

ConocoPhillips crossing oil sands exclusion thresholds

Josephine Richardson (*), Ulf Erlandsson

On 8th August ConocoPhillips (Ticker COP) issued $2.7 bn of debt in three tranches.[1] The American oil producer is rated A-, and debt was sold at spreads of 130-150bp. The financing is to fund a full acquisition of the Surmont oil facility,[2] a Canadian oil sands field, currently owned 50:50 between ConocoPhillips and TotalEnergies.

Oil sands, also known as tar sands, are a mixture of sand, clay, water, and a thick molasses-like substance called bitumen, which is used to make synthetic petroleum products. Its extraction and conversion is very energy and water-intensive, using strip mining methods that are destructive to the local forest environment, and creates toxic waste and pollution.[3]

Responsible investment policies are focused on excluding 'unconventional' oil & gas production, due to its higher environmental impact, with many large asset managers including threshold exclusions for oil sands production.[4] Negative exclusions reduce investment demand, which has historically been shown to lead to a higher cost of debt,[5] and therefore understanding and anticipating these trends is important for fixed income investors.

ConocoPhillip's acquisition of the Surmont oil field, due to complete in late 2023, will likely increase its oil sands production, likely over the often-used 5% revenue threshold exclusion. Thus:

- **Several large investors may add ConocoPhillips to their oil sands-based exclusion list, and may subsequently seek to divest holdings. These flows could be negative for COP bond prices.**
- **Investors subject to exclusion policies seem to have added exposure through buying the new bonds, and effectively financed the activity rendering this investment ineligible. This highlights the unfortunate ex-post timing typical in ESG assessments. Active managers should anticipate ESG factor changes earlier in their investment process.**
- **Passive investments are particularly at risk of financing controversial behaviour, manifested here by passive ESG trackers having bought the new COP bonds. Index construction rules appear to guarantee their future sale.**

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[1] Debt consisted of $1bn 10y (ISIN US20826FBF27), $1bn 31y (ISIN US20826FBG00) and $0.7bn 40y (ISIN US20826FBH82) bonds.

[2] "ConocoPhillips to offer notes to fund $3 billion Surmont oil facility buyout", Reuters, 9 Aug 2023. For an overview of the Surmount facility, see "Oil sands: We are proud to hold an extensive in-situ oil sands in Alberta", ConocoPhilips Canada web-page, accessed, 16 Aug 2023.

[3] "This is the world's most destructive oil operation, and it's growing", National Geographic, 11 Apr 2019.

[4] For analysis of engagement around oil sand production please see "Fidelity and the oil sands pudding", AFII, 26 Jul 2021.

[5] "Does ESG Negative Screening Work?", Eccles, Rajgopal and Xie, SSRN working paper, 11 Aug 2022.

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(*) Anthropocene Fixed Income Institute (www.anthropocenefii.org), Author for contacts: jor@anthropocenefii.org

ConocoPhillips Oil sand production

ConocoPhillips is an American independent upstream oil & gas producer, created in 2002 by merging Conoco Inc and Phillips Petroleum company. In 2011 it separated its midstream and downstream operations into Phillips 66.

ConocoPhillips, under its CEO Ryan Lance, is actively pursuing investment in new hydrocarbon production in areas where other oil majors are pulling back,[6] including unconventional production sources. For example, ConocoPhillips report to be Alaska's largest crude oil (Arctic) producer,[7] as well as "proud" to hold an extensive position in in-situ oil sands in northern Alberta.[8]

In 2021, ConocoPhillips produced 26.1 million barrels of oil, 3.9% of its production, was from tar sands, estimated at 3.6% of revenue,[9] with the Surmont field being their only producing asset in the region.[8] Production from the field is projected to increase slightly to a peak in 2036,[10] so conservatively we assume a doubling of ConocoPhillips' production on full acquisition. Absent any other changes in production (and we see no other reported acquisitions or divestments), we estimate that this will increase tar sands to 7.5% of production and 6.9% of revenue.[11]

Oil sands exclusions

After thermal coal exclusions, oil sands exclusions are arguably the most common exclusion rule in the industry. Hard exclusion rules as "zero exposure" may be hard to manage; however, many investors in such cases use a 5% (or higher threshold). A sample, very non-exhaustive, list of such exclusion rules is provided in Table 1. Note that many of these responsible investment policies apply to the asset owner/manager's full investment activtivities, and not just those marked as ESG or sustainable.

Table 1 shows only a sample of exclusion policies, the actual number is substantially larger, and – in our view – only likely to increase over time as new exclusions are introduced, and thresholds are tightened. The Surmont transaction seems likely to impede the market capacity to hold COP securities creating technical headwinds not only for bonds but also for equities.[12]

One could argue that the funds with 5% thresholds are relatively small, but it still represents a significant change for COP, to be on any exclusion list due to this criteria. Trends are generally towards tightening thresholds, and so larger investors could be brought into scope. Norges Bank, the largest investor in the Table, do not publicly state their threshold however have reported some exclusions based on this criteria. And for an investor such as MAS, the 10% oil sands threshold may decrease over time, as Allianz have already committed.

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[6] "ConocoPhillips CEO Doubles Down on Alaska Oil as Competitors Leave Arctic", WSJ, 26 Mar 2023.
[7] "ConocoPhillips Alaska home page", ConocoPhillips, accessed 16 Aug 2023.
[8] The google tag-line attached to "ConocoPhillips Oil Sands", ConocoPhillips, accessed 16 Aug 2023.
[9] Data from "Global Oil & Gas Exit List", Urgewald, 10 Nov 2022.
[10] "Surmont Project (ConocoPhillips Company) Oil Sands Field, Canada", Offshore Technology, 2 Dec 2021.
[11] Total annual tar sands production of 52.2 mmboe out of 699.1 total, with 92.1% revenue coming from fossil fuels. All numbers from [9].
[12] There may also be bank financing conditionalities based on oil sands exposure.

Table 1. Oil Sands exclusion policies. Source: Various.

Example asset owner/manager/fund	AUM (est)	Threshold	Date	Source
Aegon Asset Management[13]	€293 bn	5%	21-Jan-2022	Link
Axa	€845 bn	5%[14]	29-Oct-2021	Link
KLP	€72 bn	5%	7-Oct-2019	Link
Danske Bank AM	€100 bn	5%	1-Dec-2022	Link
Vanguard Sustainable Life/WaMU	€0.5 bn	5%	24-Sep-2020	Link
BlackRock's iShares ESG Enhanced UCITS ETF	€9 bn	5%	26-Oct-2021	Link
Norges Bank Investment Management	$1 trn	n/a	12-May-2020	Link
Monetary Authority of Singapore	$419 bn	10%	3-Aug-2023	Link
Allianz	€2.1 trn	20%[15]	9-Feb-2023	Link

Furthermore, we outlined in "Arctic oil & gas: left out in the cold", AFII, 26 Apr 2023, that COP also has a substantial exposure to Arctic oil extraction, representing 13% of revenues in 2021. For investors using more subjective rather than rules-bound (e.g. by using a Responsible Investment committee decision), the correlated focus of Arctic oil and increased oil sands of the company is likely to increase the probability of exclusions compared to a situation where the factors are considered in isolation. This could encourage active managers to divest in anticipation of exclusion flows.

In conclusion, the completion of full acquisition of the Surmont oil field will likely put ConocoPhillips in scope of 5% threshold exclusion policies, which are prevalent. This would result in future forced divestment of all securities by those investors.

The timing delay of exclusion screening

The deal is scheduled to complete at end 2023, but with effective date 1 Apr 2023.[16] This suggests that the new production could be consolidated partially for 2023, and fully for 2024.

Table 2. Projected oil sand production for ConocoPhillips. Source: Urgewald, AFII.

	% Production	% Revenue
2021	3.9%	3.6%
2023 projected	6.6%	6.1%
2024 projected	7.5%	6.9%

Table 2 shows projected oil sand production for 2024, and 2023 assuming input will be consolidated on a pro-rated basis. As this shows, ConocoPhillips will likely breach the 5% threshold for 2023.

Once the higher figure is reported, then it can be analysed by screening committees, and a breach may be confirmed. Whether the breach is in FY 2023 or FY 2024, the confirmed exclusion would be some months after the FY reported figures are released, which itself is not until the end of the period in which the production is completed.

[13] We note this investment policy also includes an exclusion on issuers deriving over 5% of their revenue from arctic oil exploration and production, which would seem to include COP, so we believe it should already have been excluded.
[14] Axa's exclusion is 5% of total global oil sand production. We note total Alberta production is estimated at 2.84 mmbod in 2021 by CAPP here.
[15] Reducing to 10% in 2025.
[16] "ConocoPhillips Provides Notice that it is Exercising its Preemption Right to Purchase the Remaining 50% Interest in Surmont", ConocoPhillips, 26 Mar 2023.

This delay facilitates the paradox of investors funding deals which produce companies which are uninvestible.

If responsible investment policies were better integrated with investment decisions, this threshold breach should be anticipated, and investment not originally offered.

Passively adding exposure

The completion of this acquisition will likely take COP in-scope of exclusision, but the fallacy of passive index construction means that ESG ETFs are compelled to buy the bond in the interim. The timing of this divestment will be driven by ESG index creation rules.

Holdings analysis of the recently issued COP bonds is sparse, but already indicates a few ESG headlined ETFs having bought the bonds on the basis of index inclusion, including iShares products. These ETFs are based on an MSCI ESG set of rules, with a 5% revenue threshold for extraction of oil sands.[17] All new eligible bonds will be included in the index, and therefore purchases by index tracking funds, until exclusion criteria are met.

Any exclusion criteria is inherently a passive investment strategy. Active managers however can choose to anticipate and incorporate these factors earlier in the investment process, however passive managers are always restricted by index construction rules.

This adds further weight to concerns around whether ESG investment can be used by passive investment strategies, as there will always be a delay between making financing available for controversial activities, and the results of those accruing on the issuers ESG balance sheet, and so index inclusion being affected.

Conclusions

The recent issuance by ConocoPhillips will be used to fund acquisition of Surmont, a Canadian oil sands field. The associated increase in unconvential production will likely bring the issuer in scope of investment exclusions, and therefore likely trigger divestment flows.

These exclusions should, in our view, have been anticipated on original announcement of the acquisition, and yet several managers seem not yet to have divested.

Passive investments in particular, where positions are dictated by index rules with an inherent delay, will end up financing excluded behaviour. This should raise concerns for investors with any type of exclusion policies.

[17] See iShares ESG Aware U.S. Aggregate Bond ETF prospectus, page S-2. Accessed 16 Aug 2023.

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