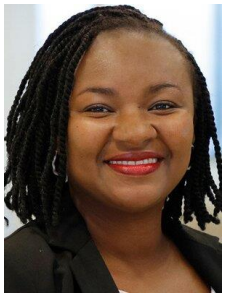
3 Contract Considerations For Renewable Fuels Trade

By **Nneka Obiokoye** (April 14, 2022)



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On Feb. 8, the American Gas Association released its first comprehensive report exploring natural gas utility pathways to achieve net-zero emissions.[1]

Among other things, the report acknowledged the need for the fossil fuel industry to move toward the energy transition and outlined certain pathways for the decarbonization of traditional fossil fuel sectors. Some solutions proposed by that report included increased use of renewable natural gas and hydrogen to offset the methane costs associated with the wholesale use of natural gas.

This is not news to the oil and gas sector. Prior to the issuance of this report, many oil and gas companies had begun exploring pathways to reduce their respective carbon footprints, including the acquisition of renewable natural gas projects and investments in hydrogen and carbon capture technology.

These efforts have been intensified following the passage of the Infrastructure Investment and Jobs Act,[2] which allocates substantial government capital to research and development efforts with respect to carbon capture and hydrogen infrastructure. The intention is to demonstrate a standard of clean hydrogen production in the transportation, utility, industrial, commercial and residential sectors by 2040.[3]

In addition to the foregoing, the Infrastructure Act allocates $8 billion[4] for the development of at least four clean hydrogen hubs, one of which is required to demonstrate the production of clean hydrogen from renewable energy.[5]

In view of the foregoing, renewable energy and fossil fuel companies alike will be seeking to enter into definitive agreements to facilitate the construction of facilities for the production and transportation of renewable fuels, including renewable natural gas and hydrogen.

Moreover, as technological advancements continue to emerge in relation to hydrogen and other renewable fuels, the demand for contracts for the purchase and sale of renewable fuels will continue to rise.

It is therefore useful to understand some of the important considerations for entering into these contracts to avoid subsequent pitfalls during the administration stage.

This article discusses three major considerations for entering into an offtake agreement for the purchase and sale of renewable fuels from the primary producer of feedstock. There may be other considerations depending on the size and complexity of the transaction, but the following provides a basic road map for determining issues that need to be negotiated.

The Dedication

Originally a concept that is found in midstream oil and gas contracts, the dedication is making an appearance in the renewable energy space.

Traditionally speaking, a dedication is a provision in a contract that requires one party —

the party engaged in the production of the desired commodity — to commit all of its production to the other party.

A dedication typically ensures that a purchaser investing significant amounts of capital in technology and infrastructure to receive, transport, and/or sell a commodity will have enough quantities to (1) justify the capital investment in the applicable facilities, (2) support the minimum operating capacity of the applicable facilities, and (3) in the case of a purchase for resale, ensure consistency in supply, with the attendant stability in pricing.

A dedication may be a stand-alone provision, or it may be accompanied by other protections such as a minimum volume commitment, a take or pay provision or similar concepts. In any case, a dedication ensures that the producer does not sell the applicable commodity to a third party unless it has satisfied the minimum requirements of the contract.

While a full scale dedication in the midstream oil and gas context is not required for a purchase contract, the typical purchase contract should contain appropriate exclusivity provisions to ensure that the party producing the commodity or feedstock is sufficiently incentivized to maximize production and delivery of the applicable product to the purchaser on an uninterrupted basis.

Who Is Building What?

Sometimes, a purchase and sale contract is just that — one party delivers the goods and the other party receives and pays for them. However, in many cases, there is more to the purchase and sale relationship.

As the world continues to figure out the technology for developing hydrogen, renewable natural gas and other renewable fuels, the reality is often that one or both parties may need to build new facilities to facilitate the transportation, receipt and processing of feedstock, or make modifications to existing facilities to accommodate the same.

Accordingly, determining what needs to be built, who is responsible for building it, where those facilities will be located, and how those costs will be allocated will be the first step in any purchase contract.

Once the baseline construction needs have been mapped out, the next step will be to determine what access rights will be required and which operational document will contain such rights. If the access requirements are minimal — for instance, where the facilities to be constructed have a small footprint — then the purchase contract may contain all the access rights pertaining to each party's facilities.

However, where such access rights are more substantial, the purchase contract will contain more generic access provisions, such as ingress and egress rights, nonintervention and cooperation provisions, then refer to an additional real property agreement — such as a lease or right of way agreement — containing the more significant rights.

Once the parties have allocated responsibility for construction and determined what access rights are required, the next step would be to consider what remedies, if any, will be available for construction delays.

It is important to note that this juncture, that not all purchase contracts with a construction provision will have specific remedies for construction delays. These remedies tend to be more pertinent when one party has a risk exposure that is tied to the completion of

construction of the other party's facilities within a specific timeframe.

For instance, an example would be where the purchase contract is for the purchase of the processed final product and the producer would risk significant loss of revenue or incur significant costs to procure storage or alternative transportation if the purchaser's facilities were not fully constructed by a certain date.

If, however, the contract is for the purchase of feedstock which happens to be a byproduct of some other profitable operations of the producer, then a construction delay may not be important as a commercial issue, except in the context of lost profits or lost opportunity.

Construction delays are often addressed by including a specific commercial operation date — with allowances for events outside the control of the party doing construction work — and remedies for delay, such as delay damages or termination.

While delay damages for failure to complete construction activities are not very common in renewable fuels feedstock purchase transactions, some contracts do contain these provisions and the parties may also seek to address risks associated with such delays through other provisions such as default, indemnities and force majeure.

The existence of construction obligations may also trigger additional considerations such as responsible sourcing of raw materials, cross-border relations, publicity issues and international trade laws, which should be addressed in discrete provisions of the purchase contract.

Finally, when new facilities are being added, the parties will need to consider and outline any pertinent issues relating to the ongoing operation of those facilities.

This includes:

- Any operation and maintenance obligations;
- Payment provisions for such operation and maintenance obligations; and
- The standards of — and remedies for failure to comply with — any operation and maintenance obligations.

Who Owns the Environmental Attributes and Tax Credits?

The final issue I will consider in this article, is the ownership of environmental attributes associated with the renewable fuel being purchased.

While this appears to be a relatively simplistic consideration, this is actually one of the most important provisions of a contract for renewable fuels or feedstock. This is because, more often than not, the purchaser is primarily seeking to enter into the transaction in order to access, use, transfer and make representations to governmental entities, investors and the general public regarding the renewable attributes associated with the applicable commodity.

As environmental, social and corporate governance considerations continue to become more mainstream in the energy industry, the ability to make representations to the members of the public regarding the renewable nature of the transaction in question becomes more important.

Accordingly, the purchase contract will typically provide that the purchaser of the renewable fuel will own 100% of environmental attributes associated with the commodity being purchased and any by-products of such commodity. However, this does not necessarily preclude the seller from sharing in the proceeds from the sale of such renewable attributes, to the extent that the same may be separately valued and monetized.

The purchase contract should also provide a mechanism for the transfer of such attributes and clearly delineate the point at which such transfer occurs. If the parties are unsure as to whether environmental attributes exist or whether new attributes could be created in the future, then the purchase contract should also allocate the ownership of future environmental attributes between the parties.

Finally, it is important to distinguish the ownership of tax credit, which typically apply to the facilities used for generating renewable energy, from environmental attributes, which typically apply to the product being sold.

While the purchaser typically owns all the environmental attributes, the tax credits are typically owned by the party that owns or incurred the capital cost of constructing the facilities in question.

However, this formula is not cast in stone and the allocation of tax credits may vary across various contracts. Nevertheless, the purchase contract should differentiate between these two concepts and allocate the tax credits separately from environmental attributes.

Conclusion

As the race toward a net-zero economy continues and more incentives are available for the development of hydrogen and other renewable fuels, contracts for the sale and purchase of renewable fuels will continue to take up a more dominant role in the energy industry, particularly in sectors that cannot be electrified.

While the above discussion is by no means exhaustive, it provides a road map to guide the negotiation of the applicable contracts as the industry continues to evolve.

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