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SLLs – Greenwash or Not?

Article

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The issue of climate change and sustainability has become an existential question for hydrocarbon companies with climate change and ESG pressures severely impacting access to capital for independent E&P companies. The global pandemic has unquestionably accelerated the energy transition and the oil and gas sector is facing intense scrutiny from shareholders and other stakeholders, increasingly lenders, to demonstrate that action is being taken to implement ESG improvements.

With certain of the Majors in the US suffering shareholder rebellions this year, we are witnessing a clear shift in how companies are being held to account for their activities and associated environmental impacts. This places ESG considerations resolutely at the top of every E&P company's agenda. Against that backdrop, this article analyses whether there is a role for sustainability-linked loans ("SLLs") in the upstream sector.

Firstly, what is a SLL? A SLL is a loan which aims to support environmentally and socially sustainable economic activity and incentivises the borrower to achieve ambitious sustainability objectives pre-agreed in loan documentation. In contrast to "green loans" which provide funding to borrowers for green projects, SLLs carry no restrictions on how the loan proceeds can be used, which makes them a viable option for E&P borrowers.

SLLs link the interest payable to the company's progress against pre-determined sustainability objectives, employing a "carrot and stick" approach to motivate borrowers with a reduction in the margin for meeting ESG targets and an increase in pricing for failure to do so. There has been exponential growth in the use of SLLs in the last few years with an increasing number in the upstream financing space. Standard & Poors reported that issuances of SLLs reached $350 billion in the first half of 2021 alone (almost twice the figure for all of 2020).

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With some banks retreating from providing finance to fossil fuel companies and, in some cases, reduced capital allocations for upstream financings, there is a paucity of liquidity in the market. Reduced access to capital means that lenders who remain in the sector are playing a significant role in shaping borrower behaviour by requiring borrowers to adopt an ESG strategy with ambitious sustainability performance targets and monitoring compliance against those targets. Financial institutions can demonstrate to their own stakeholders that there is engagement to implement ESG improvements in this sector.

Several E&P companies have now agreed sustainability-linked targets in their corporate and reserve based lending facilities. New financings for E&P companies and amendments to existing facilities are likely to incorporate these features going forward as it is a means to unlock greater access to capital and maintain relationships with lenders who require sustainability-linked features to maintain their exposure to companies in the upstream sector.

It is of paramount importance that financial institutions ensure that sustainability performance targets in SLLs are robust and meaningful to avoid allegations of the “green sheen” and the reputational risk associated with “greenwashing”. Earlier this year, the Loan Market Association released a framework setting out what borrowers, lenders and their advisers should consider when seeking to integrate sustainability factors into loan documentation. The framework focuses on identifying Key Performance Indicators (or KPIs), setting sustainability performance targets (typically the setting of such targets is an iterative process between the borrower, a lender appointed as the sustainability coordinator and ESG advisors), agreeing the terms applying to the margin ratchet, nominating an independent adviser to verify performance against sustainability performance targets and including a reporting regime. This construct seeks to circumvent allegations of “sustainability washing” by ensuring that sustainability performance targets are suitably ambitious and through accurate measurement and disclosure of borrower performance against such targets.

The KPIs that we see in E&P companies’ facilities generally concentrate on the “E” (or environmental) element by achieving reductions in carbon intensity and flaring, as well as boosting renewable electricity generation. Amid escalating stakeholder pressure for oil and gas companies to report their ESG efforts, the incorporation of KPIs and targets in these facilities and, more importantly, meeting those targets demonstrates a borrower’s commitment to improving its ESG performance. Getting the ESG narrative right may result in stronger stakeholder engagement, better access to capital and improved corporate reputation for E&P companies.

As the acceleration of the energy transition continues apace, we expect there to be a significant increase in the number of SLLs being provided to E&P companies. To the extent there is a scarcity of upstream lending from commercial banks, the liquidity shortfall could be filled by funders who face less scrutiny from stakeholders and apply less stringent ESG targets (or none whatsoever). While some may consider the use of SLLs in the upstream sector with some cynicism, SLLs motivate borrowers to implement ESG improvements in a more timely fashion than may otherwise have been the case. Loans which support environmentally sustainable activity and incentivise the borrower to achieve ambitious sustainability targets during the energy transition is arguably a good outcome for all parties.

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