

OPINION

Financing Oil and Gas through the Energy Transition

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Abstract

An energy transition is underway, and the long-term future of energy is undoubtedly going to be focused on cleaner, low-carbon technologies. Recent announcements by Western governments reflect renewed efforts to phase out financing support for fossil fuel projects. That said, the oil and gas industry and providers of financing thereto will continue to play an important part in this transition and in ensuring a more diversified and secure energy mix.

Introduction

The energy sector is undoubtedly in a transition phase, with the growth of renewable energy as a source of electricity generation pronounced in many countries. However, fossil fuels play an important part in this

transition and will continue to do so for the foreseeable future. In 1973, oil and gas accounted for 62.2% of the world's total energy supply. In 2018, oil and gas accounted for 54.4% of the world's total energy supply, with gas having grown from 16 to 22.8%.¹ That gain is against a backdrop of continued long-term growth in global energy demand, notwithstanding the shorter-term impact of the Covid-19 pandemic.

Investment spend on fossil fuels between 2026 and 2040 is projected to be between USD 0.6 trillion and USD 1.4 trillion, depending on the ability of governments to adopt policies required to meet internationally agreed objectives to reduce carbon emissions,² with energy efficiency investment projected to account for between USD 0.5 trillion and USD 0.8 trillion during the same period. The current importance of oil and gas projects to the maintenance of global energy security is illustrated by the projected supply shortage that is expected to arise due to current investment cycles in an industry faced with twin challenges of low commodity prices and a global pandemic.³

This article looks at the challenge of financing oil and gas projects during the energy transition, in light of recent announcements by governments, multilateral agencies and commercial banks to pull back from fossil fuel projects.

The role of oil and gas in the energy transition

While it may seem paradoxical, the path towards a low-carbon energy landscape will require the support of the oil and gas industry. There are two key reasons for this: (1) there is insufficient current or planned capacity from renewable energy projects to meet the global energy demand in the foreseeable future; and (2) many of the most advanced renewable technologies rely on intermittent sources of power and therefore are not suitable to meet 100% of local or regional energy demand alone. Although a number of battery and other energy storage technologies have been, or are in the process of being, developed to help address the issue of intermittency (with the cost of lithium-ion batteries falling by 85% between 2010 and 2018),⁴ scale remains a critical issue.

While the growth of investment in renewable energy sources in recent decades has been remarkable, it remains the case that the gradual decarbonisation of the global energy supply since 1900 has been driven primarily by the displacement of coal by hydrocarbons, in particular natural gas, across industries.⁵ While government policy decisions in countries such as the UK have assisted in the acceleration of renewable power as a share of the energy mix, it is cheaper domestic gas in North America that has

¹ Key World Energy Statistics 2020 available at: <https://www.iea.org/reports/key-world-energy-statistics-2020> [Accessed 12 May 2021].

² "Capital investment in liquids and gases by scenario, 2019-2040" available at: <https://www.iea.org/data-and-statistics/charts/capital-investment-in-liquids-and-gases-by-scenario-2019-2040> [Accessed 12 May 2021].

³ Wood Mackenzie, "What the coronavirus means for the energy transition" (Energy Transition Outlook, 2020).

⁴ BloombergNEF, "A Behind the Scenes Take on Lithium-ion Battery Prices" available at: <https://about.bnef.com/blog/behind-scenes-take-lithium-ion-battery-prices/#:~:text=The%20annual%20price%20survey%20has,an%20average%20of%20%24176%2FkWh> [Accessed 12 May 2021].

⁵ Vaclav Smil, *Energy Transitions: Global and National Perspectives*, 2nd edn (2016).

driven the displacement of coal. Since natural gas has the potential to be a far cleaner fuel as compared to coal, investment in natural gas projects is projected to grow for the foreseeable future, as developers look to improve production efficiency at all stages of the value chain, with demand for natural gas not expected to peak until around 2037.⁶

It seems inevitable therefore that fossil fuel projects will continue to play a critical role in the energy transition, both as a bridge to a low-carbon future and as a longer-term source of supply as part of a sustainable energy mix. This role is apparent in the energy strategies of developed and developing markets alike. In order to ensure a viable and sustainable energy transition, the transition will need to be carried out in a manner that does not jeopardise the security of the global energy supply.

In addition to supporting the transition to a low-carbon energy mix, there will be an important continuing role for oil and gas outside of energy generation. Oil and gas are used for many purposes other than energy generation, including as feed-stocks for petrochemicals and fertilisers. Materials created using oil and gas (e.g. plastics) are not prone to substitution by new energy technologies, and while there is an increasing focus on re-use and recycling of these materials or shifting to more sustainable materials, less emphasis and investment has been made by governments and corporations alike in finding alternative solutions to alleviate these other sources of demand. As a result, the demand for non-combusted use of fossil fuels is likely to continue to grow.

Innovation in the oil and gas sector

The co-evolution and co-existence of new and existing technologies is apparent in the development of cleaner and more efficient oil and gas projects. Alongside the development of technologies such as carbon capture and storage and “blue hydrogen” applications, which have the potential to reduce harmful emissions from a range of carbon-intensive power projects, significant investment is underway to increase the energy efficiency of oil and gas projects. This includes a focus on the efficiency of upstream production (with regulations in certain producing countries to end the flaring of gas produced from oil production), the efficiency of midstream production and transportation (including the process for liquefying and transporting natural gas as liquefied natural gas (LNG)) and the efficiency of downstream power production (with more efficient power plants). While increased efficiency should lead to lower capital costs over time, a number of these technologies, such as carbon capture, utilisation and storage, are extremely capital-intensive and require significant investment.

Alongside efforts to reduce the level of carbon emissions from the fossil fuel industry, the world’s largest energy companies have increasingly focused on the potential for sequestration technologies and approaches to actually remove carbon from the atmosphere, including “nature-based” solutions such as re-forestation and afforestation. These developments offer the potential for creative solutions for the financing of oil and gas projects, including through the use of carbon offset credits as part of a financing package and the inclusion of the cost of offset projects as part of project costs.

Additionally, sponsors and investors are increasingly looking to develop and finance energy projects where there is interaction between new and existing technologies—for example, by developing and funding projects where solar and “clean” hydrogen technologies are supported by gas-powered assets.

Financing oil and gas projects during the energy transition

While the energy transition requires significant ongoing investment in renewable energy, the need for investment into cleaner fossil fuel technology, allied with the continued growth for gas as an energy source, means that billions of dollars of annual investment in oil and gas is anticipated to be required for the foreseeable future and at least over the next several decades.⁷

Against this demand, it is clear that increased public awareness and political engagement regarding the need to reduce emissions of greenhouse gases is putting pressure on traditional sources of capital for oil and gas projects.

Following the introduction and widespread ratification of the 2015 Paris Agreement and the adoption by the United Nations General Assembly in September 2015 of its 2030 sustainability agenda, governmental and private investor policies have gradually shifted away from fossil fuel investment, particularly those investments in the most “carbon-intensive” industries. Governmental and supranational policy shifts away from fossil fuels, and towards renewable energy projects, has a direct impact on budget allocations in host countries as well as on the availability of subsidies to investors. The World Bank’s decision to cease the financing of upstream oil and gas projects from 2019 was subject to a narrow exception whereby the poorest countries may continue to receive such support “where there is a clear benefit in terms of energy access for the poor and the project fits within the countries’ Paris Agreement commitments”.⁸ Notably, the World Bank will continue to provide financing for midstream and downstream projects that support the ongoing role of natural gas power generation as part of

⁶ McKinsey & Company, “Global gas outlook to 2050” available at: https://www.mckinsey.com/~/media/mckinsey/industries/oil%20and%20gas/our%20insights/global%20gas%20outlook%20to%202050/global%20gas%20outlook%202050_final.pdf [Accessed 12 May 2021].

⁷ BP 2020 Energy Outlook estimates that between USD 9 trillion and over USD 20 trillion of new investment in upstream oil & gas production will be required over the next 30 years, BP, “The energy transition requires significant shifts in the pattern of investment” available at: <https://www.bp.com/en/global/corporate/energy-economics/energy-outlook/investment.html> [Accessed 12 May 2021].

⁸ “World Bank Group Announcements at One Planet Summit” (12 December 2017) available at: <https://www.worldbank.org/en/news/press-release/2017/12/12/world-bank-group-announcements-at-one-planet-summit> [Accessed 8 June 2021].

a sustainable energy mix. Similarly, a number of national oil companies in Europe are either rebranding and aggressively divesting of fossil fuel assets, including in the oil and gas sector, or at least shifting focus away from international expansion.

In the financial services industry, multilateral and commercial lenders have pledged to curb their investment in fossil fuels—including the European Investment Bank, a number of export credit agencies and multilateral agencies, many investment funds and most international commercial banks. The recent announcement that UK Export Finance (UKEF) will cease support of fossil fuel export projects is symptomatic of this trend, and has been followed by similar announcements by a number of other European governments as well as the new US administration. While certain details around these policy announcements are not known, it is clear that a very significant traditional source of financing for oil and gas projects is being closed down, and will need to be replaced. Commercial bank investment policies introduced over the last few years have tended to focus on environmental and social sustainability objectives. These policies tend to set out general criteria, include enhanced reporting obligations and in many cases restrict or prohibit investments in certain sectors. However, while a shift away from coal mining and coal-fired power projects is a common theme, the policies either explicitly or implicitly reflect an understanding of the ongoing role of oil and gas projects as part of the energy transition. As a result, many banks have introduced enhanced monitoring and reporting of, rather than an outright curb on, such investments, with a focus instead on increasing investment in more renewable energy to achieve a more sustainable energy investment portfolio.

Likewise, in the capital markets, a growing shift in the attitudes of institutional investors away from fossil fuels is informing the investment policies of the major international energy companies, as pressure from asset managers and shareholder votes lead to pledges to reduce production of, and operations using, fossil fuels. At the same time, institutional investor appetite for certain instruments in the debt capital markets is reducing. However, consistent with the aforementioned role of natural gas as a “transition fuel”, many international energy companies continue to promote and advertise their role in the LNG sector as a cleaner alternative to coal as a fuel source for power production. As of 2019, oil and gas continued to account for more than 95% of the total capex spend of the energy majors, given the relatively high returns on capital, compared to renewables and the lack of investment opportunity at the scale required to meet standard investment criteria.⁹ That said, a number of those same companies now profess to spend approaching half of their annual capex on the carbon transition.

For the majority of banks and other investors that continue to provide financing for oil and gas projects, their investments come with ever stricter conditions to assess, monitor and mitigate the environmental and social impact of such projects. While many lenders have their own internal policies in respect of sustainable development issues, they are often influenced by the Equator Principles.

The Equator Principles were established in 2003 in response to the increasing pressure faced by the commercial banking market to ensure that the projects they financed observed the highest environmental and social standards. The Equator Principles are a risk-management tool and have been agreed to among signatory financial institutions known as Equator Principle Financial Institutions (EPFIs)—which currently comprise more than 100 financial institutions across 38 countries. There have been multiple iterations of the Equator Principles, the latest of which is known as “EP4” and was adopted in 2020 (affecting transactions entered into on or after 1 October 2020). The Equator Principles apply to, among other things, project finance and advisory services to project-related corporate loans and bridge loans. While the Equator Principles are primarily a set of voluntary principles to be followed by lenders, compliance with the Equator Principles is not possible unless the borrower carries out certain steps in assessing and managing risk.

EP4 is more stringent than previous iterations of the Equator Principles and will have a significant impact on the development and financing of oil and gas projects regardless of the jurisdiction. For example, under EP3, projects located in the US and other high-income Designated Countries that complied with host-country environmental and social laws were deemed to be in compliance with the most burdensome Equator Principles (e.g. requirements relating to the preparation of broadly scoped environmental and social assessments). EP4 eliminates “deemed in compliance” language and, as a result, projects that are located in Designated Countries (and otherwise meeting the EP4 applicability thresholds) will be required to satisfy all of the Equator Principles.¹⁰

Innovations in how oil and gas projects are financed may encourage and reward energy companies in making the shift towards cleaner energy. Just as international energy companies are looking to achieve carbon neutrality through the offset of carbon emissions, individual projects can be structured in a similar manner. For example, the launch of products such as “green LNG” provides the opportunity for investors or customers to offset emissions generated by a project (or individual cargoes) through the use of verified emissions reductions (VERs). Lenders also can incentivise energy companies and projects through the use of pricing adjustments (such as margin ratchets) linked to emissions, as well as including

⁹ Anjali Ravel, “Oil majors keep tight grip on spending for green future”, *Financial Times*, 27 December 2018.

¹⁰ Latham & Watkins, “Equator Principles Update: EP4 and Projects in High-Income Countries?” (10 June 2020) available at: <https://www.lw.com/thoughtLeadership/equator-principles-update-ep4-and-projects-in-high-income-countries> [Accessed 12 May 2021].

enhanced reporting and other compliance measures in finance documents, as have been seen in the green bond and green loan markets.

Impact of Covid-19 on the energy transition

The consumption of fossil fuels (and energy more generally) is often strongly correlated with economic performance. However, as a result of the reduced economic output due to Covid-19, there has been and likely will continue to be a dip in demand in the short term, particularly in the transport sector.

While it may take some time for the global economy to recover from the humanitarian and economic impacts of Covid-19, some of these impacts are expected to endure over the long term (e.g. the greater emphasis on home-working). Notwithstanding this, current predictions point toward continued growth in global energy demand for many decades to come.

The reduction in transportation fuel consumption and the global economic downturn, together with restrictions on travel and the ability to import traded fuels, have highlighted the financial precarity of countries whose economies are excessively dependent on oil and gas exports and imports. BP's 2020 Energy Outlook theorises that the disruptions associated with Covid-19 may lead to a process of "deglobalisation", with countries increasingly looking to secure their energy supply by focusing more on local projects and less on imported

fuels. While many governments will use the opportunity post-Covid-19 to stimulate investment in low-carbon technologies as part of their economic recovery plans, these efforts will be coupled with continued investment in more traditional technologies in order to ensure a sufficiently diversified, resilient energy supply.

Conclusion

With ever-growing concerns about climate change and increasing engagement by public and private institutions in the transition to cleaner energy sources, the long-term future of energy is going to be focused on low-carbon technologies. However, notwithstanding the growing importance of renewable energy, the oil and gas industry will continue to play a part in a more diversified energy mix and global efforts to maintain the security of energy supply.

Furthermore, while the transition to a low-carbon future will take a global effort, the pace of change will vary across regions and markets, with the displacement of coal by natural gas continuing as a clear driver to the reduction of carbon emissions in many of the most significant energy markets. A key challenge for developers in the oil and gas sector will be their ability to raise financing in the face of growing political opposition to the sector, with the most efficient projects that can demonstrate robust reporting and accountability standards best placed to succeed.