3 APRIL 2023

H2Global: The emergence of a new standard offtake agreement for synthetic fuels?

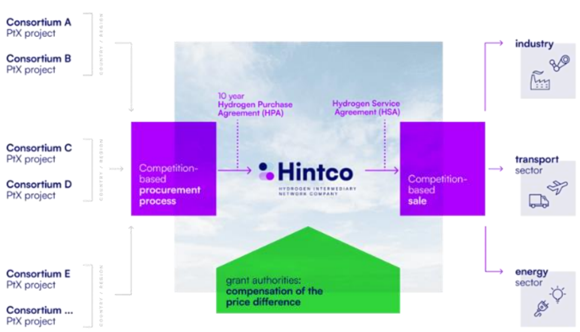
At the end of last year, the first auction round under the H2Global initiative for the purchase of green ammonia was launched, and evaluation of bids is now under way. With up to five offtake agreements expected to be granted in this first auction, and many more to come in the coming months and years, these agreements have the potential to become market-setting for these novel offtake products. As a result, the specific terms which H2Global is asking market participants to sign up to warrant scrutiny.

Background

Green hydrogen and its derivative products (such as ammonia, methanol and sustainable aviation fuel) are expected to play a key role in the energy transition, in particular in hard-to-abate sectors (such as heavy industry, long-haul transportation, etc.) where direct electrification is not yet possible or practicable. However, with some limited exceptions, the market for renewable fuels of non-biological origin (“**RFNBO**”) is not yet sufficiently mature to support the development of new projects without sovereign support, primarily due to the absence of clear and predictable long term market prices for RFNBO.

Creation and intended operation of the H2Global mechanism

Recognising this gap, the German Federal Ministry for Economic Affairs and Climate Action (“**BMWK**”) established the H2Global Foundation in mid-2021 to seek to accelerate the development of RFNBO production projects. The mandate of the H2Global Foundation and of the corporate intermediary which it has now established, the Hydrogen Intermediary Company GmbH (“**HINTCO**”), is conceptually simple, as illustrated on the chart below.



Source: H2Global

HINTCO will enter into 10-year purchase agreements with RFNBO project developers (“**Sellers**”) (including Sellers located outside of the European Union), under which HINTCO will agree to purchase certain quantities of RFNBO at a specified price, thus providing Sellers with sufficient offtake certainty to take a final investment decision in respect of their RFNBO production projects. HINTCO will then separately re-sell the RFNBO to European Union consumers (“**EU Buyers**”) under 1-year supply agreements, with any shortfall or loss of HINTCO being funded from grants made by BMWK (which has already earmarked €900 million for this purpose).

HINTCO would run auction processes both for the 10-year purchase agreements (granting purchase agreements to the lowest bidders) and for the 1-year supply agreements (granting supply agreements to the highest bidders), thus maximising competitive tension, and assisting in the establishment of a market price for the relevant RFNBO.

Whilst the H2Global initiative was launched by Germany’s BMWK, it is open to Sellers operating across the globe, and to EU Buyers located anywhere within the European Union.

HINTCO launched its first supply-side auction under the H2Global scheme on 30 November 2022, with bids to be submitted by no later than 28 February 2023, and the evaluation of submitted bids is now ongoing. That auction was for the purchase of green ammonia and it is anticipated that HINTCO will select up to five Sellers, with up to €360 million of HINTCO’s funds made available.

HINTCO’s proposed offtake terms

As part of the auction process, HINTCO published the form of the “Hydrogen purchase agreement (for the delivery of ammonia)” (“**HPA**”) which it intends to enter into with successful bidders.

As these HPAs are some of the first “standard form” offtake agreements for RFNBO projects with the potential to become widespread, their principal characteristics are worth scrutinising as they have the potential to shape the market approach (recognising, of course, that successful bidders will have an opportunity to negotiate these terms to an extent). We highlight below some of the specific features of HINTCO's proposed HPA.

Term and delivery window for RFNBO

The HPA is intended to be a 10-year offtake agreement for green ammonia products, with a specified delivery window commencing on 1 January 2024 and ending on 31 December 2033 (for the first auction window which closed at the end of February 2023). The short period between the proposed execution of the HPA and the commencement of the delivery window (a few months) is notable, as it would seem to favour projects which are already in the final stages of development as opposed to projects which require the HPA in advance of any final investment decision being taken.

Contract price

The HPA of course does not specify a contract price - this will be a key outcome of the auction process. However, the HPA usefully sets out how HINTCO intends bidders to bid for and construct the contract price, with this being divided across a number of separate categories, namely: (i) the product price, (ii) a transport charge, (iii) a logistics & dispatch charge, and (iv) allowances for export and import duties.

Interestingly, the transport charge is intended to operate as a "flat" representative figure of the cost to the Seller of the overseas transport of a tonne of RFNBO, which has implications in respect of demurrage and other variable shipping costs, discussed further below.

Risk and title to RFNBO, and applicable INCOTERMS

The HPA provides for optionality in terms of the responsibility for delivery of the RFNBO and the point at which risk and title to the RFNBO would pass to HINTCO.

The default position is that HINTCO will act as a "transparent" intermediary between the Seller and the ultimate EU Buyer(s), with the Seller being responsible for delivering the RFNBO directly to the EU Buyer(s) under the Delivery Duty Paid (Incoterms® 2020) model. The risk of loss and title to the RFNBO would then pass from the Seller to HINTCO and from HINTCO to the EU Buyer(s) simultaneously upon delivery to the EU Buyer(s).

However, HINTCO is reserving the right under the HPA to take over the transport element and to request a change to a Free on Board (Incoterms® 2020) model, under which HINTCO would have the right to designate a new port of delivery no more than 500 km away (via a direct line) of the Seller's production site, with risk of loss and title to the RFNBO passing from the Seller to HINTCO at that port of delivery and with HINTCO assuming responsibility for transport and delivery to its EU Buyers.

This optionality raises questions in respect of the necessary chartering arrangements to be made by the Seller, in circumstances where HINTCO could contractually demand a change to the transportation regime under the HPA part-way through the term, which could cause issues if the Seller has secured charters to fulfil its anticipated delivery obligations under the HPA. However, the HPA does acknowledge this indirectly, by providing that upon HINTCO exercising its discretion the parties would need to negotiate in good faith any amendments which might be necessary to the HPA, including adjustments to the contract price to reflect the changes in the Seller's costs for transport and logistics.

Delivery regime and take or pay obligations

In light of HINTCO's role as a "transparent" intermediary in the default scenario (as discussed above), the HPA includes a delivery regime in which maximum flexibility is afforded to HINTCO.

First, the HPA provides that the Seller must notify an exact delivery date to HINTCO and the relevant EU Buyer(s) at least 30 days prior to actual delivery, and provides an absolute right to HINTCO or the EU Buyer(s) to reject any delivery which is delayed beyond the notified date. In the event that the Seller fails to deliver the annual contracted quantities of RFNBO, the HPA contemplates that contract penalties would be levied and applied against the contract price (in quantities to be specified).

Further, the HPA provides that where delivery on the scheduled date cannot be effected for reasons not attributable to the Seller (including in principle where HINTCO or more likely the EU Buyer is responsible), the Seller must effect a second delivery attempt within two weeks of the first delivery date. It is only if that second delivery attempt fails that the Seller can trigger "take or pay" obligations under the HPA.

Under this "take or pay" regime, the Seller must attempt to sell its RFNBO at the highest available price (and preferentially to any HINTCO EU Buyer(s)), and in such circumstances HINTCO will be required to pay to the Seller the agreed contract price for the RFNBO less 90% of any revenues which the Seller has or could have obtained (presumably, in accordance only with its obligations in respect of offering the product to HINTCO EU Buyer(s), although that is unclear and thus of potential concern to the Seller) from such sales.

Looking at these provisions in the round, they appear to place a significant burden on the Seller, in particular in respect of the possibly harsh sanctions resulting from missing the delivery date even only marginally, and further in respect of the period between a first delivery attempt and a second delivery attempt, during which the HPA does not appear to contemplate any compensation being paid to the Seller in respect of demurrage or other costs which might arise (with the transport charge forming part of the contract price being set at a fixed amount per quantity of products transported, as noted above).

Product specification

One of the unique features of the HPA is how the RFNBO to be sold under it are regulated, as they must comply with three different sets of product specifications.

First, the RFNBO must meet technical product specifications (relating to the purity of the products and, in the case of ammonia, the temperature of the products at delivery).

Second, the RFNBO must meet additional product specifications relating to their renewable and emissions savings characteristics, under which (among other things) the production method of the products and the source of the electricity used to manufacture the products is controlled (with detailed rules governing the circumstances in which electricity can be treated as "renewable").

Third, and most interestingly, the RFNBO must meet additional sustainability requirements relating to the wider social and environmental effects of the RFNBO production project. These requirements include provisions (among others): (i) for the protection of dry regions, (ii) regulating the land use of the RFNBO project, (iii) prohibiting any forced resettlements, (iv) for the protection of biodiversity, (v) for the maximisation of local value creation and gender equality, and (vi) requiring the maintenance of high labour standards.

Compliance with the technical specifications is tested on each shipment and must be certified by an independent technical expert located within the European Union. Failure to comply with the technical standards enables HINTCO and/or the EU Buyer(s) to reject the RFNBO.

In contrast, compliance with the additional product specifications and additional sustainability requirements is to be monitored at periodic intervals by a conformity assessment body (**"CAB"**), with HINTCO being tasked with maintaining a list of approved CABs. The HPA currently appears to envisage that compliance would be tested at the beginning of the contract term, and thereafter at yearly intervals (for the additional product specifications) and every three years (for the additional sustainability requirements). Failure to comply with these specifications would result in contractual penalties being applied (and deducted from the contract price). The amounts of such penalties are to be agreed in the full HPA, although the draft contemplates that there would be (i) deductions of 10% of the contract price multiplied by each tonne of product failing to comply with the additional product specifications, and (ii) deductions of up to EUR 25,000 for each non-compliance with the additional sustainability requirements, with HINTCO determining in its absolute discretion the deduction to apply in each case.

These product specifications are a key area in which the HINTCO HPA is markedly different from previous standard offtake agreements for synthetic fuels which did not typically seek to import very substantial ESG requirements as key parts of and constraints unto the product specification. It is also notable that the HPA monitors the additional product specifications (in effect the "green attributes" of the RFNBO) contractually and without specific reference to the certification regime introduced at the European Union level for RFNBO (one might have instead provided that the RFNBO must meet the certification requirements applicable from time to time under European Union law). Considering that Sellers may be required to comply with other standards under their financing agreements (e.g. IFC Performance Standards or Equator Principles), careful management of these various sustainability requirements will be important.

Credit support

Another notable feature of the HPA is that there is no formal contractual guarantee or support given by the German state or the H2Global Foundation in respect of HINTCO's payment obligations under it. Sellers are therefore seemingly expected to contract with HINTCO on an implied understanding that the German state and the H2Global Foundation will stand behind HINTCO's obligations. By contrast, Sellers are expected to provide substantial performance bonds (or parent company guarantees, at HINTCO's election) to HINTCO for the duration of the HPA. It is anticipated that the quantum of these performance bonds will vary depending upon the scale of the contracts awarded, but the draft HPA envisages performance bonds of up to €50 million.

Conclusion: a developing landscape

The results of the first H2Global auction will no doubt be closely watched by industry participants. They may have even more prominence given the European Commission's announcement on 16 March 2023 that, in connection with the proposed Net Zero Industry Act, it is in the process of designing pilot auctions for the award of a subsidy to RFNBO producers in the form of a fixed premium per kg of hydrogen produced for a maximum of 10 years of operation. The Commission announced that the first of these auctions will be launched under the EU's Innovation Fund in the autumn of 2023, with €800 million being earmarked for the first round. Whilst the subsidy mechanism is intended to operate differently from the H2Global mechanism (with a fixed premium being paid rather than a complete purchase model), the European Commission may look to the H2Global model for inspiration in designing this mechanism.

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