A practical guide to key climate change considerations for supply chains

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Climate change has rapidly transformed supply chains and project management. To address supply chain risk and build resilience, organisations need to understand and consider the key risks to supply chains and be proactive and innovative in their approach going forward.

Whilst it remains unclear where this transformation will ultimately lead, organisations need to consider that a traditional approach to supply chain arrangements may not be adequate into the future, particularly for arrangements over the medium to long term. New approaches should be explored, with careful consideration given to legal and contractual, technical, financial, policy and risk issues.

Supply chains are also increasingly affected by changing stakeholder requirements and expectations relating to climate change and environmental factors. This is often driven by customer, consumer and supplier concerns relating to their own environment, social and governance (**ESG**) objectives. Australia's commitment to the Glasgow Breakthroughs on near zero emission steel will increase this momentum.

These new pressures being applied by climate change impact key contractual matters in many different supply arrangements, including products and materials, and services ranging from professional services, to design, construction, operation and maintenance. These arrangements require the consideration from the perspective of both the suppliers, contractors and sellers (**Sellers**), as well as principals, customers and clients (**Purchasers**).

The purpose of this Guide is to help organisations determine if a new approach to supply chain arrangements is needed. Key factors for consideration include: the nature of the product supplied; the value at risk; and the time frames over which particular contracts operate. If an organisation decides that no change is required, this decision must be made consciously, rather than by default.

As we move into a future where the legal approach to supply chain arrangements remains unclear and it is essential for organisations to maintain open communication between the legal and non-legal areas of their business. Organisations will need to work collaboratively with contract counter parties and the industry to develop solutions, as the ability to think creatively, respond adroitly, acknowledge mistakes and reflect on lessons learned will be important for long-term success.

This Guide identifies the key risks that typically arise in supply chain arrangements, and offers considerations for both the sellers and purchasers. These issues are in five broad categories:

Quality

How does climate change impact the standards goods, services or materials (**Products**) must meet?

Assurance

What new type of information is required to verify delivery on climate objectives?

Price

How to respond to rapidly changing input costs?

Risk

What response is required to changing physical, human and financial risks?

Enforcement

Are bespoke remedies required to back up new climate obligations?

Quality

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Issue	Supplier considerations	Purchaser considerations
Fit for purpose In a rapidly changing and unpredictable world, what test should be used to assess the purpose of a Product? For example, is a HVAC system designed for historic temperatures going to be considered fit if temperatures increase? See further information here.	Consider defining purpose by reference to: • tighter specifications; • clarification of the parameters in which a Product is guaranteed to be usable; • a time at which purpose is assessed; • a time limit on any fit for purpose warranty; and • explicit carve out for adaptions required to address future climate change requirements.	If it is expected that a product remains fit for purpose in light of changes to climate, does this need to be made clear to avoid the argument that this requirement falls outside of the reasonable expected purpose of the Product. Consider the trade-off between over-specifying the robustness of the Product upfront versus planning for future retrofit to respond to different climate change risks as they eventuate? If yes, can the Product be designed initially to permit later retrofit more easily?
Best industry practices This, and like terms, are interpreted having regard to the current state-of-the-art technology in the industry being referred to. There is an open question as to whether they extend to climate change goals, especially at a time of rapid transition.	Consider the need to qualify the meaning of best industry practices to take account of any climate change goals.	If best industry practice is qualified at the outset, consider whether to incorporate a mechanism to confirm the relevance of new or increased climate change goals in future (depending on time frames for supply of the Product).

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Design Life The obligation to design a Product to have a particular warranty period, or useful life, involves assumptions about the conditions that Product will encounter over that warranty period or useful life. Assumptions about those conditions based on historic experience will not be readily extrapolated to changing future conditions.	As with fit for purpose obligations, consider tighter specification of the conditions against which design life is to be assessed.	As with fit for purpose, be clear if the Product design is supposed to accommodate climate change issues.
Reliance on standards Standards are typically based on analysis of historical data which often cannot be extrapolated to changing conditions and their associated 'fat tail' risks.	If Products are to be based on historic standards make this condition explicit and limit liability if the standards do not end up being adequate for changing conditions.	Consider specifying key output or performance criteria explicitly rather than relying on standards.
Duty to warn or advise Suppliers of Products typically know much more about the suitability of their Products for particular uses than Purchasers. Purchasers typically rely on the Supplier's expertise to advise them on suitable Products.	Consider advising Purchasers of the need for different specifications to meet the challenges of changing climatic conditions? Will this impact the competitiveness of one Supplier compared with another which fails to do this, if increased Product resilience comes at an extra cost? Alternatively, expressly limit the scope of any advice in respect of changing climatic conditions.	Expressly identify the need for a Product to respond to changing climatic conditions to ensure the Supplier turns its mind to these questions. Critically assess the Supplier's expertise to advise on the impacts of changing climatic conditions given their unpredictability in terms of nature, frequency and scale. What responses are available to mitigate the risk of the Supplier's advice proving to be inadequate?
Trade-off between production and design versus operation and use Achieving low embodied carbon goals depends on design and production but also use or operation of the Product. For example, a low embodied carbon material may be used in initial construction but if it needs to be replaced often, the overall lifecycle impact may be suboptimal.	Consider the benefit of fully informing Purchasers about whole of life accounting for embodied carbon issues to ensure they evaluate all alternatives on a like for like basis. Where the Supplier has made ESG commitments that incorporate whole-of-life considerations, it may be appropriate to impose restrictions on the Purchaser's use of the Product (e.g. through warranties) to prevent inappropriate use.	Consider carbon 'burden shifting' opportunities for Suppliers if whole-of-life embodied carbon impacts are not taken into account.

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Re-use obligations Increasingly it will be necessary to account for end of life reuse, recycling or disposal of a Product. If part of the strategy is to require Suppliers to build in capacity for such re-use, recycling or disposal, there is a horizon problem, especially for long life Products. For example, by the end of life of the Product the relationship with the Supplier may be long finished and contractual liability periods may have expired, with the result that the Supplier has limited incentive to deliver on this aspect of the Product. In addition, at the end of the Product life the specifications or standards for re-usability/ recyclability may have changed, making it easier or harder to reuse or recycle the Product.	To avoid the need to give extended warranties, consider what testing, certification or other assurance Suppliers can offer at the time of Product delivery about end of life aspects of the Product. Consider how any re-use/recycling obligation can and should affect price. Does it change the cost of production? What contingency should be included to allow for future uncertainty?	Contractual approaches may include extended warranties. The efficacy of extended warranties may be limited by their upfront cost, the credit support which stands behind them, limitations and exclusions negotiated to the warranties and the practical difficulty of establishing a breach after a long period since initial purchase due to intervening events. An alternative approach may be to require re-usability/ recyclability based on particular standards or specifications (bespoke or by reference to local/foreign regulatory frameworks). The benefit of this is that it would enable compliance to be verified upfront but the sufficiency of the prescribed approach in future will remain uncertain.
Relationship terms Contracts often use relationship or behavioural qualifiers such as obligations to: • act reasonably; • use reasonable or best endeavours; or • act in good faith. While the legal meaning of these terms is notoriously ambiguous, judicial consideration to date has assumed the intention of the parties was based on traditional business and commercial interests.	Until climate change matters become fully established as common consensus, consider clarifying that these type of terms are to be interpreted having regard to the parties' respective climate change goals.	As for Suppliers.

Assurance

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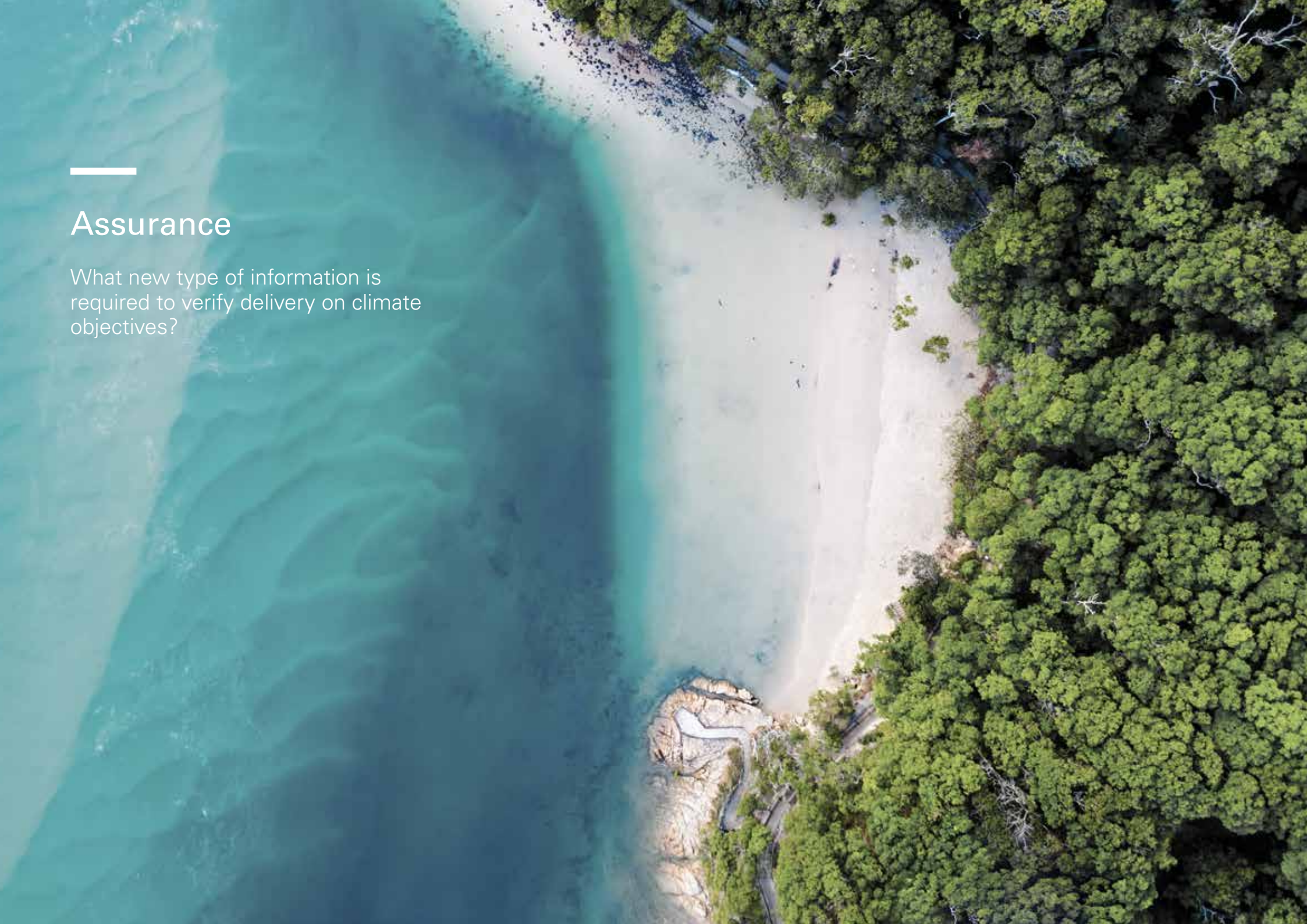

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Reporting and verification Accurate and trustworthy reporting on embodied carbon aspects of Products will become essential. If those Products are sourced from overseas, account needs to be taken of different approaches and standards in the countries of origin and transport impacts. This becomes even more complex when the same supply chains involve labour practice and other human rights risks and other emerging environmental concerns (such as the impact of micro plastics), each pressing concerns in themselves.	Suppliers should anticipate the increasing demands of key customers for detailed reporting on embodied carbon in contracts and prepare systems now to do this. Suppliers need to consider how they track embodied carbon aspects of their own activities and the need for independent certification and compliance with industry accepted standards. Further, for the Supplier's own supply chains for procuring inputs into their Products, Suppliers will need to ensure their sub-contractors supply accurate, trustworthy and potentially independently verified verification on embodied carbon matters. In the absence of Product specific information, industry averages may be used. If so, their use should be identified to the Purchaser.	Consider the need for a direct agreement with any independent certifier to ensure they owe a duty of care to the Purchaser to assess embodied carbon matters professionally and correctly. Consider independence issues especially if certifiers have a pipeline of work with Suppliers and the Purchaser only has limited need to purchase the particular Products. Particularly relevant where verification is market-driven and not formally regulated. Consider the need for independent audit rights of the Supplier's reporting or the right to require the Supplier to audit its own subcontractors. Especially for supplies over an extended period or in milestones, require periodic reporting.

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Use of the information provided Information relating to embodied carbon will become an important metric for target setting and reporting. This may raise questions of reliance, intellectual property rights and, as discussed below, confidentiality.	Consider the use that may be made of information provided to Purchasers regarding the embodied carbon aspects of Products supplied. If Purchasers provide this information to third party stakeholders (including investors, upstream customers and regulators), consider any direct exposure to those third parties for inaccurate reporting which is not covered by the liability limitation provisions of the contract with the immediate Purchaser. In the reverse, consider how the Supplier can use the information provided by the Purchaser. For example, what is the Supplier's exposure if it relies on assurances from the Purchaser as to how the Product will be used, but actual use differs?	Consider obtaining all necessary intellectual property rights to passing on, modifying or including information provided by Suppliers in the Purchaser's own reporting to its stakeholders. Consider the need for Supplier indemnities if inaccurate reporting by a Supplier leads to a third party claim against the Purchaser. Accurately reflect any conditions or limitation on the information provided by the Supplier when passing on that information to third parties.
Exceptions to confidentiality See further information here.	Acknowledging Purchasers are likely to need to be able to share embodied carbon reporting information consider any restrictions required (such as the need for third parties to sign confidentiality agreements) or presentation of information in a manner which protects against disclosure of proprietary processes to competitors. Alternatively, suppliers may have their own embodied carbon objectives, the need to report to stakeholders and the desire to publicise their progress on embodied carbon matters. Suppliers may need to establish a track record on embodied carbon matters to assist them in future tenders. Consider the need for an exemption from confidentiality and disclosure restrictions to permit this.	Consider the need to exclude embodied carbon reporting information from confidentiality restrictions to enable Purchasers to in turn report to their own stakeholders.

Price

How to respond to rapidly changing input costs?

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Rapidly fluctuating prices Climate change issues may impact disproportionally on the cost of some inputs which is out of alignment with general CPI or other inflation indices. This could arise in relation to high embodied carbon materials such as fossil fuel, steel, aluminium and cement through, e.g. regulatory intervention (such as taxes or increased regulatory standards) or supply shortages.	Consider: • targeted price escalation and cost pass through arrangements; and • risks in locking in commitments to sell Products without locking in downstream supply costs. Further, where downstream supply costs are locked in, consider how reliable that is – e.g. if price escalates dramatically it may affect the Supplier's ability to fulfil their contractual obligations. Consider the ability to deliver on fixed price commitments if the cost of the Supplier's own performed work is differentially impacted by climate change matters.	Consider whether it is value for money to have Supplier's seek to provide fixed prices for unpredictable cost increases? Consider alternative hedging strategies such as passing on costs to consumers.

Risk

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Engineer and designer liability Pivoting Products to have lower embodied carbon may require changes in design and use of different materials which do not have the long track record of traditional approaches and materials. If engineers and designers are being asked to push the state of the art to promote better embodied carbon outcomes, not all judgements will be perfect and in retrospect they may be faced with defending against criticisms and claims.	Consider the need to incentivise professional standards but at the same time not impose such risk that it stifles innovation.	Consider risk sharing regimes between the Purchaser, Supplier and third party engineers and designers which balances the benefits of progress on embodied carbon matters and provides good incentives without imposing unmanageable risks.
Consequential loss Parties seek to contractually exclude their liability for indirect and consequential losses with limited exceptions. It will likely be difficult to establish direct financial damages for breach of climate change obligations.	If the Purchaser requires carve outs, consider liquidating or otherwise defining the consequences of any breach of climate change obligations.	Consider express carve outs from exclusions of indirect or consequential loss for the consequences of breach of climate change obligations.

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Increasing physical risks Changing climate circumstances are likely to give rise to different, more frequent and more impactful events which prevent, delay or hinder the delivery of Products. Typically, contracts seek to allocate these risks through force majeure regimes. The scope of these regimes, and the processes to be followed if a risk arises, have been developed based on historic circumstances and are closely linked with the availability of insurance. See further information here.	Consider the need to revisit these regimes based on an uncertain climate future. Issues to consider include different physical events such as: • heatwaves; • bush fires; • drought; • air pollution; • salt water inundation; • increased storm, cyclone and flood events; • weather events impacting site access, transport or utility supplies; and • utility interruptions cause by any of the above especially transmission grid vulnerability. Also to be considered are any geographical limits on force majeure coverage. Remote sites at which supply chain activities such as component manufacturing takes place, may be critical and it may not be sufficient to concentrate solely on the main location at which the contract is to be performed.	If it is reasonable to expect force majeure events to be more frequent and severe, it may be more likely that Suppliers seek to get out of contracts based on the doctrine of frustration or other adjacent claims. Rather than the old style force majeure regime which provides for a fairly blunt binary risk allocation approach, consider if a different risk management approach is called for which better allows the risk to be addressed if it eventuates and the contract to continue. For example, through risk sharing mechanisms and/or engagement protocols.

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Human responses Frustration with lack of progress on climate matters will motivate stakeholder action to force change. This could take the form of: • protests which picket or occupy corporate headquarters or key work sites interfering with access; • vandalism and property destruction; • threats to officers or staff; • staff retaliation (e.g. disloyalty, strikes or an inability to recruit or retain personnel); • consumer boycotts; or • industrial action. These actions may be directed at Supplier, Purchaser or another level in the supply chain. These type of risks are not necessarily addressed in traditional force majeure or other risk allocation regimes and are often not insurable.	Consider the need to assess the impact of each of these types of risks and the allocation of risks of delay, cost and ultimately prevention.	As for Suppliers.
Bonding Provision of bonding from highly rated financial institutions is an often used approach to mitigating the credit exposure to a contract counterparty. For climate change exposed sectors bonding may become more difficult to obtain, either because the financial institution asked to provide the bond is seeking to disconnect with the sector or it is concerned with the underlying credit risk of the party procuring the bond and on its ability to repay the financial institution if there is a call on the bond.	Consider commitments to replace bonds during the term of a contract and what happens if the cost or the availability of those bonds becomes problematic.	Consider the trade-off between the implicit cost paid for provision of bonds and other security approaches such as retentions. Consider the efficacy of bonding to secure long-term obligations such as handover or end-of-term clean up, especially if the provision of those bonds is a future obligation rather than a condition precedent to the contract.

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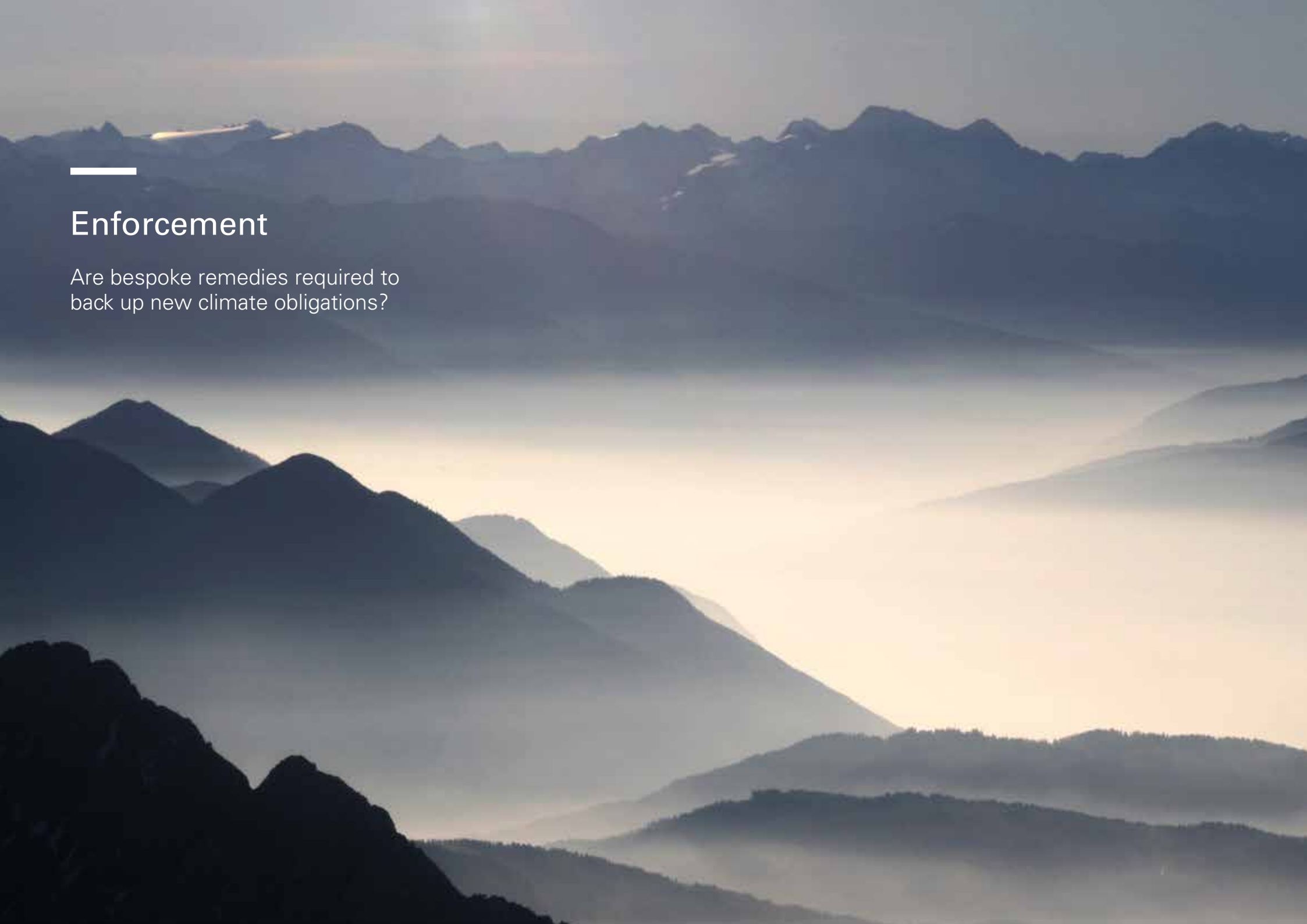
Insurance availability Climate change issues are impacting the availability of insurance. Insurers are seeking to disconnect with sectors which pose high climate change risks. They are widening exclusions (e.g. redesignating areas as flood or bush fire prone) or substantially increasing premiums for coverage. This may see parties forced to move to non-traditional insurance markets. This in turn demands greater attention on the credit standing of the insurers and the legal and political systems under which the insurance policy will be interpreted and enforced. Further, this suggests the need for increased focus on uninsurability regimes in contracts and their practical and legal efficacy. See further information here.	Consider the risks of locking in to particular insurance pricing or obligations to renew policies on terms which do not take account of market changes. Consider the robustness of insurance coverage in the face of wide scale insurance events. Rather than assuming any event may be restricted to the particular transaction or project, what happens if insurers face large claims across their policy portfolios all in a short time frame?	Consider the need for increased due diligence on Supplier procured insurance and the need for additional specifications as to the standing of the insurers used. Consider carefully the impact of expanding exclusions. Consider insurance renewal obligations and what should happen if insurance becomes unavailable? Where does the resulting residual risk lie?
Credit risk Rapidly changing climate change issues have the potential to affect the credit standing of parties. Stranded assets may materially change asset values and generate liabilities. The need for capital investment to transition to embodied carbon standards, policy and regulatory changes, litigation and changing terms on which capital and insurance are available may also be significant factors. The time scale and future impact of change may not be captured by historic financial reporting.	Is the Purchaser operating in a climate change exposed sector? What would happen if there is a systemic adverse impact on that sector? While the Purchaser's balance sheet may well address the potential liabilities under the contract viewed in isolation, would the Purchaser be able to meet liabilities if confronted with impacts across its business and other supply contracts? Consider the increased risk if the Purchaser is funding the purchase of the Product through limited recourse financing and is exposed to refinancing risk.	Consider looking deeper into credit ratings (e.g. S&P and Moody's) as a proxy for Supplier credit risk and consider their ability to track rapid climate driven changes in the Supplier's market sector. Critically review reliance on parent company guarantees. Do tests tracking credit standing over the term of a contract need to be introduced rather than assuming the credit standing of the parent assessed at the time of contract will be maintained? How would the parent's balance sheet respond to sector-wide shocks as opposed to liabilities isolated to one particular contract?

Issue	Supplier considerations	Purchaser considerations
Change in law, policy, taxes and regulator attitudes – both foreign and domestic It should be expected that there will be continuing policy changes as policy makers adjust to rapidly changing community expectations on climate change matters, including in relation to embodied carbon. This may take the form of changes to formal legislation and regulatory instruments and changing case law due to a shift in emphasis by courts. It may also manifest as changing policy from regulators either expressed in guidelines or standards or through a different consenting or enforcement emphasis. These changes may not be restricted to the jurisdictions in which the contract is to be performed but may be the result of foreign policy responses from other countries seeking to influence better climate change outcomes globally or level the playing field in their countries. Examples include tariffs, sanctions and boycotts. Finally, different tax changes may be used to promote ESG outcomes. See Corrs Insight article here.	Consider the need to be able to modify contractual obligations if required to respond to some or all of these type of changes. Consider increases in the cost of compliance, delays to compliance and potentially the need to change materially the nature of the contract. Uncertainty can also lead to regulatory delay (e.g. delay in granting approvals). Due to changes in law or the way the law is interpreted, it may be that continued performance of a contract becomes illegal. Are there changes which would justify termination? Many changes in law and policy regimes seek to exclude changes which a contract party could reasonably anticipate at the time of contract. Consider what this means in a rapidly changing climate change context or in circumstances where there is no general consensus as to what embodied carbon requirements will look like in future.	As for Suppliers.



Enforcement

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Practical steps The best remedy is to maximise the likelihood that a contractual obligation will be complied with. In a climate change context, this can be promoted by building in processes and capacities as contract requirements.	Consider including an ESG Officer in preparing tender responses. Consider the level of information required by accrediting bodies (e.g. Infrastructure Sustainability Council of Australia or Green Building Council of Australia) for the Supplier's particular circumstances before contracting to ensure this is achievable. Consider including an engagement framework in the contract to ensure a collaborative response to climate related disruptions.	Consider mandating that the Supplier include an ESG Officer in the management team with equal standing to other work stream leaders. Consider requiring regular reporting on embodied carbon matters as an integral part of normal reporting and contract management. Ask for information as to the level of training the Supplier provides for senior management on embodied carbon matters.
Expert determination Expert determination is often used to help resolve matters where particular expertise can be useful, such as technical, valuation and accounting issues. Consider whether experts would take account of climate change goals as well.	Consider making explicit the need for an expert to take account relevant climate change matters which are relevant to the matter to be determined.	As for Suppliers.

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Bespoke remedies for breach Traditional remedies, such as damages, may not be available for breach of climate change commitments in a contract. In particular: • there are difficulties quantifying the Purchaser's loss in dollar terms (for example, where that loss is damage to reputation or indirectly affects finance); • primary consequence of breach is the impact on the Purchaser's relationships with its stakeholder group; • external costs such as adverse impact on the environment or labour markets can be diffuse and not directly incurred by the Purchaser; and • the resources, costs and risks involved in pursuing a breach of an embodied carbon provision may be difficult to justify commercially against the primary objective of obtaining the Product. See further information here.	Consider what assurances the Supplier can give the Purchaser such as through certified quality assurance, periodic review by project management for both parties, audit rights and a strong track record in other transactions. If these provide the Purchaser with sufficient confidence it may be unnecessary to negotiate and price bespoke remedies such as liquidated damages or performance abatements.	Consider agreeing bespoke remedies such as liquidated damages regimes or performance abatements in the case of breach of embodied carbon promises.
Other Remedies Are there circumstances in which climate change considerations could shift such that it becomes highly detrimental to remain associated with the other party? Such circumstances could include class actions or other third party litigation, the imposition of government sanctions on dealing with the other party, illegality or significant reputational damage?	Consider the need for rights to terminate in these circumstances. Exercise of such a right may come at the cost of a termination payment to the other party. If yes, consider the merit in quantifying this amount up front rather than leaving an unquantified exposure which may make exercise of such rights commercially impracticable.	As for Suppliers.

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