordability of the plans and proper implementation are also critical for long-term success. Companies that are unaware or unable to mitigate these risks will likely see their revenues shrink and credit profiles decline over time.

KBRA analyzes all material credit-related factors, including those related to ESG, that may affect corporate issuers and seeks to provide transparency on the impact these factors have on credit. In KBRA's view, ESG factors will increasingly have an impact on corporate credit quality—and we aim to provide thought leadership on the relevance of ESG to creditworthiness.

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