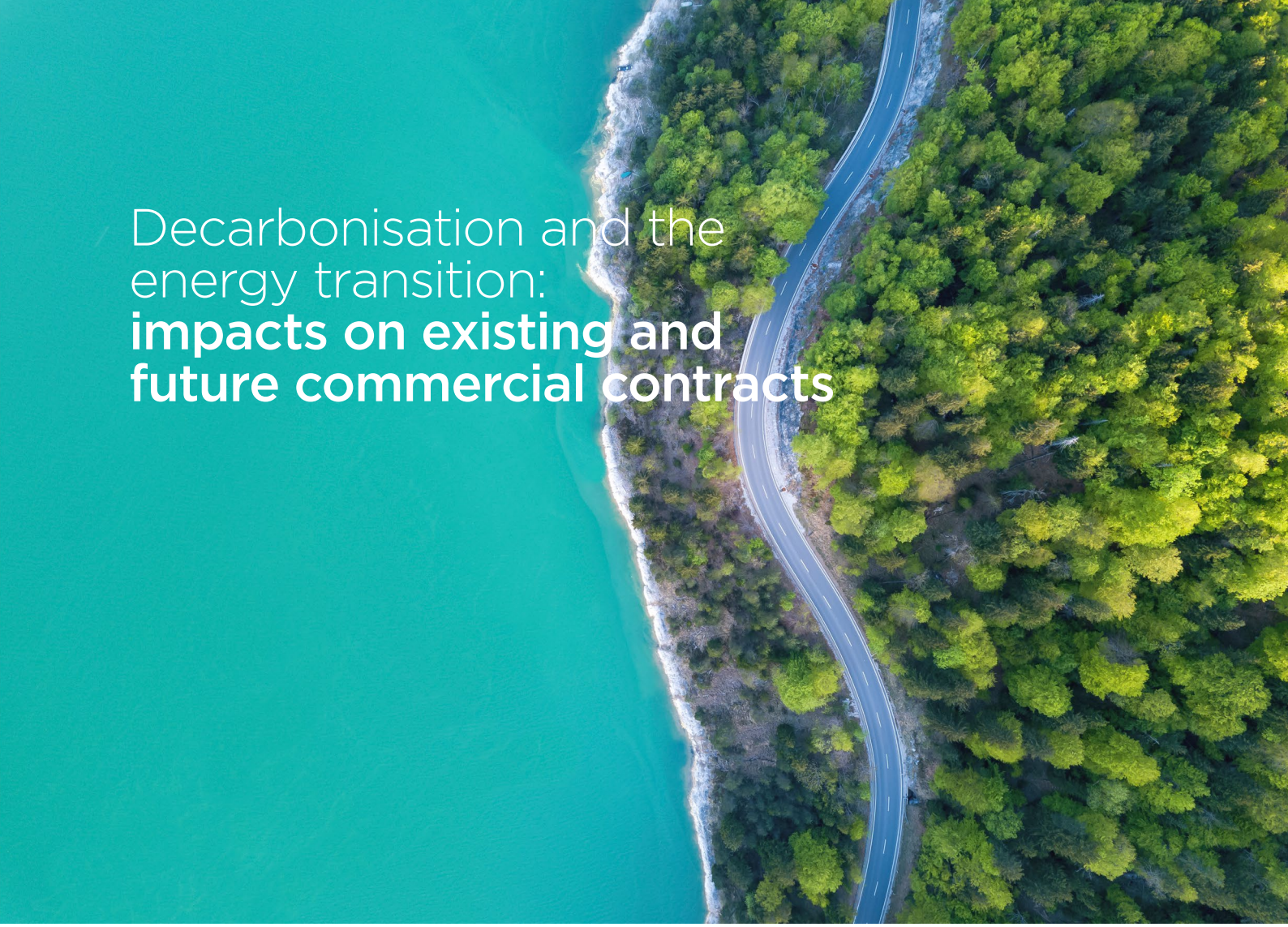


Decarbonisation and the energy transition: **impacts on existing and future commercial contracts**

Decarbonisation – meaning the reduction of carbon intensity in a particular area of activity – is the major industrial and commercial challenge of our time. It is an objective being pursued to varying degrees by states around the world, for example through the Paris Climate Agreement. It is also being pursued at the initiative of many private corporations and industry bodies, both for policy and commercial reasons, with a vast range of commercial entities seeking voluntarily to reduce the carbon emissions associated with their businesses. The rise of initiatives such as ESG (environmental, social, governance) investment has led wider stakeholders such as financial institutions, investors and lenders to take a closer interest in this as well, with decarbonisation-related policies and targets increasingly being incorporated into lending and investment behaviour.

There are therefore different drivers towards decarbonisation, which are likely to manifest differently in terms of the impact on commercial actors.

Regulatory thresholds or restrictions (for instance, set by state entities) may bind commercial entities – potentially even outside of their home jurisdiction. Companies may themselves adopt corporate policy, with non-binding aspirational objectives at one end of the spectrum and self-imposed mandatory targets and commitments at the other, each with corresponding implications for reporting obligations and shareholder management. Lenders and investors may adopt their own policies which impose indirect – although no less significant – practical constraints on how businesses operate through the terms they set for loans and investments.

The result is that commercial actors across the world are left operating within a web of overlapping commitments, strategic objectives and in some cases, legal obligations driving towards decarbonisation. While this is relevant to almost all types of industrial activity, it naturally has direct and acute implications for the energy sector.

It is therefore inevitable that there will be large-scale and far-reaching changes over the coming decades, which will create a vast range of new opportunities and challenges for businesses. The question is, what does this mean for how those businesses plan for the future?

In previous issues of Inside Arbitration, we have considered the types of disputes which may arise from the energy transition and from climate change more generally (see Inside Arbitration: Issues 11 and 12). In this article, we consider some of the implications of the move towards decarbonisation for the way existing contractual forms are interpreted and applied. We also look to how future contracts may be designed with decarbonisation in mind. In short, what will the changes to the commercial and regulatory landscape over the coming decades mean for the management of commercial relationships, and in particular the structure of contractual frameworks?

Applying and interpreting existing contracts in a decarbonising world

The major challenge for commercial parties will be a lack of clarity in existing contracts on the allocation of the risks associated with decarbonisation. Friction may arise as companies navigate their own energy transition alongside the changing strategic objectives of their suppliers, joint venture partners, lenders, investors and customers, as well as regulators. These rapid changes in the regulatory and commercial landscape are likely to put many existing contracts under strain, as parties find that they may

no longer provide an adequate framework to help them resolve these frictions.

Which contracts could be affected?

- **Long-term contracts** may have been concluded many years or even decades ago, under different expectations about how the relevant industry would evolve. Decommissioning obligations, for example, have been a staple feature of oil and gas projects for decades. The contractual framework to allocate rights and responsibilities in respect of these obligations has been exhaustively developed in the industry. But the increasing emphasis on repurposing offshore infrastructure (for example, into offshore wind or carbon capture & storage facilities), rather than decommissioning it, may not fit neatly into a contractual framework drafted many decades ago, potentially creating contractual lacunae around the transfer of risk and cost burdens and the prospects of ongoing stewardship.
- **Model form contracts** which have been developed by certain industries may be poorly suited to the new challenges and risks arising from decarbonisation. Warranties and indemnities in current model or standard forms may not provide adequate protection or certainty in respect of the types of changes arising from decarbonisation initiatives. Contractual parties may try to stretch the language in those contracts to accommodate circumstances that were not anticipated when those provisions were developed – for example, attempting to retrofit standard form natural gas transmission contracts around the transport of hydrogen. Eventually, parties may be pushed into redrafting those model forms or opting to use entirely bespoke contracts, departing from the extensively tested and refined language developed by industry over time.

Specific challenges: voluntary commitments, lenders and limitations of liability

A major area where existing contracts are likely to be tested is around the relevance of decarbonisation commitments which come from sources other than regulation – namely, commitments which have been voluntarily assumed as part of corporate policy or which come from commercial third parties like lenders.

Many contracts contain some provision for how to allocate any increased costs and risks associated with changes imposed by state entities. They may even provide other contractual mechanisms like termination rights to allow the parties to adjust their relationship accordingly. However, these provisions may not assist where a contractual party has voluntarily committed itself to reduce the carbon intensity of its activities as part of its corporate policy.

What happens where a party within a joint venture has voluntarily adopted decarbonisation commitments which go beyond those required by regulation, but the other parties have not?

There is a wide spectrum among commercial actors as to the targets to which they have committed (if any), the timescales involved, and the way those targets are defined – for example, "net zero" means something different to "reducing carbon intensity" by a certain proportion, which is again different to "carbon neutral for Scope 1 & 2 emissions". A company's decarbonisation policy will be driven by a range of internal and external factors, including the appetite (or tolerance) of its stakeholders for change. It is striking to contrast the way in which political, societal and shareholder pressures can impact clients in this sector very differently, and lead to markedly different approaches across different jurisdictions. It follows that within a single joint venture or within one contractual relationship, there may be vast differences in the degrees of commitment to decarbonisation among the parties, each defined by different metrics and to be achieved at different paces.

This mismatch is likely to generate commercial differences as to what is an appropriate decarbonisation measure in any given project, testing the boundaries of any contractual discretion granted to particular parties. The scope of operators' duties and how a "reasonable and prudent operator" (RPO) is defined may therefore evolve substantially over the coming years against the backdrop of the changes anticipated from decarbonisation. What amounts to "reasonable" risk management under existing contracts – for example, in assessing good oilfield practice or a requisite level of diligence – may become a more contentious concept, as parties seek to define it by reference to factors which would not have been anticipated by the parties when the contracts were concluded many years ago.

Is it consistent with the RPO standard, for example, for an operator to install new technology for the measurement of emissions which impacts the efficiency of output, where such technology is not yet mandated by regulation but is likely to be so in three years' time? Such questions are

likely to test the limits of contractual language around necessity, risk management and proportionality.

What happens where a contractual party's parent company has adopted a corporate policy on decarbonisation, but the contractual party has not done so?

For example, a commitment to phase out the use of certain carbon-intensive technology in manufacturing or a certain form of transport in the supply chain is likely to have cost implications and may even impact the ability to perform existing contracts. In some circumstances, the changes required by a decarbonisation policy may fundamentally alter the underlying economics of a project or a contract. Existing contracts may provide little guidance as to what relevance voluntary commitments – and particularly those made elsewhere within a corporate group – should have when the bill is presented for the changes required to comply with them.

What happens where third party commercial entities like investors or lenders seek to impose their own ESG-oriented decarbonisation goals through their terms?

Equally, existing contractual provisions may not assist where changes to the underlying financial support for a party or a project arise from the adoption of ESG-oriented decarbonisation goals by investors and lenders – for instance, where ongoing financial support or refinancing becomes contingent on a certain reduction in emissions. In those circumstances, a party may find itself compelled to insist on certain operational changes to a project within a joint venture, or to change its requirements under a supply contract, but may not have recourse to a contractual mechanism to allocate the costs of doing so.

In all of the above circumstances, parties may be forced to try to rely on force majeure provisions, hardship clauses (where available) or the doctrine of frustration to seek to excuse defects in performance. Where the economic prospects for a project become very different in the face of decarbonisation initiatives, one or more parties may look for ways to rebalance the underlying financial model. Parties may even seek to stretch the available grounds for termination to create opportunities to prematurely exit projects which no longer remain commercially viable for them under these changed conditions. The scope of these sorts of contractual mechanisms is likely to be tested in coming years as parties are confronted by the impact of decarbonisation.

Will existing contractual limitations of liability be effective for errors in emissions reporting obligations?

Finally, limitation of liability provisions in existing contracts may not be well-suited to the vast expansion in liability which may arise in response to emissions reporting regimes. With companies increasingly required to monitor and report on carbon emissions associated with their supply chains, many parties will find their existing supply contracts ill-equipped to protect them against errors in this reporting.

Looking to the future: how will new contracts be designed to accommodate the impacts of decarbonisation?

As companies transition to decarbonisation, there will undoubtedly be very substantial growth in investments, new collaborations, infrastructure projects and technological innovations. Against a background of ongoing regulatory change, these new commercial forms will bring significant opportunity. But they will also give rise to novel legal and commercial risks to which contractual drafting will need to respond.

Some of these changes will reflect changes in market participants, most notably in the energy sector. A steady increase in M&A activity and joint ventures is expected in the energy sector over the next few decades, driven significantly by traditional energy companies looking to diversify their portfolios in order to meet their decarbonisation targets. We will continue to see new entrants in the market, collaborations between competitors in the fossil-fuel industry, as well as 'non-traditional' partnerships between long-standing energy companies and technology and renewables counterparts.

Specific challenges

Complex JVs

For instance, the development of hydrogen production facilities is likely to be dominated by multi-party joint ventures, based on significantly more complex contractual arrangements than the traditional two or three party relationships typically seen in the oil and gas sector. These may well be built on new and untested contractual arrangements that sit outside the norms developed over decades by the oil and gas sector. Future contracts will therefore need to account for a potential mismatch in approach between market players that may come from divergent backgrounds. We expect the negotiation of indemnities, representations and warranties (particularly those relating to the green credentials of stakeholders), events of default

and termination rights to take centre-stage in how future decarbonisation-related contracts are drafted.

Renewables: contractual arrangements and allocation of risk

Many well-established energy companies with an upstream oil and gas focus are moving increasingly into renewables projects in order to meet their net-zero targets. Renewable projects, however, are exceptionally technical, requiring complex scientific and engineering expertise. Large-scale renewable projects also typically involve a suite of back-to-back interlocking contractual agreements with multiple parties for various works (for example, engineering, construction, supply and manufacturing, operation and maintenance, licencing and tariff, finance, insurance, etc.). Any disruption or delay in one aspect of the project (for example, construction delays or supply chain disruptions), is likely to affect contractual performance under other linked contracts with other parties. Stakeholders will therefore need to consider carefully the allocation of risk in contracts relating to renewable energy projects. Contractual frameworks may need to expressly regulate interface risk between different works contracts, specifying clearly each party's responsibilities, agreed construction and operational milestones, trigger events, as well as duties to cooperate.

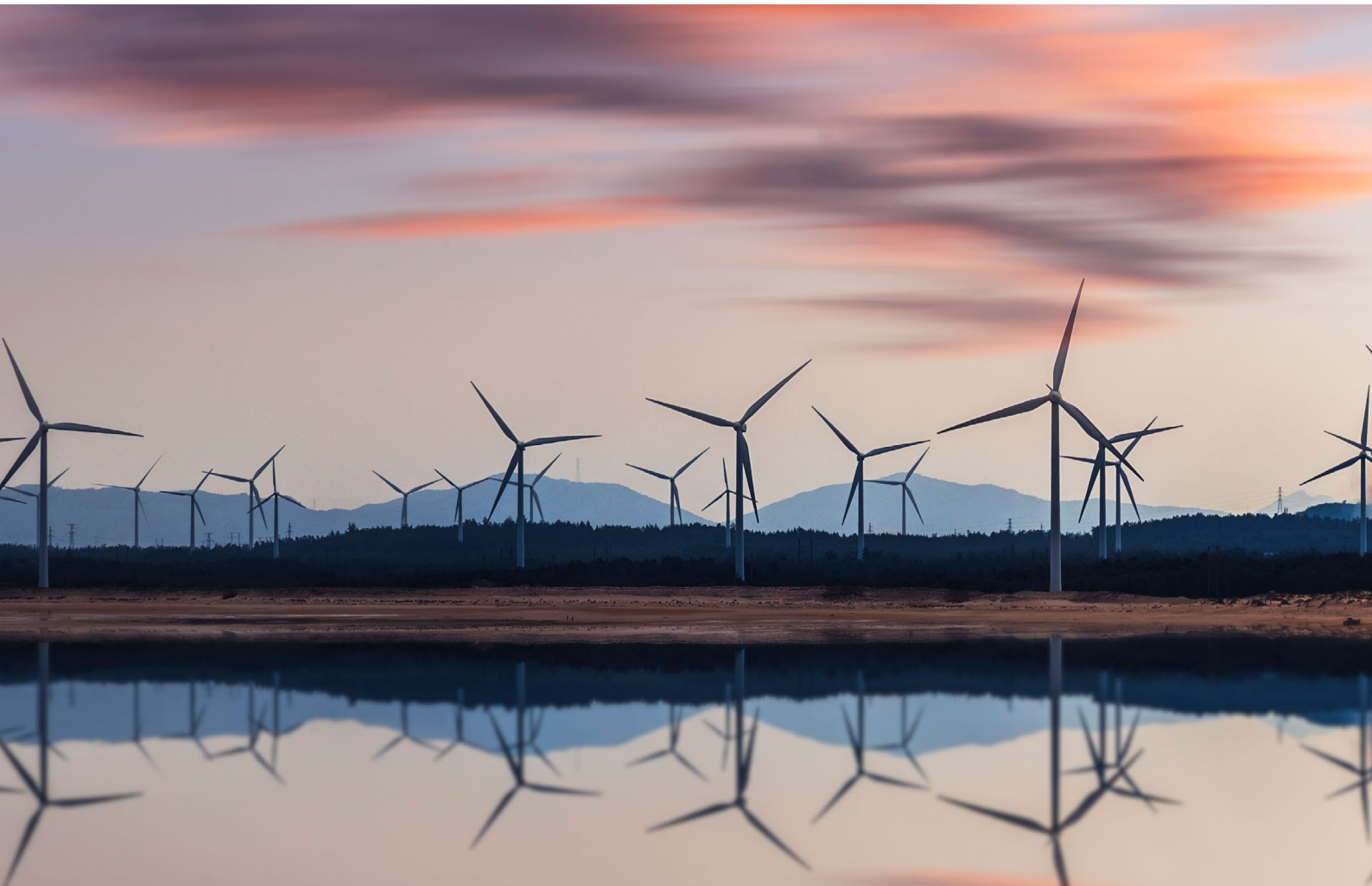
New technologies

Contractual frameworks will also increasingly address the rights and obligations associated with the use and management of new technologies which are developed as companies decarbonise. Whether it is wholesale new energy technologies, such as hydrogen, or new types of electricity storage facilities or carbon measurement and verification facilities, technology is likely to be a key proprietary asset for many companies. Bespoke technology-sharing agreements and associated intellectual property (IP) licencing agreements are expected to become more common features of contractual suites underlying major projects.

A key part of this will be addressing the significant uncertainty and risk associated with relying on technology still in the process of development. Contractual provisions around representations and warranties will need to be carefully negotiated, as breach of contract and negligence claims relating to the performance of the technologies loom large. Market players will want to factor the risk of unforeseen technical issues into their contractual arrangements. There may also be risks over licencing of technologies, such as the scope of licences and royalties payable where one party owns the IP but licences it to another to develop in exchange for future royalties.

Investment finance

Given the significant investment required for the energy transition, we also expect to see a growth in complicated financing structures backed by ESG objectives in the energy finance sector. Investors (and shareholders) are increasingly taking account of sustainability-linked performance targets in their project financing decisions. Future commercial contracts, particularly financing agreements, are likely to include express requirements for companies to report on and reduce the environmental impacts associated with projects.



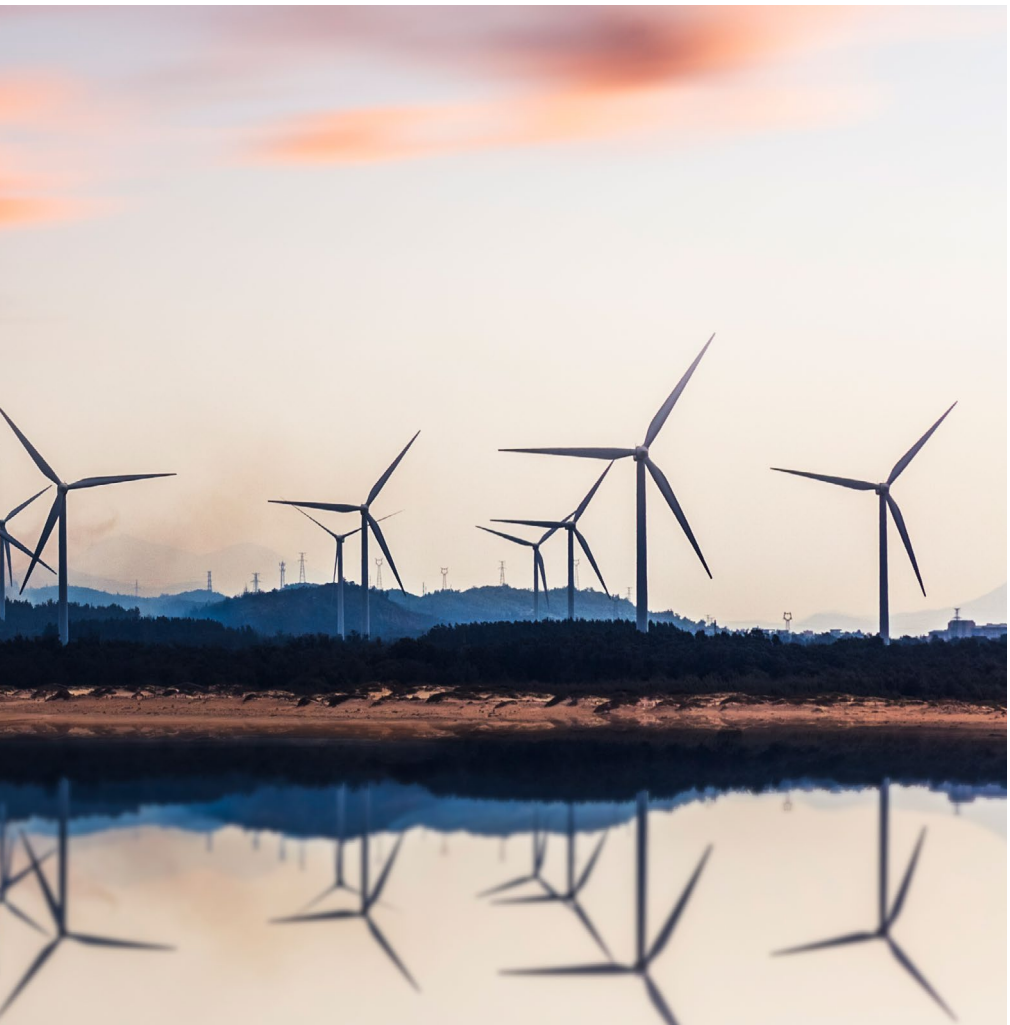
Specifications and industry standards

Contracts are likely to become more explicit as to the technical specifications and industry standards with which parties are required to comply, and may require the parties to make contractual representations as to the sustainability of their projects. Parties will increasingly be required to monitor and report on the environmental impacts of their operations across their supply chains (as well as their own Scope 1 emissions). Reporting requirements may increasingly be linked to events of defaults under financing agreements. Stakeholders may even insist on new kinds of contractual termination rights relating to a project's carbon footprint or environmental credentials, such that if carbon emissions associated with a project or a supply chain become too significant, the counterparty can exercise its right to terminate.

In parallel, the lack of robust and globally accepted frameworks for measuring, reporting, and verification of carbon emissions is likely to exacerbate uncertainty in future commercial contracts. The accurate measurement and reporting of carbon emissions is key in achieving any decarbonisation targets. We expect to see more emphasis on carbon measurement processes, verification and auditing mechanisms for carbon emissions data, related guarantees and consequences of misreporting (such as misrepresentation or breach of warranty claims) in future contractual obligations.

Anticipating regulatory change in contractual frameworks

Finally, commercial parties looking to the future will be alive to the likelihood of further regulatory change to come, particularly in sectors which remain in the relatively early stages of development. For instance, the regulatory architecture for carbon capture, use and storage projects, and the certification of hydrogen technologies is yet to be fully developed. It will therefore be critical for parties to consider ways in which they can incorporate protections for themselves in their contracts to account for the uncertainty of a rapidly evolving regulatory landscape. Contracting parties may also consider ways to allocate financial responsibility for the higher costs of compliance associated with regulatory changes (for example, the imposition of carbon taxes to minimise the carbon impact of projects) across supply chains and within joint ventures.



The challenges to come

Commercial parties are facing a time of rapid, far-reaching change in how they do business. One of the only certainties they face is that the coming decades will introduce uncertainty into almost every sector. The best protection against that uncertainty is for parties to anticipate the areas of friction which decarbonisation is likely to introduce into their business, whether with their suppliers, their customers, their joint venture partners or their investors, and consider the suitability of existing contractual mechanisms to help them work through those areas of friction. Contracts being concluded now are an opportunity for parties to build those mechanisms into their commercial frameworks, so that when these points of friction inevitably arise, they will be better placed to address them.

If you would like to discuss what decarbonisation is likely to mean for your business, please do not hesitate to get in contact with us.

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Hear **Craig Tevendale, Louise Barber, Arushie Marwah** talk about **Decarbonisation and the energy transition:** impacts on existing and future commercial contracts here