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THE SHELL DECISION: AN INTERNATIONAL LEGAL NIGHTMARE FOR THE ENERGY INDUSTRY

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The Institute advocates that Australia must maintain a secure investment climate and be internationally competitive, whilst moving towards and contributing as much as it can to global efforts to build a low-carbon society.

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Key Points

- The decision of The Hague District Court against the Royal Dutch Shell Group, *Milieudefensie et al v Royal Dutch Shell* in May 2021 ('the Shell decision') has dramatically increased the risk of investing in greenhouse gas-emitting energy projects and transactions around the world. This requires a legislative solution.

- The Shell decision, coming in the same year as the 26th UN Climate Change Conference of the Parties (COP26), has signalled the start of a legal nightmare for policymakers and investors not just in the Netherlands but around the world.

- A process of decarbonisation is underway globally. It needs to be managed both domestically and internationally. At the same time, investments in carbon-intensive industries that are valuable to society and to the economies of many countries need to be protected. Investors cannot possibly rely on the uncertainty of judicial decision-making to provide them with investment guidance and investment protection. In any case, no government wants to be dictated to by foreign courts.

- A possible way forward for Australia would be to establish a licensing facility to authorise the discharge of greenhouse gas emissions by 'qualifying investments'. What investments might qualify, and what price and terms the government might require for use of a licensing facility, would need to be carefully weighed up and would take some time. In the meantime, the government, in the global climate negotiations, will need to take care not to expose its energy industries to unmanageable legal liability.

- An Australian licensing facility could channel its revenue into a Future Energy Fund, not unlike a sovereign wealth fund, which could in turn direct its capital to investment in low-emissions energy technologies.

Background: The Law of Tort and the Legal Duty of Care

In May 2021, the global oil and gas industry was shocked by a Dutch court's decision requiring the Royal Dutch Shell Group ('Shell') to reduce by 2030 its greenhouse gas emissions, and those of its suppliers and customers, by 45% compared to 2019 levels ('the Shell decision' or simply 'the decision').[1] The decision was based on the legal duty of care.

The decision was not confined to the Netherlands, nor to Shell's upstream operations, but required Shell to reduce its worldwide emissions at all levels. These comprised not only Shell's direct emissions from its production and use of oil and gas ('Scope 1 emissions') but also the emissions of its energy suppliers ('Scope 2 emissions') and the emissions of its customers around the world ('Scope 3 emissions'). Shell had reported in 2018 that 85% of its emissions were Scope 3 emissions.

Shell has announced that it will appeal the decision. However, an appellate outcome may take two or three years. Governments and investors should not be expected to sit around awaiting the outcome.

The Shell case was mounted by MilieuDefensie, the Dutch arm of the Friends of the Earth, and involved Greenpeace Nederland and several other non-government organisations (NGOs). The NGOs successfully argued there was a failure by Shell to perform its duty under Dutch law to take care of people who were likely to be harmed by its emissions, including people in other countries. The NGOs also sought to bring a class action against Shell for recovery of damages although this was not successful.

The Shell decision was based on the explicit responsibility to prevent harm under the 'unwritten standard of care from the applicable Book 6 Section 162 of the Dutch Civil Code'. This required an assessment of the legal duty of care when engaging in potentially harmful activities. An earlier case, known as the *Urgenda* case, whereby the Dutch Government was ordered to limit GHG emission to 25% below 1990 levels by 2020, provided precedent for a court-imposed obligation to reduce emissions.[2]

The Shell decision did not rely on any statute law or legislation of the Netherlands as host state but on its system of civil law. More specifically, the decision was based on what lawyers call the law of tort. Most legal systems around the world, whether they are civil law or common law systems, impose and enforce a duty of care. This is the case in Australia and its six constituent states, as well as in other federal jurisdictions such as the United States of America.

Only a few days after the Shell decision was handed down, an Australian court held that, under Australian law, the law of tort imposed a duty of care on the Minister for the

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[1] *Friends of the Earth Netherlands et al. v Royal Dutch Shell* (2021) Rechtbank Den Haag (Court of Justice, The Hague) ECLI: NL: RBDHA: 2021: 5339.
[2] *State of The Netherlands v Urgenda Foundation* (2019) Supreme Court of The Netherlands ECLI: NL: HR: 2019: 2006.

Environment not to cause injury to Australian children by facilitating the release of emissions (‘the Sharma decision’).[3]

It was predicted by this author in 2019 that an earlier finding of an environmental court in New South Wales would encourage climate change activists in all jurisdictions to consider legal action as a tool in the global campaign against climate change beyond whatever commitments their government may have made under the Paris Agreement. It was suggested that this warranted a re-examination by all governments of their energy and climate policies in the context of their bilateral and multilateral commitments.[4]

Sweeping Aside the ‘Development Bargain’

Australia is the host nation for a huge range of onshore and offshore fossil fuel investments which it has built up over two centuries. Shell has operated in Australia for 120 years where it has developed a huge, multi-billion dollar portfolio of investments in the production and export of natural gas, which it exports to major customers in Asia.

The Dutch court has now created a legal nightmare for investors in carbon-intensive industries around the world by introducing an additional category of investment risk - effectively intervening in the way other countries govern themselves environmentally.

In imposing an obligation on Shell as a major oil and gas investor to reduce its worldwide emissions, the Dutch court has swept aside the historic ‘development bargain’ between host states and investors for the development of natural resources. This historic development bargain revolved around the host state granting an investor the right to extract and remove resources in exchange for ‘production sharing’ with the host state, or payment to the host state of royalties on the value of the resources removed, and/or taxation on the investor’s profits. The development bargain bound the investor to comply with the host state’s environmental laws but it also provided ‘bankability’ for project development.

The Dutch decision did not involve any process of consultation or bargaining amongst those whose interests were affected, nor any change in international law or the laws of energy producing countries. On the contrary, the Dutch court has simply imposed an additional obligation on a Dutch energy producer.

Many energy export contracts will need to be reviewed and renegotiated as a result of the Shell decision. The decision could also have had a *force majeure* effect on existing export contracts by making it impossible for them to be performed profitably, although no outsider to those contracts would have any way of knowing at this point of time.

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[3] *Sharma v Minister for the Environment* [2021] Federal Court of Australia 560.

[4] Robert Pritchard, ‘*One Judgment Brings Upheaval for Energy and Climate Policy In Australia’*, Energy Policy Institute of Australia, Public Policy Paper 2/2109, February 2019. http://energypolicyinstitute.com.au/images/2-19_Robert_Pritchard_PP.pdf

It should be emphasised that the Shell decision was not a result of a quirk of the judicial system of the Netherlands. It owed its origins mainly to the delay of governments to mold their respective national energy policies to the objectives of the UN Framework Convention on Climate Change, that came into force in 1994, and the Paris Agreement, that came into effect in 2016.

In undertaking coal, oil and gas investments, investors, their suppliers and their bankers typically undertake a process of identifying all risks and allocating responsibility for these risks before making a final investment decision and before binding themselves contractually to proceed. The Shell decision has made this risk-allocation process more difficult and in some cases impossible to achieve. This has created a legal nightmare for investors, who typically would expend around a quarter of total project costs before making their final investment decision.

Governments, investors and communities will now need to collaborate more closely in working towards agreed solutions but collaboration may not be enough by itself - the ramifications of the Shell decision require a legislative solution.

Is There a Role for an Emissions Licensing System and a Future Energy Fund?

The Shell decision was not the first court-imposed intervention in the field of climate change. However, requiring Shell to reduce its ‘Scope 3 emissions’ has exposed present and future investors in all emissions-producing industries to the wider, more uncertain, and more unpredictable, risk of liability under the law of tort.

If the Paris Agreement were to become a legally-binding set of international obligations, participating countries could enact domestic laws to implement their pro-rata obligations. However, the prospect of this happening seem slim at the present time.

A national energy vision is needed. As the Institute has previously emphasised:

> *“A national energy vision is needed to guide the nation toward a reliable and affordable energy system whilst maintaining the nation’s energy export trade and pursuing greenhouse gas emissions reduction – taking community and stakeholder concerns into account.”* [5]

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[5] Energy Policy Institute of Australia ,submission to the Commonwealth Government, *“An Australian Energy Vision and Framework for Energy Policy Priorities”*, August 2016.
http://energypolicyinstitute.com.au/images/EPIA_Vision_Paper_August_2016.pdf

In Australia, various proposals have been put forward over the last decade to introduce carbon taxes as a measure to mitigate the risks of climate change. Yet, there have been many policy differences and policy failures at federal and state levels and no carbon taxes currently apply.

It may now be unavoidable for Australia to consider a legislative response to the Shell decision. Specifically, Australia may need to introduce a domestic licensing system to legally authorise the discharge of emissions that would allow ‘qualifying investments’ to continue while emissions are reduced in an orderly and affordable way.

The introduction of a domestic licensing system would raise the question whether the government might impose a licensing fee and what the government might do with the revenues. Could any revenues be paid to a Future Energy Fund dedicated to the further development of low-emissions technologies?

The current Australian government has described its current approach to climate policy as a ‘focus on technology, not taxes.’ In 2020, the government promulgated a ‘Low Emissions Technology Roadmap’ representing a statement of economic goals and support for five technologies that were prioritised for government financial support.

To complement the Low Emissions Technology Roadmap, a Future Energy Fund could invest entirely in emissions-mitigation and emissions-reduction initiatives. A Future Energy Fund would operate analogously to a sovereign wealth fund yet, as a point of difference, it could be co-funded by licensing fees from industry rather than be reliant on production royalties or taxation.

The essential feature of an Australian Future Energy Fund would see contributions from industry as offsets in a policy environment where carbon tariffs and carbon taxes seem extremely unlikely. Both the Australian government and industry need to work together in the pursuit of the common goal of decarbonisation in order that Australia can meet its Paris Agreement target of 26-28% reduction in 2005 carbon levels by 2030. It will be increasingly difficult for carbon-intensive industries in Australia to manage the broad-ranging risks of fossil-energy divestment, international GHG mitigation, and the need to decarbonise ‘hard to abate’ sectors.

The contributions of energy companies to a Future Energy Fund could be based on their respective volumes of emissions. Contributions to a technology-neutral, zero-emissions energy innovation fund could remain with fund trustees rather than disappear into public financial accounts.

A Future Energy Fund could also align Australia to the global ‘net-zero by 2050’ emissions target, which to date the Australian government has not directly committed itself to.

Although the Commonwealth has responsibility for the international aspects of Australia’s climate policy, including Paris Agreement obligations, self-governing state governments have set their own emissions reduction targets. Australia should not pursue an energy policy vision that diverges between federal, state, and territory policymakers or that may be subject to arbitrary change.

As a federal country, the Australian government would also need to design and implement a Future Energy Fund in such a way as to ensure that it is done with requisite legislative power under the Australian Constitution.

The Essential Need for Investors: Reducing Uncertainty

The Shell decision has sent an unsettling message to governments and greenhouse gas-emitting energy investors alike. It has created a legal nightmare for investors. Governments should not respond by picking technology winners or imposing arbitrary emissions reduction levels.

Legislation to reduce investment uncertainty in greenhouse gas-emitting industries, at the same time as reducing the rate of emissions in the broader economy, is called for.
The establishment by Australia of a legislatively-based emissions-licensing system and a Future Energy Fund would signal to the international community and to investors that Australia is willing to play a proactive role in promoting low-emissions technology as a contribution to the continuing climate challenge.

A Future Energy Fund could devote resources to innovation and emissions reduction. A Fund could concern itself with the broad spectrum of innovative energy technologies that address climate change risks. It would also address increasing stakeholder, finance and regulatory calls for emissions abatement. Some innovative technologies could reduce the rate of emissions; others could make the economy more resilient.

Conclusion

In May 2021, with the Shell decision, a Dutch court has swept aside the historic development bargain that has governed the resources development industries by requiring Shell to take account of the environmental impact of global greenhouse gas emissions. In the same month, with the Sharma decision, an Australian court held that a duty of care was owed by an Australian Minister to children who would be affected by the Minister’s decision to approve an extension to a coal mining project.

There is no escaping the fact that climate change is a pressing global problem that no country can solve on its own. However, every country must play an appropriate part.

In the lead-up to the Glasgow climate change conference in November 2021 and beyond, Australia will need to take care that its international commitments do not expose its economy and its energy industry to unmanageable and unaffordable risk.

The climate problem will certainly not be solved by exposing Australian industry to the uncertainty of judicial decision-making processes, whether they are domestic or foreign. Until an international treaty regime comes into force, necessary carbon-intensive industries in Australia will need legislative protection while the government designs an orderly and affordable emissions licensing system for qualifying activities. This could be facilitated by a Future Energy Fund as this paper postulates.

About the Author

Robert Pritchard is executive director of the Energy Policy Institute of Australia and managing director of ResourcesLaw International in Sydney. He has a lifetime of experience as a lawyer, company director and adviser to industry, governments and organisations on energy projects, policies and technologies. Pritchard was the first chairman of the Section on Energy Law of the International Bar Association and served for many years on the Finance Committee of the World Energy Council. He was the editor of 'Economic Development, Foreign Investment and the Law' (Kluwer Law International and International Bar Association, 1996). Pritchard is also chairman of the St Baker Energy Innovation Fund and SMR Nuclear Technology and a consultant to the Australian law firm Piper Alderman.