HERBERT SMITH FREEHILLS

The future of lending to the oil and gas sector

Intense, continued focus on sustainability has put pressure on the oil and gas sector to openly demonstrate its efforts to effect change across the environmental, social and governance (ESG) spectrum. The sector is still a critical one for energy transition, and for ensuring access to energy in developing markets, so it is important that the very significant contributions that these businesses can make across the whole range of ESG factors are recognised and encouraged.

The ESG improvements that these businesses make can be used in lending products, to publicise their progress and to incentivise further change. Sustainability-linked loans provide the most natural mechanism for this: key performance indicators (KPIs) are used to set sustainability performance targets (SPTs) and currently there is an incremental pricing benefit for meeting those SPTs. The KPIs and SPTs can be drawn from across the ESG spectrum, and can be tailored to fit the relevant business.

22 JULY 2021
London

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HSF ESG Hub

In this briefing we look at the use and development of sustainability-linked loans in the oil and gas market.

Impetus for change

A move to sustainability has been for some time a core strategic focus of most hydrocarbon businesses. The confluence of environmental and societal forces driving the greening of the economy has given rise to a business need and a desire to do something meaningful, which is underpinned by pressure from governments, intergovernmental organisations such as the International Energy Agency, and stakeholders including lenders and investors.

Further, central banks and financial institutions are recognising that the risks from climate change, and also from lack of biodiversity and nature-based risks more widely, are financial risks like any other, and this is likely to affect credit decisions that banks and other lenders make.

The green and sustainable bond markets are relatively well developed compared with the equivalent loan markets. Sustainable loan products are gaining traction and are becoming more widely used as their scope is explored, but they remain relatively nascent and this means that there is a lack of consistency in the terms of the loans themselves, and differences in lenders' eligibility criteria for the products that they offer.

The platform

The loan market trade bodies globally have developed high-level market standards for sustainability-linked loans; for more detail on this please see BOX 1. These are not legally binding but are intended to provide some consistency across the market, and support the integrity of the product.

Inter-linked is the developing legislation and regulation, which can be used to answer the two key questions in sustainable lending:

1. **How do you determine, in an objective way, whether the asset or business being financed is environmentally sustainable?**
2. **What if it isn't? How do you ensure that there is some accountability for borrowers and financial institutions, and counter sustainability-washing?**

The EU Taxonomy Regulation sets out how a decision can be made as to which economic activities are environmentally sustainable. It is intended to be a tool to assess whether a financial product or business is environmentally sustainable, and to enable comparison of the environmental sustainability of different activities. See BOX 2 for more details. Of course, the problem with setting out what is and what is not environmentally sustainable is that such a binary, codified tool can lack the ability to deal with subtlety, nuance and real-life investments. For example, one project will encompass a number of different economic activities, some of why may be taxonomy-aligned and some of which may not. Natural gas (and nuclear) technologies have so far been excluded, and a separate classification system has been proposed. This is expected to be published in the autumn, which leaves little time for scrutiny before the Taxonomy comes into effect next year.

The UK is working on a similar idea, with the aim of publishing its own taxonomy as part of its wide-ranging Green Finance Strategy: the Green Technical Advisory Group, chaired by the Green Finance Institute, will make the recommendations. It is expected to be broadly similar to the EU Taxonomy but there may be some differences in approach (for example, a principles-based approach, rather than a prescriptive one, would have the potential to be more flexible).

Both the UK and the EU have already expressed an intention to impose ESG reporting requirements under their respective sustainable finance strategies. In the EU so far this focuses on the financial sector, but the UK has gone further by publishing a roadmap to mandatory Taskforce on Climate-Related Financial Disclosures (TCFD)-aligned disclosures across financial and non-financial sectors. This is coupled with increasing investor demand for enhanced disclosure of sustainability-related information.

Sustainable lending in the oil and gas market

- Sustainability-linked loans have the advantage of flexibility because of the potentially wide scope of the SPTs, the targets which must be met.
    - The SPTs can be set by reference to goals which relate to the borrower's business as a whole, aligning with its own ESG strategy; this is often the approach in corporate facilities. Typically two to four SPTs will be set. These could be based on:
        - environmental improvements, for example reducing emissions of greenhouse gases, using significantly more renewable energy or improving the energy efficiency of an aspect of the business,
        - social goals, such as increasing diversity on a board, or in the workforce more generally; or
        - governance advances, such as increasing cyber-security.

  - In loans to finance specific projects or assets, the SPTs could be more narrowly defined by reference to that project or asset, which would be analogous to what we are seeing in the real estate finance market, where sustainability-linked loans increasingly focus on the development or asset being financed rather than the overall business.

- A sustainability or ESG coordinator, or sustainability or ESG structuring agent, will usually be appointed from the lender group to assist in the process of setting the SPTs. In some cases, further external input may be needed to confirm that the KPIs and SPTs are appropriate and sufficiently stretching.
- In longer-term facilities, the targets may be updated over time, or where there is a significant change to the borrower's business by way of acquisition, large asset disposal, or significant regulatory change, for example.

Challenges

- Lack of a standard methodology for reporting: there is, so far, no accepted methodology for reporting on SPTs. Lenders will virtually always require a level of external verification, audit or third party review of the borrower's reports, which will add to the cost and time burden on the borrower of servicing the loan.
- The over-arching concern of lenders (and also of regulators and investors) is avoiding green- or sustainability-washing in making sustainable loans, and this is brought into particularly sharp focus in the hydrocarbon industry. Individual lenders have their own eligibility criteria, and a fear of reputational damage may mean that these are more stringent than the Sustainability-Linked Loan Principles (see Box 1) in some respects. This will affect the setting of SPTs, the eligibility criteria for projects, assets and businesses, analysis of the overall impact of the financing, and also the reporting requirements.
- Linked to both of the points above, there can be a reticence to publicise sustainability-linked features of loans in the oil and gas market, for fear of being seen to have introduced targets for publicity reasons, rather than because they are meaningful, which does not assist in standardising reporting standards and requirements.

Consequences of failure to meet SPTs

- In sustainability-linked loans, if the SPTs are not met, in most deals currently in the market the margin may increase. One question is whether it will increase above the original level as a further disincentive to under-performance. If so, it is possible that the additional cost of servicing the facility could be diverted into improving the borrower's ESG performance, for example, since many lenders may not think it appropriate to benefit from a borrower's failure to meet its sustainability targets. However, there is another school of thought in which any margin uplift should go to the lender, as compensation for the changed risk profile of the loan because it is not as sustainable as expected.
- It would be very unusual for the failure to meet an SPT to constitute a default in a sustainability-linked loan, although the provision of inaccurate information or a breach of a general reporting obligation may be a standard breach of covenant leading to an event of default.
- However, where sustainability-linked loans are made to the oil and gas sector, the real consequence of not meeting the SPTs is reputational damage, and potentially harming relationships with lenders and investors. This is likely to have a fundamental effect on the use of SPTs in loans to this market, and we anticipate that in just a few years ESG criteria and SPTs will be a standard feature of syndicated loans with no pricing consequence.

The future

Given the intense focus of investors, society, governments and regulators on sustainability, the direction of travel in this area seems clear. There may be further developments in greening the financial services sector, for example differentiating the capital treatment of green and sustainable loans, which would provide an added incentive for lenders.

The development of the UK taxonomy, and the technical standards associated with the EU taxonomy, will help a market position on eligibility criteria develop, and hopefully market practice around reporting standards and requirements will also coalesce.

BOX 1

Sustainability-linked loans

Sustainability-linked loans have a small incremental pricing benefit to the borrower for meeting certain sustainability targets in its business. The Sustainability-Linked Loans Principles (SLLPs) developed by the Loan Market Association, the Asia Pacific Loan Market Association and the US Loan Syndication and Trading Association broadly fall into two categories:

- the requirement for the borrower and its lenders to identify sustainability key performance indicators (KPIs) which are "material to the borrower's core sustainability and business strategy, and address relevant environmental, social and/or governance (ESG) challenges of the industry sector", and from those, set and calibrate ambitious and meaningful sustainability performance targets (SPTs); and
- the need for transparency in determining whether those SPTs have been met, through both the borrower's reporting obligations and an external review or audit to verify the borrower's performance against the SPTs.

These are different from green loans, which are used to fund green assets or projects, with tightly controlled use of the loan proceeds. It is quite difficult for hydrocarbon businesses to access green loans in the ordinary course, given lenders' strict eligibility criteria.

BOX 2

EU Taxonomy Regulation

This came into force in July 2020. It sets out how a decision is made as to which economic activities are environmentally sustainable. The activity will be assessed as to whether it substantially contributes to at least one of six environmental objectives, being:

- climate change mitigation;
- climate change adaptation;
- protection of water and marine resources;
- transition to a circular economy;
- protection and restoration of biodiversity and ecosystems; and
- pollution prevention and control.

Further, that activity must do no significant harm to any of the other five environmental objectives mentioned, and must comply with minimum safeguards – for example the UN Guiding Principles on Business and Human Rights – in order to qualify as environmentally sustainable.

Determining these points is a very technical exercise, and performance standards, or technical screening criteria, will set out the detailed criteria to determine if an activity is really sustainable, and therefore "taxonomy-aligned".

The focus in the EU so far has been on climate change: further developments, focusing on environmental sustainability outside climate change and on social objectives, are expected to follow, which will raise similar issues.

Please do speak to one of our team to discuss this in more detail, and to see how sustainability-linked loans, may be relevant for your business.

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