



Natural resources contracts and net-zero transitions

2023

Kim Talus

UEF // University of Eastern Finland

I work mainly in the natural gas sector, but have over the recent years also worked with general regulatory issues like competences of energy regulators, details of unbundling obligations, power sector issues and nuclear power generation related questions. Currently I am also involved in a task relating to planting of 3 billion trees. The lesson from this project is that you should always always read carefully emails from potential clients and see what they actually want you to do!

My talk will focus on long-term natural gas contracts and the energy transition.

“Recalling the objectives defined under the Paris Agreement that has been ratified by the Sides and that defines their commitment to reducing greenhouse gas emissions;

Acknowledging that natural gas shall continue to play an important role in terms of energy consumption and electricity generation in the European Union until 2030, after which its use in the European Union will decline in line with its climate neutrality commitment by 2050;”

“Recalling the objectives defined under the Paris Agreement that has been ratified by the Sides and that defines their commitment to reducing greenhouse gas emissions;

Acknowledging that natural gas shall continue to play an important role in terms of energy consumption and electricity generation in the European Union until 2030, after which its use in the European Union will decline in line with its climate neutrality commitment by 2050;”

MEMORANDUM OF UNDERSTANDING ON COOPERATION RELATED TO TRADE, TRANSPORT, AND EXPORT OF NATURAL GAS TO THE EUROPEAN UNION between EU, Egypt and Israel (signed 15 June 2022)

UEF // University of Eastern Finland

I find this somewhat funny considering that natural gas investments and trade is long-term business, not something that happens over night.

At the same time, this illustrates very well the problematic relationship with long-term gas agreements and the net-zero ambitions of countries or regions.

NATURAL RESOURCES CONTRACTS AND NET-ZERO TRANSITIONS

Investments and trade in natural gas are based on long-term agreements.

Bi-directional relationship between the net-zero plans and private agreements:

1. Impact of net-zero on private long-term agreements
2. Impact of private agreements on net-zero by 2050

Natural gas as the example: value chain impact

UEF // University of Eastern Finland

At a global level over 75% of natural gas is traded under long-term agreements.

This creates a lock-in effect for buyers and sellers, in some cases also pipeline operators.

And may create problematic situations where demand in downstream market falls, where import prices go up or where governments ban certain fuels. It is not likely to the case for natural gas in the near future but could be an issue down the line, when the decarbonisations measures start to impact natural gas.

This is clearly an under-researched area in the academic studies.

These agreements have a bi-directional relationship with the net-zero plans.

Natural gas is a good example as the contractual commitments typically cut through the entire value chain from production to transport and to end use.

FUTURE SCENARIOS AND IMPACT ON GAS CONTRACTS

- (1) Government measures that increase the import price of natural gas
- (2) Government measures that lead to significant reduction of demand for natural gas
- (3) Government measures that ban the imports of natural gas either generally or from certain proscribed supply sources

UEF // University of Eastern Finland

I am examining 3 situations.

(1) GOVERNMENT MEASURES THAT INCREASE THE IMPORT PRICE OF NATURAL GAS

- Proposal for a Regulation of the European Parliament and of the Council on Methane Emissions Reduction in the Energy Sector
- Proposal for a Regulation of the European Parliament and of the Council Establishing Carbon Border Adjustment Mechanism
- CBAM does not apply to natural gas imports, but it's an example directionally of changes that could be on the horizon for natural gas imports

UEF // University of Eastern Finland

Regulation on methane emission reduction in the energy sector requires measurement and reporting to methane emissions throughout the value chain.

Regulation on carbon border adjustment mechanism would put a levy on the carbon intensive products imported to the EU .

GOVERNMENT MEASURES THAT INCREASE THE IMPORT PRICE OF NATURAL GAS

- Carbon-neutral LNG: Key requirements in contracts relating to carbon-neutral LNG (or for that matter pipeline natural gas) include: 1. Clarity of the GHG definition and accounting criteria, 2. Pricing (especially in long-term contracts), 3. Overall liability and remedy regime.
- Pricing: carbon neutrality component in the pricing formula
- Destination flexibility: developments are not uniform in all markets
- Force Majeure and hardship provisions: Applicability? Foreseeability?

UEF // University of Eastern Finland

For contracts, this means that in order to respond to these developments, contractual parties need to further develop the agreements for carbon-neutral LNG and in particular certain types of clauses. Before we have an international agreement in place on standard definitions and accounting in place, these agreements are going to be somewhat general. We see this already in the existing agreements on carbon-neutrality.

The carbon neutrality will also have to make its way to the pricing formulas in long-term agreements.

In order to respond to this, increased destination flexibility for the buyer will be a key issue. They need to have the ability to divert cargoes to markets that are not yet subject to the same regulatory conditions.

Cost of imports does not easily fall under a normal force majeure provision. The buyer would have to show that the import price increase would lead to an actual inability to both take and pay.

A hard-ship provision would apply where **one of the parties to the agreement cannot perform without substantial**

economic hardship. This is a better option but usually requires that this situation is caused by unforeseen circumstances. This may be an issue, especially for new and recently concluded contracts.

(2) GOVERNMENT MEASURES THAT LEAD TO SIGNIFICANT REDUCTION OF DEMAND FOR NATURAL GAS

- IEA net-zero scenario: demand for natural gas will decline 55 percent by 2050 (from 2021 levels)
- EU net-zero target for 2050
- Proposal for a Directive of the European Parliament and of the Council on common rules for the internal markets in renewable and natural gases and in hydrogen (inc. ban of long-term agreements from 2049)

GOVERNMENT MEASURES THAT LEAD TO SIGNIFICANT REDUCTION OF DEMAND FOR NATURAL GAS

- Take-or-pay and durations: Shorter project cycles?
- Destination flexibility: developments are not uniform in all markets
- Force Majeure and hardship provisions: Applicability? Foreseeability? Mitigation?
- Frustration (under New York law): magnitude of the impact, remaining commercial possibilities, possible ability to mitigate and foreseeability. (Gulf LNG Energy LLC and Gulf LNG Pipeline LLC v ENI USA Gas Marketing LLC, 17 November 2020)

UEF // University of Eastern Finland

Take-or-pay usually underpins large scale energy investments. This may become an issue when the demand starts to decrease.

From the seller's perspective this might mean we will see shorter-cycle projects that aim to capitalize on the investment much faster than in traditional oil and gas investments today.

For the buyer, this means emphasis on volume flexibility and shorter term contracts.

Similar to the previous slides, destination flexibility will be a key issue as the buyer will want to divert cargoes to markets where the demand exists.

Again similarly to import prices increase, force majeure and hardship provisions may not be very helpful.

Another interesting question is the potential help from the frustration doctrine that may provide relief from contractual obligations. In the Gulf LNG case, the arbitral tribunal granted relief in the context of the US shale gas revolution and found that the radical changes in the markets making imports of LNG impossible was not foreseeable and declared the agreement to construct an LNG import facility as terminated.

For frustration doctrine to be of assistance, the relevant considerations include the magnitude of the impact, remaining commercial possibilities, possible ability to mitigate and foreseeability.

There is more case law from the US on frustration related to Covid-19 pandemic.

(3) GOVERNMENT MEASURES THAT BAN THE IMPORTS OF NATURAL GAS

- National bans on coal-fired power generation in the EU
- Major coal producing countries restricting coal activities (China: financing new coal mining projects overseas / increasing public pressure to ban new coal projects in Australia)
- Bans on new oil exploration and production projects in a range of countries and territories (France, Denmark, Greenland, Spain and others)

UEF // University of Eastern Finland

Examples of these measure are focused on coal in particular, but also oil and gas exploration in a growing number of countries.

GOVERNMENT MEASURES THAT BAN THE IMPORTS OF NATURAL GAS

- The role of force majeure and frustration: 1. reasonable measures to mitigate and 2. government owned companies.
- Change of law provisions: Need for a new energy transition provision
- Government-caused change to natural gas installations: EU Taxonomy Regulation (Regulation (EU) 2020/852 – needs to be considered (power production facilities, LNG import terminals etc)

UEF // University of Eastern Finland

Again similarly to import prices increase, force majeure and hardship provisions may not be very helpful. Especially where government measures are not part of the force majeure formulation. Foreseeability is clearly becoming an issue in this respect.

In terms of change of law provisions: I don't think any country would agree to stabilize the contract in terms of climate change measures. This means that parties would need to include a specific energy transition provision. IBA and Association for International Energy Negotiators appear to be making progress in creating the first model provision for this issue at the moment.

Similarly, parties need to take into consideration new rules that may impose mandatory hydrogen mixing with natural gas for pipelines or LNG facilities or require that gas installations are converted to hydrogen installations. We see something to this effect in the rules under the EU Taxonomy Regulation.

CONCLUSION 1: "its complicated"

The situation is complicated for the oil and gas industry: we need them for the foreseeable future but increasing sustainability requirements and demand reductions makes investments more difficult

There is a clear need to consider the bi-directional relationship between long-term energy agreements and the energy transition.

CONCLUSION 2: "at least this will be over"



UEF // University of Eastern Finland



Kim Talus

Professor and McCulloch Chair in Energy Law
Director of Tulane Center for Energy Law
Tulane University

Professor of European Economic and Energy Law
UEF Law School

Professor of Energy Law
University of Helsinki

UEF // University of Eastern Finland