SUSTAINABILITY-LINKED BONDS

Sustainability-linked bonds can improve a company's capital structure on potentially favorable terms. But energy companies must thoughtfully craft measurable and meaningful KPIs to catch this financing green wave.

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As appetite for energy investments has shifted dramatically in the past decade, energy companies have repeatedly transformed their investor-outreach strategy in response. ESG-focused investing and the advent of sustainable financing frameworks have generated interest.

Although sustainability-linked bonds (SLBs) may not fundamentally change the risk of investing in the energy industry, they are worth exploring as a way for companies to attract new investment capital, achieving measurable ESG-related goals and allowing some institutional investors to satisfy their own ESG mandates.

But while this dynamic may drive marketing, securing value from SLBs requires nuanced discussion of an issuer's strategic ESG-related goals, how to realistically achieve them on a discrete time frame and how to avoid claims of "greenwashing."

Calibrating appropriate key performance indicators (KPIs) and sustainability performance targets (SPTs) is key to success and require collaboration among the issuer, its advisors and second party opinion (SPO) providers.

A new capital gateway

From 2010 to 2014, upstream issuers highlighted securing undeveloped acreage to demonstrate development runway and potential upside. After the steep decline in oil prices in 2015, messaging shifted to operational efficiency.

Many investors stepped back from energy following their losses during this period, particularly from high yield, based on economic concerns and policy decisions influenced by stakeholder mandates.

As commodity prices improved in late 2020 and have remained strong in 2021, the discussion has evolved to align with market emphasis on sustainability, while continuing to maximize efficiency in general. Equity (both institutional and retail) and debt investors are now prioritizing ESG-related goals.

As investor marketing messages have evolved in recent years, so too have sustainable financing products, including "transition" bonds used to fund a company's transition toward reduced environmental impact. However, investors and issuers took interest in these products in earnest upon the release of various ESG-focused financing frameworks by the International Capital Markets Association (ICMA).

The products initially available under these frameworks require sustainable use of proceeds, which inherently limits the types of industries that can access them. That changed in June 2020 when the ICMA released its Sustainability-Linked Bond Principles (SLB Principles).

SLBs are not only enthusiastically welcomed by investors but also incentivize issuers to achieve stakeholder-mandated ESG-related goals. Focused on achieving externally verifiable goals, SLBs are likely the most viable ESG-related financing product for the oil and gas industry.

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While some investor fatigue in the energy sector remains, SLBs appear capable of motivating investor engagement and tapping into new pockets of capital. This aligns with the mandate many institutional investors have to invest a certain amount of their portfolio in ESG-related matters.

By mitigating the hesitancy to invest in traditional oil and gas companies, SLBs could help the industry proactively respond to the broader energy transition.

SLBs do not eliminate the challenges that face the industry, and commodity prices are still volatile. But SLBs do address the investor mandate to increase operational sustainability or focus (particularly in the case of oilfield service companies) on increasing other companies' operational sustainability.

From an investment perspective, more appetite for energy market exposure creates downward pressure on pricing and reduces the cost of capital for companies, diminishing risk of future financial distress.

KPIs and SPTs

SLBs, unlike their older sibling, green bonds, do not require issuers to invest proceeds toward ESG-related matters. Instead, the SLB Principles focus on five core components: KPIs selection, SPTs calibration, bond characteristics, reporting and verification.

By pursuing an SLB offering, a company may achieve a lower cost of capital with an environmentally advantaged product, while also displaying to its stakeholders its ESG-related commitment.

However, because of both the ICMA's framework and some investor skepticism as to the validity of these goals in the financing context, KPIs and SPTs must be meaningful, impactful, quantifiable, externally verifiable and comparable against industry benchmarks.

Designing such metrics requires a collaborative triangulation of strategic considerations among the company, its advisors, SPO providers and a third party willing to certify the applicable SPTs (typically, the company's independent auditor). For oil and gas companies, it may also be worthwhile to separately engage with the SPO provider in advance to conduct a preliminary review of the issuer's ESG profile and get feedback on the viability of potential SPTs.

Energy-Focused Sustainability-Linked Bonds

Issuer	Date/Terms	KPI(s)	SPT(s)
NRG Energy Inc.	December 2020: $900MM, 2.45%, due 2027; August 2021: $1.1B, 3.875%, due 2032	Reduce GHB emissions.	Reduce GHG emissions to 31.7 million metric tons of CO_2 equivalent per calendar year or less by year-end 2025 (a roughly 50% reduction from 2014 baseline).
Solaris Midstream Holdings LLC	March 2021: $400MM, 7.625%, due 2026	Increase recycled produced water sold and reduce groundwater withdrawals sold, expressed as a percentage of bbl of recycled produced water sold per year/total bbl of water sold per year.	Increase bbl of recycled produced water sold to 60% by 2022 from a 2020 baseline of 42.1%.
Enbridge Inc.	June 2021: $1B, 2.5%, due 2033	GHG intensity level, tonnes CO_2e/PJ; representation of racial and ethnic diversity as a percentage of workforce; women on BOD.	Reduce GHG emissions intensity by 35% by 2030 compared to 2018 baselines; achieve 28% representation of racial and ethnic diversity in the workforce by 2025; achieve representation of 40% women on BOD by 2025.

First, a company and its advisors must craft a sustainability framework, including appropriate KPIs and SPTs designed to meaningfully improve its ESG profile. Avoiding any goals that would arguably have been achieved in any event is critical, lest they attract claims of greenwashing and broader market pushback.

The framework should then be reviewed by a third party willing to review the KPIs in the timeframe provided by the framework and certify that the SPTs have been met. While this third party is often an independent auditor, the process may prove challenging because such declarations do not typically relate directly to audited financial statements.

Finally, the company must work with an SPO provider to determine whether it can opine that the KPIs are sufficiently meaningful, impactful and quantifiable, and that the framework is consistent with the SLB Principles.

SPTs contained in an SLB's framework typically must be met significantly in advance of maturity (often 18 to 24 months from issuance). If the SPTs are not achieved by the verification date, there is typically a step-up in coupon and redemption premium.

The KPIs and SPTs need to stand up to investor scrutiny, as will the coupon and premium adjustments for failing to achieve them. This highlights the importance of collaboration between the company and its advisors to formulate appropriate KPIs, achievable SPTs and pricing terms that will appeal to investors.

Whether and which companies will be able to leverage SLBs remains unclear. Oilfield service operations, which are more emissions-intensive than upstream or midstream companies, may be better positioned to issue SLBs by featuring SPTs linked directly to their emissions.

Upstream companies face more challenges, but it is possible to design meaningful and impactful KPIs directly related to their operations.

Increased investor familiarity with SLBs during the past year has resulted in increased skepticism about whether SPTs were meaningful and aggressive enough that issuers would not otherwise achieve them, even without the motivation of the preferential pricing of SLBs.

The market demands ambitious SPTs, requiring organizational commitment to ESG-related goals. And investors may seek more aggressive changes to pricing and other bond characteristics to ensure this commitment.

The real world

The energy SLBs that are currently outstanding have not yet reached their SPT deadlines, so assessing any actual positive ESG-related impact may be premature.

Nevertheless, existing U.S. SLB issuances continue to trade well in the aftermarket. The market enthusiasm that has met many of these sustainable finance offerings—and the potential changes to the bonds' financial characteristics if ESG-related goals are not met—has rendered SLBs attractive to many potential participants.

Domestic energy SLB issuances are still nascent. And, if these initial SPTs are not achieved, investors may require additional changes to covenant packages or steeper penalties for future issuances to clear the market.

Outlook

SLBs may be helpful in optimizing a company's capital structure. But, despite positive investor sentiment, they are not likely a panacea for energy companies.

A successful SLB offering requires appropriate KPIs and achievable SPTs. Presently, the tailoring is more art than science—companies must remain nimble despite the ever-evolving process and market demands and consult early with outside counsel and opinion providers to assess whether appropriate KPIs can be developed.

In the future, there may be additional investor focus on what the SPOs are certifying as valid KPIs and, potentially, provide for more of a "stick" to issuers that do not achieve SPTs.

Investors are asking more detailed questions in the marketing process about how these goals would differ from the company's existing ESG-related targets, and to the extent the issuer is a public company, those targets likely are visible.

Nevertheless, given the potentially favorable pricing and the market enthusiasm to date, energy companies should be justifiably (though cautiously) encouraged about the possibility of SLB offerings. □

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