ARTICLE

# Covid-19 is shaking up the energy sector, with disputes on the horizon

Covid-19 is dramatically affecting the global energy markets, with drastic demand and price reductions since the crisis outbreak. Uncertainty is prevailing on the evolution of the energy markets.

If one still needed an emblematic example to illustrate the impact of Covid-19 on the energy market, there could not be a better one than the negative prices for West Texas Intermediate (WTI) crude oil on 20 April 2020. The spread of the virus has already forced an economic slowdown and now a recession that is anticipated to lead to serious economic downturn, unprecedented since the end of World War II.

All economic sectors are impacted by the virus or more precisely by the measures taken to manage the ensuing health crisis. In the energy sector, this has translated into a significant reduction in demand for energy: industry, commercial spaces and offices are closed, commuting and travel have been drastically reduced… more than 1/3 of the world's population is now in lockdown!

The worldwide spread of the virus has led to immediate and significant impacts on the energy sector. However, these impacts and consequences also have a longer-term reach: the consensus is that business and the economy will not go back to the way they were before. Everyone agrees that there will be a "before" and an "after" Covid-19 in the way we live, affecting our personal and professional lives.

The energy sector will not escape this, and due to the inertia created by the current economic crisis, the sector will be affected for many years ahead.

Energy companies need to adapt to what would be the new "normal". These companies and investors will put more emphasis on exceptional risk, requiring extensive mitigation provisions and stronger credit support in contracts, especially when they underpin large investment in projects.

Adapting to the new reality will also mean that current contracts and projects are to be reviewed and re-assessed, which could lead to a new wave of energy disputes.

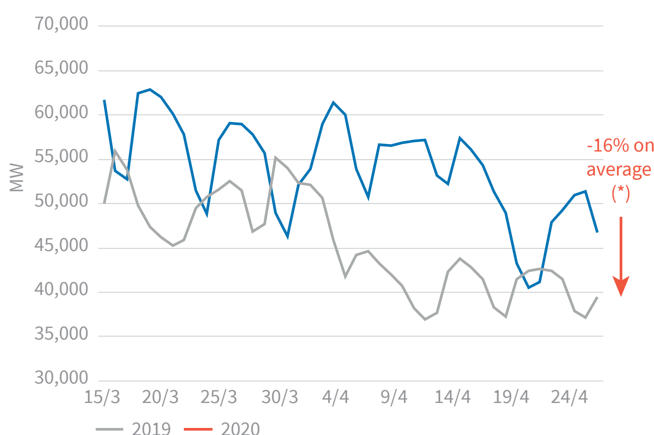
In this paper, I am considering the key issues and challenges caused by the Covid-19 crisis in the energy sector. I first recall some of the immediate effects of the crisis on energy demand and prices (part 1). I then discuss the changes to be expected in contracts and projects, once the current health crisis is considered to be "over" and things will be back to "normal" (part 2). Unsurprisingly, this crisis is expected to have lasting effects in the energy sector.

# Impact on energy demand and prices

The most immediate and visible impact of the Covid-19 is the reduction in global energy demand, which has in turn led to a reduction in energy prices.

Due to the lockdown and the corresponding slowdown of economic activity, power demand has dropped significantly compared to normal levels. In France the average daily demand on a weekday in France is now similar to the daily demand on a weekend. On Wednesday 18 and Thursday 19 March 2020, it was 16% below the usual levels for the same period last year as shown on Figure 1.[1]

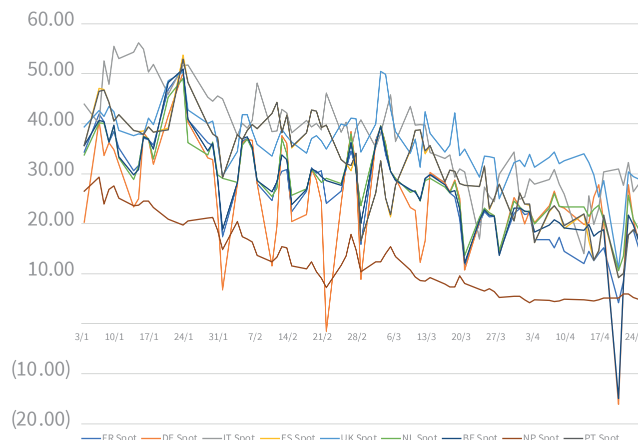
**FIGURE 1 – EVOLUTION OF ELECTRICITY CONSUMPTION IN FRANCE – AVERAGE DAILY CAPACITY (MW)**




Source: RTE
(*) Note: Before adjustment for weather conditions

As already observed in some occasions in the past, day-ahead power prices on European markets were negative for 3 days in a row in April 2020 as shown on Figure 2[2]. This is due to the combination of the “classic” factor of high renewable production and reduced demand compared to the expected load curve.

**FIGURE 2 – EUROPEAN ELECTRICITY MARKETS – EVOLUTION OF SPOT PRICES (EUR/MWH)**




Source: energymarketprice.com

Obviously, the most commented upon and spectacular decrease in demand is undoubtedly to be found on the oil market; the International Energy Agency (IEA) is forecasting a record 9.3 mb/d year-on-year decrease in 2020.[3] Jet fuel and kerosene demand have been particularly affected due to the reduction by more than 60% of commercial flights across the world.[4] According to the International Air Transportation Association (IATA), total revenues of airlines could drop by $314 billion in 2020 compared to 2019, a 55% decline.[5] Major US airlines are now seeking financial aid from the Government, with the US Treasury Department agreeing on a total of $25 billion rescue package on 14 April 2020.[6] Governments across the world have been forced to intervene to avoid airlines going bankrupt; for example, Virgin Australia, the country’s second-largest airline, is seeking bankruptcy protection as it is pushed into insolvency.[7] Given the uncertain economic environment and the risk of long lasting travel restrictions, it is difficult to imagine if and when demand for jet fuel and kerosene might go back to pre-Covid-19 level.

The reduction in oil demand has also translated into a reduction of prices. The decreasing trend in oil prices, both Brent and WTI, started back in January 2020. Combined with

1 « Power Demand Slows in Europe as Virus Lockdowns Kick In ». Bloomberg, 20 Mar. 2020. https://www.bloomberg.com/news/articles/2020-03-20/power-demand-slows-in-europe-along-with-coronavirus-lockdowns

2 “Three Consecutive Days with Negative Prices in Some European Electricity Markets Due to the Wind Energy and the Coronavirus”. AleaSoft Energy Forecasting, 20 Apr. 2020, https://aleasoft.com/three-consecutive-days-negative-prices-european-electricity-markets-wind-energy-coronavirus/

3 “Oil Market Report – April 2020” – IEA - https://www.iea.org/reports/oil-market-report-april-2020

4 “Coronavirus Dashboard for Energy Demand” – S&P Global Platts, 30 March. 2020

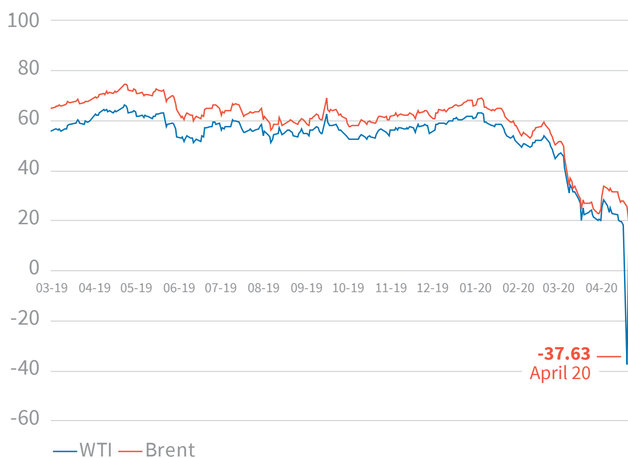
5 “Global airlines’ estimated coronavirus losses rise to $314 billion: IATA” – Reuters, 14 Apr. 2020 https://www.reuters.com/article/us-health-coronavirus-iata/global-airlines-estimated-coronavirus-losses-rise-to-314-billion-iata-idUSKCN21W1LN

6 “Crippled Airline Industry to Get $25 Billion Bailout, Part of It as Loans”. The New York Times, 14 Apr. 2020. https://www.nytimes.com/2020/04/14/business/coronavirus-airlines-bailout-treasury-department.html

7 “Fears Virgin Australia Could Survive Coronavirus but Be Put out of Business by Qantas”. The Guardian, 22 Apr. 2020. www.theguardian.com, https://www.theguardian.com/business/2020/apr/23/fears-virgin-australia-could-survive-coronavirus-but-be-put-out-of-business-by-qantas

the OPEC decision to increase production[8] (although this has been amended since then)[9], the oil prices were sent crashing down. On 20 April 2020, WTI quotations were negative, with a minimum of -37.63 USD/bbl for the Front Month, for the very first time in its history.[10] It is worth noting that these negative prices are a direct consequence of the reduction in demand due to the Covid-19, the increase in supply from OPEC and Russia, but also the result of the specificities of the Futures market in the US, as it is settled at an inland delivery point and is heavily subject to domestic shale production. For instance, Brent crude prices, although they also decreased drastically, did not turn negative.

**FIGURE 3 – EVOLUTION OF CRUDE OIL PRICES – SPOT (USD/BBL)**




Source: energymarketprice.com

The decreased price had a very severe adverse impact on various oil companies, affecting their revenues and so their ability to repay their debts[11], with the risk of forcing the smaller and more indebted ones into insolvency. As some analysts predicted, all these factors could lead to financial carnage in the oil sector, particularly in the US where shale oil, as well as shale gas production, would drop massively.[12]

The reduced oil prices and the uncertain economic environment are also affecting the oil majors. Some of them saw their stock market valuation halved since January 2020[13]. For example, BP's share price has fallen from £481 to £233 since the beginning of 2020[14]. In response to the crisis, these companies announced major revisions to their capital expenditure for 2020. For example, Exxon, Shell and Total announced a reduction of their 2020 investment of $10 billion[15], $5 billion[16] and $3 billion[17] respectively, representing a reduction of about 20% to 30% of their initial budgets.

As a consequence, some projects are delayed, such as LNG Canada[18], or the Greater Tortue for which BP issued a Force Majeure notice, with the result of delaying final investment decision[19].

Gas prices are also facing downward pressure globally, but not to the same extent as oil prices. Lower prices for gas could actually end up having a beneficial impact on gas demand by making it more competitive, such that coal-to-gas switching could accelerate. For supply contracts with Brent indexation, like many of the LNG contracts in Asia, buyers will be benefiting from a favourable price in a few months (due to the time lag in the price formula) which could mitigate the financial consequences of their volume risk.

# Longer term impact on energy contracts and projects

## Energy contracts will be adapted to cater for similar risks in the future

Because of reduced energy demand, companies which committed to purchase a given quantity of energy are facing a major volume risk in their supply contracts, but also in their transportation/shipping contracts. Since the beginning of the crisis, companies have been trying to make use of their contractual rights to reduce their exposure. Such contractual rights could be exercised, for example, by invoking Force Majeure (FM), Material Adverse

8 https://www.cnbc.com/2020/03/06/opec-meeting-coronavirus-weighs-on-oil-demand-as-oil-prices-fall.html

9 https://www.cnbc.com/2020/04/09/oil-jumps-ahead-of-make-or-break-opec-meeting.html

10 Hundreds of US Oil Companies Could Go Bankrupt. CNN, https://www.cnn.com/2020/04/20/business/oil-price-crash-bankruptcy/index.html . Accessed 23 Apr. 2020.

11 FAR Ltd press release - 30 March 2020. https://far.live.irmau.com/irm/PDF/1b76b282-2788-4ef6-991e-788d4c8d4088/FARUpdate

12 Things That Matter - Understanding How COVID-19 Turns Energy Fundamentals Upside Down | RBN Energy. https://rbnenergy.com/things-that-matter-understanding-how-covid-19-turns-energy-fundamentals-upside-down Accessed 22 Apr. 2020

13 "Will the Coronavirus Kill the Oil Industry and Help Save the Climate?" The Guardian, 1 Apr. 2020. www.theguardian.com, https://www.theguardian.com/environment/2020/apr/01/the-fossil-fuel-industry-is-broken-will-a-cleaner-climate-be-the-result

14 BP Share Price (BP.) - London Stock Exchange. https://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB0007980591GBGBXSET1.html Accessed 22 Apr. 2020.

15 "ExxonMobil Shaves $10 Billion off Its Capital Investment for 2020". Offshore Energy, 7 Apr. 2020, https://www.offshore-energy.biz/exxonmobil-shaves-10-billion-off-its-capital-investment-for-2020/

16 "Shell, Total Cut Spending, Share Buybacks in Response to Oil Price Slump" | S&P Global Platts. 23 Mar. 2020, https://www.spglobal.com/platts/en/market-insights/latest-news/oil/032320-shell-cuts-spending-and-buybacks-in-response-to-oil-price-slump

17 id.

18 "March 27 - COVID-19 Update". LNG Canada, https://www.lngcanada.ca/news/covid-19-response-update-4/ Accessed 23 Apr. 2020.

19 "BP Issues Force Majeure to Golar over Tortue Ahmeyim LNG Project". Reuters, 8 Apr. 2020. https://www.reuters.com/article/us-golar-lng-lng-bp-idUSKBN21P2J7

Change (MAC) or Hardship clauses (if the contract contains such clauses), allowing for a suspension of the rights and obligations under the contract, a revision or even the termination of the contract.

When the crisis started to hit the Chinese economy severely, Chinese companies made a major use of FM clauses to suspend the performance of their contracts (in the energy and other industries) with the China Council for the Promotion of International Trade (CCPIT) having issued more than 3,300 certificates for contracts worth $38 billion combined.[20]

With the worldwide spread of the economic contagion, the issue of FM (or clauses with similar effects) became global, particularly in the petroleum products business, and has been widely commented upon and debated in the legal community as there is no unique answer to the applicability and enforceability of this type of contractual clauses in the face of the current situation. Much depends on the language of the contract and on the governing law of the contract.

It is worth noting that in some contracts, an extended period of Force Majeure event could open the right for a party to terminate the contract. Usually, such prolonged Force Majeure time period is about 6 months. The 6-month milestone has not been reached yet since the beginning of the crisis, but it would not be surprising to see some parties terminating contracts on the basis of prolonged FM. It remains to be seen how lawful these terminations would be.

Even though such termination could trigger the payment of termination liabilities, it might still be a rational economic decision to terminate such contracts if their performance turns out to be more onerous that the liabilities faced.

No one knows when this health crisis will be totally over and what the ‘new normal’ might look like. But companies should by then have had time to learn lessons from the crisis, as they did after the 2008 economic crisis.

Existing supply contracts or capacity contracts in infrastructure could be subject to renegotiation (subject to contractual rights) and/or dispute in case of unsuccessful renegotiation. The focus of these expected renegotiations and disputes will undoubtedly be on the “usual suspects” clauses in contracts (price, price review, quantity, flexibility, duration) but also on the aforementioned clauses of FM, MAC, etc...as well as dispute resolution mechanism clauses. Parties may well look to amend these provisions to cater for specific procedures to be used in similar exceptional circumstances.

This will lead to extensive negotiations (or renegotiations) of contracts to include specific and detailed clauses on the mitigation measures, in line with most (if not all) LNG contracts. It can be expected that such practice would extend to all commodities contracts and lead parties to develop an extensive list of remedies and mitigation measures to be taken if similar events were to happen again. The question would remain as to what to do if history repeats itself; what could be the mitigation measures to be taken in an environment of global energy demand reduction where storages are full? According to the IEA, floating storage increased by about 28.5% to reach a total of 103.1 million barrels.[21]

Credit support is also likely to be much a more extensively discussed and scrutinised aspect of contracts in future. Parties may from now on expect stronger credit support from their counterparties, especially for contracts which are underpinning an investment in large supply or infrastructure projects, to mitigate the risk of insolvency or bankruptcy of critical buyers/shippers. In the current environment, companies are more regularly settling their positions and drawing on the credit support provided. Credit support might then be factored into the operational decisions taken by portfolio managers, prioritising those contracts with better credit support.

This push for progressively stronger credit support may also lead to an increase in requests for credit support on the seller’s side. Facing the risk of the seller or infrastructure operator defaulting, buyers and shippers may well request credit support to be provided in case of adversarial events being encountered.

## Projects risk of being delayed or cancelled

Energy projects, either supply or infrastructures, are by their nature long term and capital intensive. Decisions to invest are based on an assessment of the economic viability of the project over its lifetime. Such economic viability is mostly determined (and indeed highly impacted) by demand, price and access to finance.

20 https://www.ft.com/content/bca84ad8-5860-11ea-a528-dd0f971febbc

21 “Oil Market Report – April 2020” – IEA - https://www.iea.org/reports/oil-market-report-april-2020

Projects which are currently in their construction phase are facing issues of delay and cost increase, one issue often accompanying the other. Delays are mostly due to the availability of workforce and/or equipment, as suppliers could not deliver them in due time, which could be considered as Force Majeure in some contracts. These delays are increasing the overall costs of the project (construction costs and financial costs) and are jeopardising the possibility of completing the project on time. The economic rationale supporting the development of the project would certainly be affected, but could projects under construction be totally stopped and cancelled or would they go ahead in any case?

Project sponsors and banks or lenders are expected to devote much more attention to the counterparty risk of the parties in the contracts underpinning new projects. Many projects need a firm and long-term commitment to be economically viable. The issue for new projects will be to have sufficient highly credit-worthy counterparties able and willing to commit on firm long-term contracts.

In the aftermath of this pandemic crisis, it would be reasonable to question the extent to which companies will be willing and able to engage in long term firm commitments that would guarantee the financing of projects, as their financial sustainability could be considerably diminished on a market-wide basis. So, what does this mean then?

Many Final Investment Decisions could be anticipated to be at best postponed and at worst cancelled because of the new economic environment. New capital-intensive projects will find it more difficult to access financing due to their higher risk profile. Consequently, the cost of financing should also be more expensive, negatively impacting further the economics of such projects.

Regarding the LNG market, the next wave of US LNG export projects could be one of the main "victims" of such crisis: they are exposed to US shale gas production on the procurement side and in a large part to oil indexation on the selling side, potentially making it unattractive due to high risks, especially if financial resources are scarce and more costly.

Other LNG projects elsewhere may be affected. I have already mentioned that BP notified FM for the 'Greater Tortue' project in Mauritania/Senegal. But other projects, among which those in Mozambique are often rumoured to be a leading contender, will come under pressure. The delay or cancellation of such supply projects would impact companies in the short-term and would impact the global supply/demand balance post-2025, being the period when they were supposed to come onstream. If market demand picks up by that time, the market may then in fact be undersupplied.

Another major uncertainty faced by the hydrocarbon industry is how and to what extent Covid-19 would impact the Energy Transition overall: would it accelerate it, or would it slow it down? Many are arguing that it is time to move faster towards the Energy Transition and to accelerate the implementation of renewable projects. Nevertheless, as for any private sector projects, these projects need to be financed and profitable. These market uncertainties are also affecting the perspective of renewables development, although some companies like Iberdrola have already announced that they will commit to more investment in these projects.[22] While some companies are pledging their commitment to invest, public money may once again be needed to foster the development of these projects as the investment may be less attractive due to lower oil prices. But massive increase in public debt and drop in customer affordability make subsidies more challenging and harder to pay for.

Some commentators are currently criticising the efficiency of incentives granted to renewables over the last few decades by way of development grants, tax breaks, feed-in tariffs and price support schemes, arguing that this investment was made to the detriment of other public services in need for investments or indeed other areas now needing further investment, such as energy storage, grid support and upgraded transmission capacity. On the other hand, the development of industrial scale hydrogen and carbon sequestration projects on a scale that will lower the carbon intensity of a country's power use is such that it is difficult to see this happening without considerable government support and incentives. This debate will certainly continue as implementation of Energy Transition continues in upcoming period of recovery from Covid-19.

22 Greentechmedia.com - 2 April 2020. https://www.greentechmedia.com/articles/read/iberdrola-plots-post-lockdown-investment-spree

## A wave of disputes is looming

Contracts and projects in the energy sector are facing and will continue to face multiple challenges caused by the current economic crisis and its expected long-lasting effects.

As with any crisis, major and profound changes to the way business is operated will be incurred. In the energy sector, it could require the review and redefinition of contracts and projects.

These required changes will, with all certainty, lead to a number of contractual or investment disputes. Such disputes would be a way to resolve issues affecting the parties, but may also be a way to generate revenues when operational revenues are reduced.

Investors and companies are currently focusing on preserving all their contractual rights and/or are already threatening to trigger arbitrations. An illustrative example of situation that may arise in the energy sector can be found in another capital-intensive sector. In Peru, the Government has proposed an emergency measure to suspend the collection of toll fees[23]. While the constitutionality of this bill is questioned, its enforcement could lead to investment or contractual claims by concessionaires over unilateral changes to their contracts. Concessionaires of energy assets may end up facing similar situations

This new wave of disputes related to Covid-19 will be initially linked to events and breaches occurring during the Covid-19 period, for example on the rightful use of Force Majeure or other clauses in the contract, on the obligations to have mitigated the risk, on the Fair and Equitable Treatment of investors. Some of these disputes will be either caused, or indeed compounded by, market conditions that were already developing, as discussed earlier in this paper.

However, a second wave of disputes linked to Covid-19 could be anticipated. Once back to "normal", new disputes may arise as a consequence of the continuing economic effect of Covid-19. Parties which have accepted a reduction or suspension of their contractual rights in the midst of the crisis would certainly expect to benefit again from such rights straight away once back to "normal". This may be possible for supply contracts (to some extent at least, as there might be a new ramp up production for hydrocarbons production) but would be difficult for construction contracts: how could an EPC contractor be expected to resume work on all its projects (the ones delayed in addition to the ones contracted before but which could not be delayed whilst maintaining its schedule for delivering its future order book)?

The one certainty is that innovative strategy, negotiation of new contractual and management of disputes will be de *rigueur* for those players that thrive in the "new normal".

23 Peru warned of potential ICSID claims over Covid-19 measures. GAR. 09 Apr. 2020

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