ESG PACK FOR COMMODITY TRADERS

BY HFW IN ASSOCIATION WITH BARRISTERS FROM ESSEX COURT CHAMBERS

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ESSEX COURT CHAMBERS
BARRISTERS

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If you have any questions, please refer to the contributors' page.

INTRODUCTION

In recent years, we have become increasingly aware that the future of the planet and all those who live on it hangs in a delicate balance. To preserve that balance, we must learn how to develop a prosperous and sustainable society that can operate within our planet's limits. What's more, we must learn to do so quickly.

The recent UN Climate Change Conference (COP26) was yet another step in that direction. Tackling climate change will require an unprecedented and coordinated global effort. Nevertheless, climate change is not the only challenge we face. The United Nations Sustainable Development Goals remind us that there are many other areas in which we also need to make progress. These range from eradicating poverty to ensuring responsible consumption and production.

The challenges we must overcome to achieve these goals are complex and diverse. For the purposes of this pack, we have loosely grouped them under the umbrella term of environmental, social and governance issues ("ESG Issues"). This includes "green" issues such as halting biodiversity loss, but also social and governance issues like corruption and slavery.

ESG issues are acutely relevant to global commodity markets where there is an increasing focus on their environmental and social impacts. The picture is made more complex by long and convoluted supply chains, which can be opaque, obscuring problematic practices at the point of production. This is fuelling a drive for increased transparency in supply chains. Transportation of commodities also carries ESG implications, especially in connection with their carbon footprint.

There is no doubt that these changes are creating new legal risks, which may affect those producing, buying, selling and transporting commodities. As any business knows, it is important to understand these legal risks so they can be proactively managed.

However, legal tools can also be deployed to help create solutions. ESG issues carry both risks and opportunities. Innovative companies that remain ahead of the curve will be best placed to capitalise on these opportunities. Those who lag behind will be more vulnerable to the risks. In this pack, we want to introduce you to some legal ideas that will help keep you ahead of the game. We explore four areas that are relevant to any commodity trader: (1) sale and purchase contracts, (2) trade finance, (3) transport contracts, and (4) government regulation.

At HFW, we are committed to using our legal expertise to help our clients build more sustainable businesses. To this end, our pioneering sustainability initiative was launched earlier this year. We invite you to explore the Sustainably Hub on our website, as well as our recent report on the Future of Sustainable Business.

It is clear that we are living through a momentous turning point. This comes with significant risks, but also many opportunities for companies who are innovative and adaptable. We strongly believe that law can be a powerful tool for driving the positive change we need. We hope you enjoy this pack, and that it helps you consider the legal implications of ESG issues for commodity traders.

Brian Perrott

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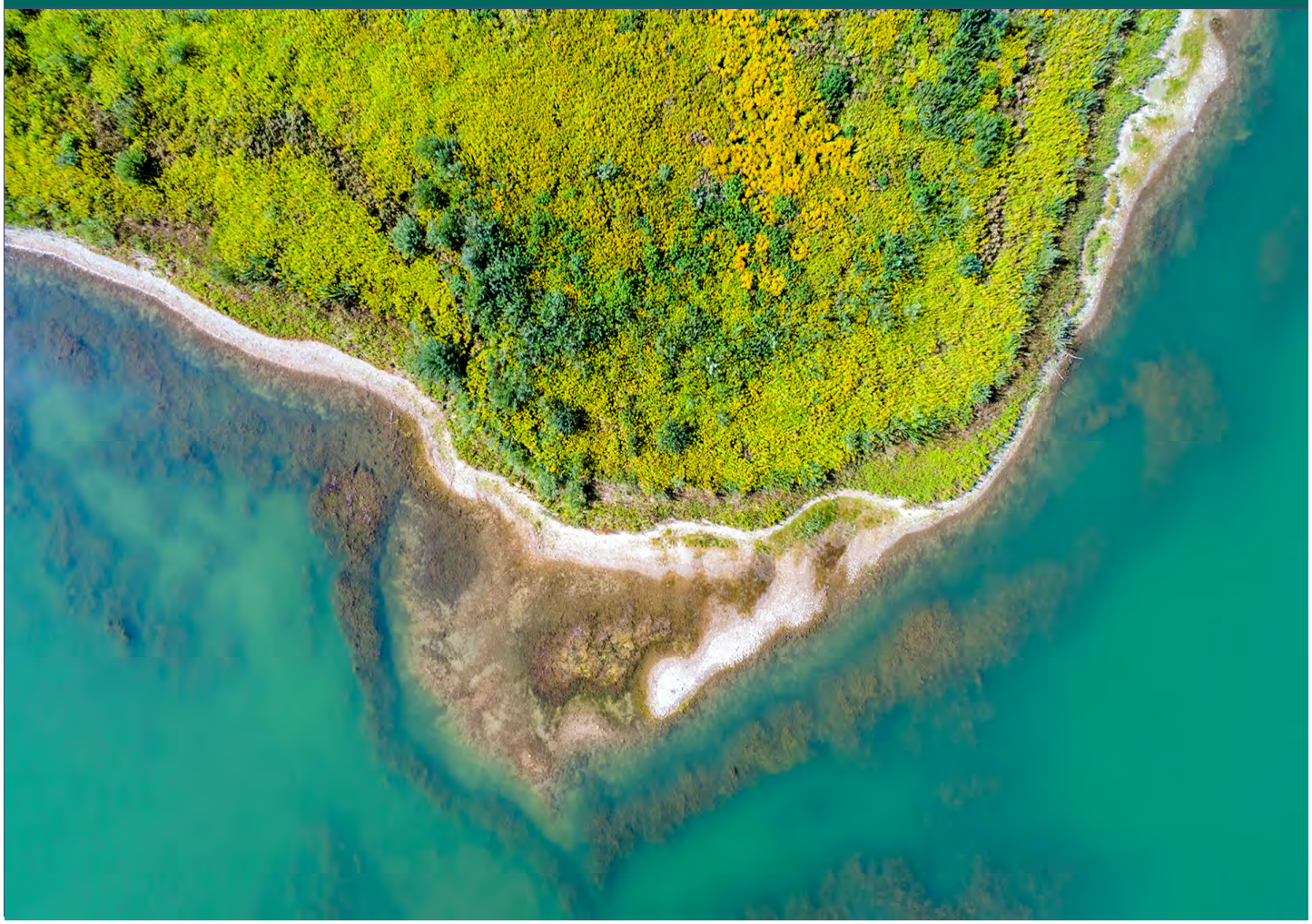
01

SALE AND PURCHASE CONTRACTS



CERTIFICATION

Sale and purchase agreements are at the heart of global supply chains, and it is therefore not surprising that we are seeing ESG provisions being included in more and more of these contracts.

Imposing obligations on a party brings with it the need to monitor and inspect compliance. When it comes to ESG issues, and convoluted international supply chains, monitoring compliance can be particularly onerous. To offset this burden, companies may turn to pre-existing and recognised sustainability standards and rely on certification bodies to verify compliance with those standards.

Certification Systems

There are many certification systems globally. Some focus on particular areas and others on specific markets. A company's choice of certification system will depend on the particular commodity, the company's sustainability goals and (often) its obligations to the next party up or down the chain.

By way of example:

- The International Sustainability & Carbon Certification[1] ("ISCC") is a globally recognised sustainability certification system for all feedstock and markets. The ISCC aims to implement ecological and social sustainability requirements, monitor greenhouse gas emissions and good management practices. The ISCC offers different certification products for different markets. To be able to use the ISCC seal/stamp, a party will need to choose a relevant ISCC certification, engage an authorised certification body (there are currently 36 authorised bodies), register with the ISCC and submit to an audit by the certification body based on the applicable ISCC certification and guidance. The certification body will then issue a certificate for ISCC to publish on their website.
- Parties in the soy market may look to certification systems such as the Round Table on Responsible Soy Association[2] ("RTRS") - a non-profit organisation that promotes the production and use of responsible soy. The RTRS promotes very high environmental standards, including zero deforestation and zero conversion, and has set wide-reaching social and labour requirements. RTRS offer different certification products depending on whether the applicant is a producer or a later link in the supply chain. The initial certificate will be valid for 5 years, but within that time, the certificate holder will be subject to audit(s) by the certification body.

Certificates and Sales Contracts

When buying certified commodities, it is important that the corresponding sales contract is adapted to reflect this. This is especially the case where sustainability issues are of significant importance to a company or their customers. The terms of the contract can bolster and reinforce the protection offered by certification regimes by creating specific obligations, which are enforceable directly between the parties. This will assist in providing a legal avenue for recovery if commodities do not fulfil the required ESG criteria.

If the agreement on certification is reached orally and/or prior to the conclusion of the contract, there is a risk that the inclusion of a general "entire agreement" clause elsewhere in the contract could strike out that prior agreement. "Entire agreement" clauses usually prevent the parties from relying on other agreements, negotiations or discussions, which are not expressed in the contract. This presents a risk that any oral or pre-contract agreements relating to ESG obligations that are not incorporated in the written contract fall away.

[1] https://www.iscc-system.org/
[2] https://responsiblesoy.org/?lang=en

However, if a party (such as a seller) makes an untrue statement for the purposes of inducing the other to enter into a contract (such as a representation that it holds a certain certification), the innocent party may still be able to make a claim in misrepresentation. In the absence of any specific wording, entire agreement clauses will generally not protect or shield a seller from misrepresentation claims.

Best practice is to ensure that an obligation for a party to hold a certain certification, or a product to be certified by a particular body is expressly written into the sale and purchase contract. The clause will need to be sufficiently detailed to ensure it is not at risk of being struck out as ambiguous or vague. A 2018 study found that the overwhelming majority of sustainability and corporate responsibility clauses incorporated into contracts were expressed in general terms, without any clear and precise scope or objectives.[3] Whilst the reference to an external certification regime may seem specific enough on the face of it, a certification system may offer many different types of certifications and a vague reference may be open to differing interpretations. Parties should also consider and make clear the related practical arrangements, such as when is the party required to be certified, if and when a copy of the certificate is required to be produced, additionally, who is responsible for the associated costs.

Objectives

Incorporating certification requirements may not only protect parties' commercial interests, but also encourage them to be conscious of sustainability issues. Nevertheless, these provisions will only make a difference if they are capable of being enforced and are actually enforced. The International Association of Contract and Commercial Managers reported that 73% of companies included sustainability clauses in their contracts, but 25% were not sure on their rights to terminate the contract in the event the other party was in breach.[4]

It is important for the buyer (being the party who is usually imposing a certification requirement) to make clear what protection it is looking to achieve. If the seller fails to produce a certificate in time, or if it is discovered that the seller has breached the underlying certification standards, what does the buyer want to be able to do? If the buyer wants to reserve the right to reject the goods, or terminate the contract, for a breach, the contract should expressly provide for this. If it does not, a buyer may be stuck with having to accept the goods at a discounted price and/or make a claim for damages – but neither may be enough when a company's reputation is on the line concerning ESG issues.

[3] https://www.eticanews.it/wp-content/uploads/2018/07/ecovadis_contrat_clauses_RSE__20.06.2018_eng_v5-1.pdf

[4] Ibid.

DISCLOSURE AND TRANSPARENCY

The need for greater disclosure and transparency in commodity supply chains is rising up the global agenda. Whilst legislative developments are on the horizon, companies can get ahead of the curve by beginning to consider disclosure and transparency in the context of sustainability now. With the potential to have an impact on entire value chains, this will be of relevance to all market participants, including those involved in the production, processing and trading of commodities.

Much will depend on the particular commodity in question. For instance, ESG considerations relating to soya beans will be different to those surrounding the mining of metals. Nevertheless, transparency is an overarching factor in determining whether a particular commodity is sustainably sourced.

Transparency is an important precondition for accountability and good governance within supply chains. Its absence enables opportunities for corruption, illicit business practices, mismanagement and unethical behaviour. In this section, we briefly explore supply chain transparency in the context of two specific examples or areas, namely illegal deforestation and modern slavery.

Deforestation

Four forest risk commodities sectors – cattle, palm oil, soy and timber – are driving more than 80% of deforestation worldwide. Whilst much attention has been drawn to the impact of palm oil in recent years, resulting in positive effects, cattle and soy production are far more land intensive. Cattle and soy supply chains, however, are often characterised by a particularly acute lack of transparency and traceability, and therefore represent high areas of risk for illegal deforestation. Around 11% of global greenhouse gas emissions derive from the felling of trees and the clearing of land, typically for agricultural purposes. The vast majority of this is illegal.

In this regard, legislative steps are being taken to address the issue. For instance, the UK recently passed the Environment Act 2021. Among other matters, the Environment Act 2021 aims to:

- Prohibit larger UK businesses from using commodities associated with wide-scale deforestation, and
- Require regulated business to establish a system of due diligence for each regulated commodity used in their supply chain, report on their due diligence, and introduce a due diligence enforcement system.

Additionally, the European Commission has introduced a draft law which would ban the import and export of certain commodities where they have been linked to deforestation. The draft law obliges operators to exercise due diligence prior to placing the relevant commodities on the EU market This has been further considered in a recent HFW Briefing.

Modern slavery

Approaches adopted in relation to social aspects of sustainability may provide a template for the environmental aspects. Recognising that companies have a role to play in combatting modern slavery and human trafficking, a number of governments have enacted legislation to impose improved, mandatory transparency obligations upon companies.

The UK's Modern Slavery Act 2015 requires organisations with a global turnover above £36 million to publish a slavery and human trafficking statement each financial year. The statement requires organisations to disclose the steps they have taken to ensure that human trafficking is not occurring within any part of their supply chains or businesses, or to state that they have taken no such steps.

Moreover, the statement may include information regarding organisations' supply chains, policies, due diligence processes, management of risk, and training.

Reporting obligations concerning modern slavery are also a feature of the California Transparency in Supply Chains Act 2010, and Australia's Modern Slavery Act 2018. Notably, however, France's corporate duty of vigilance law, introduced in 2017, covers a broader scope, requiring large companies to identify and prevent both adverse environmental impacts and human rights impacts.

Companies should consider including wording within their supply contracts to prohibit specified actions such as the use of forced labour. The mechanisms contained within or relating to modern slavery legislation may well be of relevance when considering how to address environmental issues, and, as above, further regulatory developments in this area are awaited.

Contractual toolkit

Practically, contracts represent a key instrument for companies who wish to take a lead and protect themselves against illegal deforestation and other sustainability issues. Contractual provisions have the power to transmit obligations to others, ensure that participants in supply chains become aware of their environmental impacts, and encourage positive behaviours. In contrast to most legislation, standards implemented via international commercial contracts are capable of extending and operating beyond borders and jurisdictions.

Examples of potential mechanisms may include:

- Provisions requiring counterparties to disclose certain types of documents or information, such as regarding the origin of a commodity or associated emissions, allowing for practices, policies and impacts to be assessed;
- Provisions requiring suppliers to not only hold certain certification documentation, or to ensure that products are certified, but also to provide copies of certificates obtained by each party from further up their supply chains;
- Provisions providing the right to move to greener suppliers to achieve sustainability objectives; and
- Provisions requiring suppliers to conduct carbon footprint assessments, warrant that projected footprints are accurate, and implement plans seeking to continuously reduce those footprints.

Ultimately, there is no single standard clause that should be incorporated – different approaches may be taken to address the issues at stake. However, in the context of a range of climate risks, efforts are being made to develop precedent clauses, which can be adapted.

Another item in the toolkit, which may be of particular relevance to the extractive industries, is the disclosure of agreements between companies and governments (where possible). This includes licences and impact assessments. For instance, Tullow Oil has opted to make its production sharing agreements with Ghana and Guyana available on its website.

A growing number of consumers and investors are expecting greater transparency in commodities supply chains, and non-governmental organisations may play a role in providing some of the information they desire. Considerations of quality and processes sit alongside prices and products. Companies that strive to meet such expectations may be able to strengthen public acceptance of their commercial activities and could better position themselves within their respective markets. In any event, however, legislative developments are, or will be, in the pipeline.

KEY DEVELOPMENT: BLOCKCHAIN TECHNOLOGY

Transparency is developing from a technological perspective. Relevant technologies in this space include electronic warehouse receipt systems, trading platforms and blockchain-based systems, which can improve efficiency and transparency within supply chains. Blockchain technology, for instance, has been applied to ensure the traceability of commodities such as gold, rice and coffee.

More generally, enhanced information gathering and traceability capabilities are important factors in the promotion of greater cooperation between supply chain participants. Blockchain underpins smart contracts, which may involve computer-coded legal terms and automated contractual performance. Smart contracts can enable market participants to track components or goods as they progress through supply chains, thereby enabling greater visibility.

Further, blockchain technology has been used to facilitate the transfer of electronic trade documentation such as e-bills of lading. Blockchain platforms such as Contour may provide greater transparency than conventional systems based on paper documents, for example by including auditable records of the ownership history of documents, and the changes that have been made to them.[5]

[5] https://www.contour.network/post/contour-partners-with-cargox-to-transform-bills-of-lading

REMEDIES FOR BREACH OF ESG PROVISIONS

Introduction

As we have seen, the increasing importance of ESG issues may lead to the introduction of new provisions into sale and purchase agreements. For example, a buyer may require a guarantee from a seller that greenhouse gas emissions in the production and transport of a product do not exceed a specified amount.

Nevertheless, what if a counterparty does not comply with this new provision? What remedies are available? Careful thought should be given to this in advance of entering into a contract. The value of any new provision may be limited if adequate legal remedies are not available.

Key questions to consider include:

- What are you trying to achieve by including this provision?
- What are the potential outcomes if the provision is breached?
- What losses would you suffer?
- Would monetary damages be a sufficient remedy?
- How easy would these damages be to quantify?
- If not, what other remedies may be available to you?

The answers to these questions will depend on company's objectives. Some sustainability provisions may be included to ensure a product or service complies with legal requirements, or because they enhance the value of the product. Others may be motivated by the values of a company and their voluntary sustainability ambitions. Such questions are therefore particularly important in the context of ESG issues.

We consider below some of the more common remedies, which companies may want to consider.

Damages

A breach of contract gives rise to a right to recover monetary damages, subject to any relevant exclusions or limits.

Damages are aimed at compensating an innocent party for the losses suffered as a result of their counterparty's breach. The aim is not to punish the party in breach. Generally, the objective would be to put the innocent party in the position they would have been in had the breach not occurred.

Damages may compensate for financial and material losses incurred. In principle, one may also be able to claim monetary damages for certain kinds of non-financial losses.

However, there are certain challenges whenever pursuing a claim for damages. For instance, it is necessary to establish causation, i.e. that the breach of contract caused the loss suffered. Furthermore, losses will not be recoverable if they are too remote from the breach of contract. It is also necessary to quantify the damages being claimed.

These challenges can be particularly thorny in the context of ESG issues. For instance, we are all negatively affected by climate change, but practically showing how specific greenhouse gas emissions have caused a particular loss can pose legal challenges. Quantifying those losses may be even harder.

Even if these hurdles are overcome, are monetary damages an adequate remedy? In many cases, the answer will be 'yes'. However, in cases where a company's values or reputation is at stake then

monetary damages may provide scant comfort. Furthermore, many kinds of environmental and social damage are not easily rectified after-the-event by financial means.

Bespoke Remedies

Of course, it is open to the parties to set out their own contractual remedies. This may be a useful tool if seeking to avoid some of the challenges outlined above.

One approach may be to expressly state the sum which will be payable if a particular provision is breached. These liquidated damage clauses can side-step many of the issues around proving and quantifying loss, as well as issues relating to remoteness.

Clauses of this kind should be carefully drafted. They must represent a genuine pre-estimate of the loss which is likely to flow from a breach. If they do not, there is a risk that a Court or Tribunal will consider it to be a penalty clause in which case it would be unenforceable.

Other tools which can be considered are indemnities, adjustments to price if certain criteria are exceeded, or provisions for a set fee to be payable if certain conditions are fulfilled. With careful drafting, contracts can be equipped with various mechanisms to support ESG objectives.

Termination

Sometimes it is necessary to pull the plug. However, the right to terminate does not arise automatically for breach of contract. A contractual party must commit a fundamental breach of contract or a breach of 'condition' which goes to the root of the contract.

Care should always be taken when terminating contracts as premature termination may be considered a repudiatory breach for which the terminating party is themselves liable.

Much of the uncertainty around whether a breach is serious enough to warrant termination may be rectified through well-drafted provisions. For instance, one can expressly state that a provision is a condition, breach of which shall entitle the innocent party to terminate the contract and claim damages.

Given that ESG issues can be linked to significant reputational risk, having the ability to walk away from a contract can be an important remedy.

Conclusion

In order to achieve both sustainability and commercial objectives, thought should be given in advance to what contractual remedies may be available.

These considerations will vary considerably depending on the type of contract in question, the sustainability issues at stake, and a company's objectives. Thinking pro-actively about these factors will put contracting parties on the front foot should issues occur during the performance of a contract. This section has provided a snapshot of some of the more common remedies but is by no means complete.

Having meaningful remedies can incentivise parties to abide by sustainability provisions. Clever drafting may therefore protect both commercial interests and broader sustainability aims.

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02

TRADE FINANCE

SUSTAINABALE COMMODITY TRADE FINANCE

The HFW Geneva trade finance team takes a look at sustainability from the perspective of commodity trade finance and discusses some of the challenges and trends that are starting to emerge.

Introduction

The commodity sector is almost uniquely exposed to ESG risks; according to S&P Global's Sector Risk Atlas, six of the top ten sectors most exposed to ESG risks are commodities-focused.[6] The risks include environmental threats from pollution, water use and greenhouse gas emissions, as well as human rights, health and safety and other social risks for workers and local communities affected by extraction, processing or transportation of commodities. The ESG exposures of the commodities sector, combined with society's appetite for commodities and the focus of investors on ESG issues, suggests that sustainable commodity trade finance (CTF) has a key role to play in the move towards a more sustainable commodity sector.

There are many challenges that are still holding back investors and the market. Are sustainably sourced and produced commodities more costly than products produced in less sustainable ways? This seems likely. Health and safety measures, risk assessments and environmental due diligence all come at a cost, as do efforts to assess, verify and certify the sustainability of commodities. There are also wider costs for society if sustainability risks are not addressed - these are the so-called externalities such as the costs to the environment, to communities affected by human rights failures and to future generations if we fail to tackle climate change. In the commodities value chain, there is not yet a clear standard on who should bear any of these costs but the commodity trade finance market is developing rapidly.

Regulatory challenges

Regulation might help the market "price" these costs and push market participants in the direction of more sustainable commodities. Governments and regulators are increasingly requiring sustainability risks to be taken into account by companies in their decision-making or disclosures, as discussed in more detail in Part 1 of this pack in the article "Disclosure and Transparency". However, the regulatory environment is still a work in progress in most jurisdictions and there are no settled global standards for commodity traders to look to. For an inherently cross-border sector like commodity trading, the lack of global standardisation in rulemaking is challenging and potentially costly from a compliance and risk perspective.

There are voluntary sustainability standards and frameworks that the commodities sector could turn to. However, the plethora of voluntary sustainability frameworks makes it difficult for market participants to know which standard to follow and for investors to compare sustainability risks even within the same sector.

Sustainable Commodity Trade Finance products

It is unlikely that any of these challenges will slow the shift towards sustainable commodities for long. Sustainable commodity trade finance may prove to be the tipping point. The banks involved in trade finance are increasingly under pressure from their stakeholders, including institutional investors, employees and activist shareholders, as well as regulators, to make sustainability commitments and

[6] https://www.spglobal.com/ratings/en/research/articles/200722-environmental-social-and-governance-the-esg-risk-atlas-sector-and-regional-rationales-and-scores-11582800

disclosures. This is driving a surge in banks offering their customers 'green' and sustainable finance products.

Green and sustainability-linked loans

Green and sustainability-linked loans are one such product which the commodities sector is embracing. Green loans are aimed at funding 'eligible' green projects; the loan proceeds are tracked to ensure this is the case. However, green loans are not just for 'green' companies. Any borrower is able to access the green loan market provided the loan is structured in the right way. For the commodities sector, this means that even so-called 'brown' industries can be eligible provided there is a suitable commitment to decarbonisation.

Whilst green loans are tied to funding for an eligible 'green project', sustainability-linked loans are more flexible. Loan proceeds are not tied to particular 'green' projects. This makes them attractive for traders wanting access to working capital facilities. Gunvor, a major energy commodities trader, renewed its USD 725 million sustainability-linked borrowing base facility in 2020. Trafigura, one of the largest commodity traders in the world, closed its first sustainability-linked loan in March 2021, a USD 5.5 billion syndicated facility with ESG targets related to cutting greenhouse gas emissions and responsible sourcing of metals. These types of loans are structured to incentivise the achievement of sustainability targets. Typically, if the borrower hits its sustainability targets, then it benefits from a reduced interest rate on its debt.

As the use of sustainability-linked loans grows in the commodities sector, we are seeing sustainability targets that are bespoke to the particular industry and ESG risks of the borrower. In the agri-sector, for example in the soy bean and coffee sectors, targets might relate to the traceability of supply chains and sustainability of farming methods. In the energy sector, targets are more likely to relate to environmental issues like carbon emissions and water management, but also social issues like safety of workers. In the second part of this section exploring Trade Finance, the Geneva HFW team discuss with Sucafina, a multinational coffee trader, the structuring of their flagship USD 740,000,000 trade finance facility, a sustainability-linked loan with sustainability targets relating to responsible sourcing and the advancement of coffee farmers in East Africa, as well as to the achievement of more carbon efficient and deforestation free supply chains.

Sustainable supply chain finance

Banks involved in trade finance are looking to roll out other products that might help meet their sustainability commitments. One example is sustainable supply chain finance (SCF). Under a standard SCF arrangement, a large buyer arranges with its bank to offer favourable payment terms to its suppliers. The bank agrees to pay the suppliers upfront for a small fee and the buyer repays the bank at a later date. Crucially the bank is only taking credit risk on the buyer, typically a large multinational with a good credit rating, and can charge a lower fee to small suppliers that may otherwise struggle to get good credit.

A sustainable SCF arrangement takes the standard SCF structure and adds a sustainability requirement. Typically, a buyer would require their suppliers to meet certain sustainability criteria before they can gain access to the SCF programme. This allows a large buyer to better manage the sustainability risks in their supply chains and to offer favourable terms to suppliers that can demonstrate sustainability commitments. So far, these products have been slow to take off, in part due to logistical and structuring challenges to get these programmes off the ground. However, a number of banks including ING and BNP Paribas are pushing ahead with sustainable SCF programmes. One

example is a pilot involving BNP Paribas and Unilever which aims to offer tea farmers in Malawi preferential payment terms.[7] The pilot uses blockchain technology to track and collect a range of sustainability data on the tea production. Because of the high level of assurance on the production, the buyer is able to approve a payment by the bank to the farmer at a much earlier point in the production, even before goods are shipped.

Sustainable Letters of Credit

Letters of credit, one of the oldest and most fundamental instruments in international trade, might also play a role in the shift to sustainable commodities. Under a pilot project run by the Banking Environment Initiative, the seller of goods must meet internationally recognised sustainability standards before it can get paid by the bank under a Sustainable Shipment Letter of Credit (SSLC).[8] The World Bank, through its guarantee program, has given its backing by offering pricing incentives to trade finance banks that participate in an SSLC. So far, only palm oil commodities with an RSPO (Roundtable on Sustainable Palm Oil) certificate are eligible but if SSLCs catch on the programme could be expanded to other commodities.

The Way Forward

Banks involved in sustainable CTF can benefit from efforts to improve the gathering and tracking of sustainability data in commodity supply chains. The World Bank hosts the GMAP tool which provides freely available data on the environmental and social risks of agri-commodities and maps sustainability certificates. Tools like this can help trade finance banks to set meaningful sustainability targets for their customers and to manage their own sustainability risks.

When it comes to regulation, efforts to introduce mandatory sustainability reporting and obligations have quickened. The UK was one of the first countries to adopt mandatory climate-related disclosures in line with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). For now, the rules, which kicked-in on 1 January 2021, only apply to premium listed companies on a "comply or explain" basis but the government intends to extend the rules to all large companies. Globally, the EU is leading the charge with a raft of sustainability policy measures and regulations, including rules on sustainability disclosures by the financial market and an EU-wide green taxonomy aimed at giving companies and investors a common language for managing sustainability risks. This is driven by the EU's ambitious action plan on sustainable finance and the European Green Deal which aims to create a path towards EU climate neutrality by 2050.

A global standard for voluntary sustainability reporting may be within reach. The International Financial Reporting Standards Foundation (the IFRS) recently announced the creation of the International Sustainability Standards Board. This could help make sustainability reporting more consistent and comparable, in a similar way to how IFRS accounting rules have made financial reporting more consistent around the world. Unlike the IFRS accounting rules, which are not followed in the US, there is a real chance that a common set of sustainability reporting rules could be adopted globally.

The ICC might also spur the market to adopt standardised rules for sustainable trade finance. In November 2021, the ICC announced a plan to create a new standard for trade finance transactions that would be based on the UN Sustainable Development Goals. The ICC has a long history of shaping international rules, having developed the Incoterms and UCP rules, standardised voluntary rules that

[7] https://cib.bnpparibas/blockchain-is-more-than-just-numbers-for-these-small-farmers/
[8] https://www.cisl.cam.ac.uk/resources/sustainable-finance-publications/sustainable-shipment-letter-of-credit

are used in millions of dollars' worth of international trade every day. Ultimately, the question is whether this will prove to be yet another standard that commodity traders will have to navigate, or whether this is a major step towards convergence on a globalised approach to dealing with sustainability issues in trade finance.

The really big news would be if global regulators are persuaded to offer capital relief for sustainable trade finance assets. If this becomes a reality, then sustainable trade finance as an asset class could really take off. For this to happen, regulators will need to be convinced that the risks of holding these assets really are lower than for their non-sustainable counterparts. If banks face lower capital costs for holding sustainable trade finance assets, then they will have more room to pass on the benefits to their trade finance customers.

Conclusion

With the global momentum generated by COP26, the shift towards sustainable commodities is building and it is unlikely that any of the challenges faced will slow it for long.

Sustainable finance is integral to that momentum and we expect to see new developments in the year ahead.

Client Insight: The Coffee Trader Perspective

The HFW Geneva trade finance team talks to Sucafina, a multinational coffee trader, about their sustainable finance initiatives and what their sustainability commitments mean for smallholder farms in East Africa.

It is quickly clear from discussions with Justin Archer, Sucafina's Head of Sustainability, that sustainability is not just a tick-box exercise for Sucafina. Managing sustainability risks in the coffee supply chain is critical for Sucafina, a family business established in 1905 in Jaffa, Palestine and now one of the leading coffee trading houses in the world, headquartered in Geneva, Switzerland.

Increasingly, sustainable Commodity Trade Finance (CTF) arrangements are used by traders and their investors to manage ESG risks. We had the opportunity to discuss with Justin what Sucafina's sustainability commitments mean in practice for the farmers in their supply chain and also some of the challenges Sucafina has faced in structuring its principal financing facility, a now USD 740,000,000 sustainability-linked borrowing base facility, with ambitious targets relating to responsible sourcing and the advancement of coffee farmers in East Africa, as well as to the achievement of more carbon efficient and deforestation free supply chains.

HFW: Justin, can you please tell us about your role as Sustainability Officer and why sustainability is important for Sucafina?

Justin: I've been at Sucafina for over three years working as Head of Sustainability. Coffee trading is a very unique business in that nearly everything we do has an impact on someone's livelihood, the land and the ecology that surrounds it. An estimated 125 million people make a living from coffee and the number is many times higher when you consider the employees of the various service providers that support our industry such as banks, logistics operators, insurance providers, and the like. In most cases, we are not directly responsible for the impacts created by coffee consumption, but as the crucial link between coffee producers and the rest of the market we certainly recognise that our leadership in sustainability has to be influential. Sucafina is a company whose mission is to be a leader in farm-to-roaster sustainability, and we continue to innovate – through the use of blockchain technology or the application of satellite mapping – to drive change in our industry.

HFW: How is sustainability embedded in Sucafina's financing facilities?

Justin: When we engage all parts of our business - in this case our Finance team - to think and act sustainably, it allows us to channel our energy and passion into actions that support the long-term growth of our industry and our company. Access to finance is the bloodline of the commodity business and it's therefore very empowering to see that our financial partners also share a strong commitment to sustainability. The emergence of sustainable financing is an additional incentive for companies to embrace corporate social responsibility but is also a way to accelerate the kind of transformation we think is necessary to support People, Planet and Profit.

Philippe Penet, Chief Financial Officer, adds that sustainability is at the heart of Sucafina's group strategy and that Sucafina believes that sustainable financing will become the norm with all stakeholders in the coffee value chain having a key role to play. As such, sustainability criteria in financing products for the coffee commodity sector will soon become a "must have" rather than "a nice to have".

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Philippe Penet, Chief Financial Officer, adds that sustainability is at the heart of Sucafina's group strategy and that Sucafina believes that sustainable financing will become the norm with all stakeholders in the coffee value chain having a key role to play. As such, sustainability criteria in financing products for the coffee commodity sector will soon become a "must have" rather than "a nice to have".

HFW: Please tell us more about the sustainability targets under the loan facility and how these were chosen?

Justin: Sucafina launched its first two-year sustainability-linked financing facility in 2019. The financing was structured to create incentives to achieve certain milestones linked to (1) responsible sourcing, (2) the capacity building of farmers and (3) the empowerment of women farmers in particular. The focal point for these activities was East Africa - because Sucafina has a unique history with the region, being one of the largest investors and exporters, and also because most East African producers are smallholder coffee farmers who are highly exposed to economic shocks and environmental risks.

Sucafina recently refinanced and increased this facility. As part of this refinancing, Sucafina has renewed its sustainability objectives, continuing with its objective to increase the number of certified farmers in its supply chain and adding KPIs relating to the reduction of carbon emissions and the monitoring of deforestation as part of its broader objectives towards more carbon efficient and deforestation free supply chains.

HFW: Can you tell us about the impact of the projects that Sucafina contributes to? How have farmers and communities benefited?

Justin: For responsible sourcing our goal was to increase the number of certified farmers that we work with by 5% each year. On capacity building, our commitment was to increase the number of farmers to whom we provide education and training by 15% per year. This work has been carried out by Sucafina directly or by its Kahawatu Foundation, which is highly active in Rwanda, Burundi and Uganda. For gender, our goal was to raise the profile of women - who do most of the farm work but typically benefit the least from coffee sales - by ensuring a higher representation of women in farm leadership groups and associations. All targets were met in 2019, as well as in 2020 - the worldwide disruptions caused by COVID-19 not-withstanding.

HFW: From the more technical side, can you tell us how performance against the sustainability targets under the loan facility is monitored and measured? What happens if Sucafina meets the targets, or conversely if targets are not met?

Justin: All targets relating to the advancement of farmers under the 2019 facility were monitored by a third-party assurance provider who audited our results by accessing our training databases and conducting physical and desk-based verifications. In the case of responsible sourcing, certificates of inspection issued by the various global inspection companies provide evidence of the increase in the number of farmers certified by Sucafina. Implementation of the environmental targets under the refinanced facility will be monitored by an independent third-party provider. The fee structure of the financing facility allows for a discount on the interest charged by the banks to Sucafina. Achieving all three targets attracts the biggest discount, whilst a failure to achieve any of the targets incurs a penalty. By agreement, any discount earned on the interest rate is re-invested in Sucafina's sustainability budget or donated to the Kahawatu Foundation to reinforce the company's overall sustainability.

HFW: What are the biggest sustainability issues facing the coffee industry over the next 5-10 years and how can the industry tackle these challenges?

Justin: The economic welfare of farmers continues to be a grave concern. As consumers we simply must be prepared to pay a higher price for our coffee, and we must ensure farmers receive a higher portion of the added value that is generated on their product. Better - and more stable - incomes are also a necessary pre-condition for improving human rights, not just for farming households but for the many migrants and casual workers who find seasonal work on farms. There is also an even sharper focus on the environmental sustainability of global farming practices - not just in coffee. The world is now, quite rightly, focusing very hard on 'net zero' strategies in terms of carbon emissions and the use of natural resources. For coffee this means more emphasis on regenerative agriculture, better risk monitoring of deforestation as well as strategies to reduce carbon emissions at the farm and logistics level.

HFW

03

TRANSPORT CONTRACTS

ENERGY EFFICIENCY: SLOW STEAMING

What and Why?

The IMO estimates that "*extensive speed optimization*" would be capable of reducing GHGs from shipping by up to 75% from 2008 levels.

The reason why such significant results are potentially achievable from slow steaming is that the relationship between speed and not consumption is not linear. Broadly, a percentage reduction of *x* in speed results in a percentage reduction of x^3 in emissions. A speed reduction from 20 to 19 knots may produce a 10% reduction in fuel consumption. The environmental group Seas at Risk has calculated that a 10% reduction in the speed of world fleet would result in a 19% reduction in CO_2 emissions, and that "*half of all ship greenhouse gas mitigation potential is in reduced speed*".[9]

Slow steaming began as a commercial response to high bunker prices and low freight rates after the 2007-2008 financial downturn. It started in the container market but has spread to tankers and dry bulk carriers. Cost of bunkers and oversupply of tonnage remain drivers, but environmental and regulatory imperatives have become equally important.

How widespread is slow steaming? Clarkson's and the UK Chamber of Shipping have published data suggesting that the speed of container ships has fallen by 25% since 2008. MAN Diesel & Turbo surveyed 200 representatives of the container, bulk and tanker shipping industry in 2011, and found that 47% of container fleet respondents and 80% of bulk vessel respondents were using slow steaming in some or all of their vessels, some of the time. Although market conditions have changed since 2011, it seems that the use of slow steaming remains widespread.

Challenges and Responses

Slow steaming presents technical, legal, and commercial challenges.

Technical considerations: The IMO noted in Circular MEPC.1/Cir 683, 17th August 2009, "*sailing at less than optimum speed will consume more fuel rather than less*", and "*[p]ossible adverse consequences of slow speed operation may include increased vibration and sooting*". The problems are not insuperable and have been addressed in part by new techniques and training for Chief Engineers, by engine retrofits and by ship design (most eye-catchingly Maersk's EEE-class of 18,000+ TEU container ships optimized for steaming at 19 knots). But these technical challenges complicate any attempt to introduce a mandatory slow-steaming regime.[10]

Legal considerations: Under a voyage charterparty or bill of lading there would normally be an express or implied obligation to proceed with the "*utmost despatch*", i.e., at full speed and by the shortest and quickest route: ***The "Hill Harmony"*** [2001] 1 AC 638. Intentionally proceeding at slow speed could constitute a deviation, risking the consequence that the owner becomes unable to rely on the exclusions and exceptions in the Hague Rules, thereby also losing P&I cover. Intentional slow steaming will not be excused under Article 4 rule 2(a) of the Hague Rules as an error in the navigation or management of the ship: ***The "Pearl C"*** [2012] 2 Lloyd's Rep 533.

The BIMCO Slow Steaming Clause for Voyage Charter Parties (2012) addresses this simply by providing that "*The Owners shall be entitled to give instructions to the Master to reduce speed or RPM (main engine Revolutions Per Minute) provided that the Vessel's speed, basis good weather conditions, shall not fall below [...] knots*"; and that where the vessel proceeds at a reduced speed in accordance with such an instruction, there will be no breach of the obligation to proceed with due / utmost despatch. It also obliges the voyage charterer to ensure that bills of lading include similar wording, and to

[9] https://seas-at-risk.org/issues/shipping/reducing-ship-speed.html.
[10] https://splash247.com/research-questions-the-validity-of-slow-steamings-green-claims.

indemnify the owner where this is not done. The conventional allocation of responsibilities is preserved, in that it is only the owner who can instruct the master to slow steam. The charterer's position is protected by the specification of a minimum speed. There is a sub-clause to make clear that this 'minimum speed' does not prohibit a vessel from steaming at a slower speed where required for normal operational reasons such as going in and out of port.

The BIMCO Slow Steaming Clause for Time Charter Parties (2011) includes similar provision to protect an owner from any allegation of having failed to proceed with due despatch. Aside from this, the clause provides that "*At all speeds the Owners shall exercise due diligence to ensure that the Vessel is operated in a manner which minimises fuel consumption*" (including by voyage planning, adjusting the vessel's trim and operating engines, and using voyage optimization and similar services if provided by charterers). The charterer is permitted to give the master slow steaming instructions, which must be in writing. The clause makes clear that the master's obligation to comply with such an instruction is subject to his overriding obligations in respect of vessel safety and protection of the marine environment. The BIMCO clause distinguishes between "*slow steaming*" (where the engines continue to operate above the cut-out point of the auxiliary blowers) and "*ultra-slow steaming*" (below that cut-out point). In either case, the speed must remain within the engine manufacturer's recommended parameters.

The BIMCO clauses appear fit for purpose. There seems to have been little if any reported criticism of them, and there are no reported court or arbitral decisions in which their application has been disputed. This may mean that the clauses are not being used but is more likely to mean that they are not causing problems. The scope of the 'due diligence' obligation to minimise consumption in the time charters clause may in due course end up being tested.

Commercial considerations: The considerations here are obviously specific to particular markets, cargoes and prevailing freight and bunker rates.

Slow steaming yields significant savings in fuel costs: in the region of USD$2.5 million on a single Europe – Singapore voyage for a large container ship. And its downsides (delay and increased fixed e.g., crew costs) may be limited, for some charterers at least. Maersk, for example, has reported benefits in announcing a slower schedule for its liner services but being able to compensate through increased reliability (since a vessel which was scheduled to slow steam can more easily make up time if required). The 2011 MAN survey mentioned above found that a majority (70%) of ship operators reported positive reactions to slow steaming from their customers, and (interestingly) that none had concerns about the impact of late delivery on sensitive or perishable cargo.[11]

As against that, there will be charterers for whom the value of the cargo and the importance of having it delivered quickly far outweigh the fuel efficiencies of slow steaming. And, clearly, slow steaming has not yet become universal, implying that existing market forces on their own do not currently make slow steaming optimal for all charterers.

Mandatory Slow Steaming?

There are moves at the IMO to introduce mandatory speed limits – led, interestingly, by a number of shipping companies in the bulk trades, with support from the French Government.[12] The proposal is

[11] https://www.swedishclub.com/upload/Loss_Prev_Docs/Machinery/MAN%20PrimeServ%20-%20Slow%20Steaming%20Rapport%202012%5B1%5D.pdf.
[12] https://www.lloydsloadinglist.com/freight-directory/news/120-shipping-companies-call-for-mandatory-speed-limits-for-ships/74260.htm#.YJgBmLVKiUk. The letter is available here: https://www.transportenvironment.org/publications/open-letter-imo-member-states-supporting-mandatory-speed-measure-reduce-shipping.

controversial and has been opposed by the main container lines. A speed limit would differentiate between sizes and types of ship and could take the form of annual average speed limits rather than a maximum that can never be exceeded. Any regulation would have to be framed in such a way as not to require inefficiently slow steaming (i.e., as a result of departing too far from the vessel's design speed).

The debate is beyond the scope of this section. Given the pressing ecological imperatives and the pressures likely to be brought to bear on the shipping industry by increasingly green-conscious finance, it is suggested that carefully-calibrated and sector-based regulation of shipping speeds should be welcomed, even if there are some sectors (e.g., perhaps the container industry) which can demonstrate good reason for remaining outside its framework.

ENERGY EFFICIENCY: VIRTUAL ARRIVAL

"*It is inherently wasteful for a vessel to steam at full speed to a port where known delays to cargo handling have already been identified.*"[13] 'Virtual arrival' is the logical response. At least, it ought to be; this section looks at some of the technical and commercial hurdles in the way of its more widespread adoption.

What is Virtual Arrival?

'Virtual Arrival' is a process of agreement between a vessel's charterer and its owner/operator, whereby the vessel's speed is reduced *en route* to a destination so as to arrive at (and not before) a particular required time. The resulting financial benefits are shared between the owner and the charter in an agreed proportion and methodology.

More specifically, 'Virtual Arrival Time' is the notional time at which a vessel is treated as having arrived at a destination. That contrasts with the 'Actual Time of Arrival' and the 'Required Time of Arrival' (both of which mean what they say, and ought to be more or less the same as one another).

When and why might Virtual Arrival be used?

The concept of a virtual arrival is only useful where there is a known delay at a destination (usually a discharge port). Its relevance lies with voyage charterparties rather than time charterparties, because 'arrival' is a concept with less or no financial significance in a time charterparty.

The concept can only be used where there is agreement not only between the owner and the charterer, but also involving the port / terminal authority, and potentially cargo receivers and other interests.

Virtual Arrival has the benefits of slow steaming, but (in theory) none of the disbenefits, since the premise of the arrangement is that the vessel will end up berthing at precisely the same time as she would have berthed if a virtual arrival regime had not been implemented. The emissions-reduction potential of virtual arrival has been calculated in the region of 5-20%. For a VLCC, this corresponds to savings of 77 tonnes to 226 tonnes of HFO per voyage, and bunker cost savings ranging from 39,000 USD to 105,000 USD per voyage.[14]

How does Virtual Arrival work?

The process involves the following elements:

- Identification of a delay at the destination.
- Agreement between relevant parties to implement virtual arrival, including (a) agreement of 'Required Time of Arrival' at the destination, (b) methodology for calculating voyage data and associated reporting requirements.
- Provision of information by the Master (as to bunkers & ETA etc.).
- Reduced speed by the vessel.

[13] Intertanko / OCIMF, 'Virtual Arrival: Optimising Voyage Management and Reducing Vessel Emissions – an Emissions Management Framework' (2nd ed, 2011). This excellent document remains a leading authoritative guide to how virtual arrival works, and includes worked examples of post-voyage analysis reports.
[14] Jia, H., Adland, R., Prakash, V., & Smith, T. (2017), 'Energy efficiency with the application of Virtual Arrival policy', *Transportation Research Part D: Transport and Environment*, 54, 50-60.

- Arrival of the vessel at the destination, where (for the purposes of berthing priority) she will be treated by the port authority as if she had arrived at the Virtual Arrival time.
- Post-voyage analysis by a Weather Analysis Service Provider ("WASP").
- Computation of a Virtual Arrival time.
- Use of the Virtual Arrival time to calculate demurrage.
- Calculation, agreement and sharing of savings in accordance with the agreed methodology.

The process therefore depends on a high degree of cooperation, and on trust in and expert use of weather routeing and other data. It is to that extent a 21st century response to a 21st century problem.

Legal Issues

The legal issues arising are the same as with slow steaming more generally, but with the added need to define a methodology for calculating the virtual arrival time and for calculating and sharing the resulting financial benefits.

Thus, the BIMCO Virtual Arrival Clause for Voyage Charter Parties (2013) includes the following elements:

- Right of the charterer to request the owner in writing to instruct the Master to adjust the vessel's speed to meet a specified time of arrival at a particular destination (subject to the owner's consent "*which shall not be unreasonably withheld*").
- Any extra time on the sea voyage to be compensated at an agreed percentage of the demurrage rate (50% in default of agreement to anything else).
- Parties to agree the amount of that extra time, with expert determination in default of agreement.
- No breach of the duty to proceed with due despatch, provided that the Master "*has exercised due diligence to comply with*" the instruction given to reduce speed.
- Charterers to include terms protecting owners in bills of lading, and indemnity owners to the extent of any additional liability they may incur.

The BIMCO clause does not provide for any sharing of the savings of bunker costs; by contrast, Clause 27 of BPVoy 5 provides for owners and charterers to share bunker savings equally.

Commercial Issues

To date, the use of virtual arrival has been disappointingly limited. This is on one level puzzling, given that virtual arrival ought to present a 'win-win': reduced fuel costs for owners and reduced demurrage and port costs for charterers, with no delay to the arrival of the cargo. There is no shortage of ports where delays are regularly encountered.

The reasons for this limited uptake have been explored in a 2019 paper based on interviews with shipping company managers and seafarers.[15] The authors identified three main drivers:

[15] Poulsen, René Taudal and Sampson, Helen 2019. 'Swinging on the anchor': the difficulties in achieving greenhouse gas abatement in shipping via virtual arrival.' Transportation Research Part D: Transport and Environment 73 , pp. 230-244. 10.1016/j.trd.2019.07.007 file.

- Virtual arrival is less attractive to a ship owner / operator than arriving at the earliest permitted time and earning full demurrage over any waiting period. (It may also be less attractive to the crew, who lose the 'catch up' time they would otherwise have had waiting at anchorage.)
- The financial benefits accruing to a charterer from virtual arrival may well be small or irrelevant by comparison with the potential disbenefits of a slow-steaming vessel encountering a problem and then arriving late (perhaps resulting in a refinery having to close), or the potential advantages foregone if a ship is physically present in port and a change to the berthing schedule means she can take advantage of an earlier berthing opportunity.
- Some ports will not accept a 'virtual arrival' as entitling a ship to a place in the berthing queue. Where there is uncertainty, a charterer will be unwilling to take the risk.

Ways Forward

The three obstacles identified above ought all to be capable of remedy. They are problems of coordination, communication and incentivisation, which can be mitigated if there is sufficient pressure on and within the industry to take appropriate collective action.[16]

The first point could be addressed by allocating more of the financial benefits of virtual arrival to the owner, or by wider measures such as carbon taxes which would increase the financial incentives of lowering emissions. The third point is challenging but could be improved by an agreement or set of standards binding or encouraging port operators to accept virtual arrival for berthing line-up purposes. The second point may be harder to remedy, but equally is unlikely to apply to all cargoes; and good communication and transparent processes ought to go a long way towards identifying when (exceptionally) 'hurrying up and waiting' will actually deliver commercial benefits as opposed.

It may be expected that as the pressure grows on the shipping industry to implement more stringent emissions reductions, the benefits of virtual arrival will come to look more attractive and its use will increase.

[16] For a recent detailed analysis of potential ways forward, see a 74-page paper by the IMO and others: GEF-UNDP-IMO GloMEEP Project and members of the GIA (2020) 'Just In Time Arrival Guide – Barriers and Potential Solutions'. The GIA is the Global Industry Alliance to Support Low Carbon Shipping.

IMO 2020 AND LOW SULPHUR FUELS

It has been nearly two years since the revised sulphur emissions regulations of MARPOL Annex VI, more commonly referred to as "IMO 2020", came into force. On 1 January 2020, the introduction of lower limits in relation to the sulphur content of marine fuels represented around a 70% reduction in aggregate sulphur oxide emissions generated by shipping.[17] However, further endeavours will still be required of the shipping industry to assist in tackling the ever-present issue of adverse climate change.

There are, in essence, two main regulatory aspects to IMO 2020:

- The first is that since 1 January 2020, the sulphur content of fuel oil consumed by vessels has been limited to a maximum of 0.5%. This is a significant reduction from the previous limit of 3.5%. Accordingly, vessels must utilise inherently low sulphur content fuel, or meet the requirement by way of an alternative exhaust method.
- Secondly, from 1 March 2020, there has been a prohibition on the carriage of fuel for marine consumption containing a sulphur content of more than 0.5%. The limits apply compulsorily to all vessels operating outside designated Emission Control Areas, in which a stricter cap of 0.1% applies. Given that IMO 2020 is applicable to MARPOL member states and flag states, it has, in effect, global application.

Compliance with IMO 2020 broadly involves owners utilising: (i) compliant fuels, such as very low sulphur fuel oil ("VLSFO") or marine gas oil; (ii) exhaust gas cleaning systems, commonly referred to as "scrubbers", which enable the continued use of heavy fuel oil ("HFO"); or (iii) alternative clean fuels, which include LNG, biofuels and fuels based on hydrogen or ammonia. The question of whether it is worthwhile for owners to invest in the instalment of scrubbers has been hotly debated. Whilst there was uncertainty surrounding the extent to which scrubbers would be employed, it now seems that the vast majority of vessels transitioned from HFO to VLSFO.[18] There remains a market for HFO, however, with demand deriving from vessels relying on scrubbers. In addition, refineries have developed new blends, producing compliant fuels by way of combining fuels of high and low sulphur content.

There had been much discussion, for example in the run up to the coming into force of IMO 2020, regarding potential commercial, legal and practical challenges that could have arisen for stakeholders. Indications suggest, however, that the transition to lower sulphur emissions was implemented exceedingly smoothly throughout 2020. For instance, compliant fuel was rarely unavailable, there were no related disruptions to global trade, and safety issues relating to VLSFO do not appear to have arisen. This represents a remarkable feat that is a testament to the extensive preparatory work undertaken by all stakeholders in advance of IMO 2020 coming into effect. The smooth implementation of IMO 2020 has resulted in an array of positive health and environmental effects. These include significant improvements in air quality and the prevention of acid rain and ocean acidification.

Notwithstanding the success of IMO 2020, however, the shipping industry has a continuing role to play in combatting environmental issues. Looking forwards, the IMO has set a target of reducing greenhouse gas emissions from shipping by at least 50% by 2050, compared to 2008 levels.[19] Meeting this target necessitates proactivity from the shipping industry in seeking out alternative, clean fuels.

Several options for such alternative fuels are being explored. Ammonia, for example, is one option that has been touted as a promising future "green" fuel. It has much to bring to the table – amongst other positive characteristics, ammonia is abundant, emits no carbon dioxide when combusted, and can be produced using renewable resources. Although the production of renewable (or "green") ammonia requires a significant amount of electrical energy, it is also said to be highly scalable. In comparison to

[17] https://www.imo.org/en/MediaCentre/PressBriefings/pages/02-IMO-2020.aspx
[18] https://www.imo.org/en/MediaCentre/PressBriefings/pages/02-IMO-2020.aspx; https://www.imo.org/en/MediaCentre/HotTopics/Pages/Sulphur-2020.aspx
[19] In addition to reducing carbon dioxide emissions per transport work by at least 40% by 2030.

hydrogen, ammonia is also less explosive, has a higher energy density (though still lower than conventional marine fuels), and is far more simple to liquefy for storage and transportation.

On the other hand, there are drawbacks associated with the use of ammonia. For example, although not highly flammable, ammonia is a very toxic substance, capable of causing fatalities in relatively low concentrations after short durations of exposure. It will therefore require specific handling and storage expertise, as well as auxiliary equipment. Whilst the combustion of ammonia does not release carbon dioxide, it releases nitrous oxides and therefore the exhaust will need to be controlled.

As with many new and developing concepts, however, there are currently numerous barriers to the widespread uptake of ammonia-based fuel. These include the need to establish the relevant infrastructure and protocols relating to its safe handling, as well as the fact that vessels are currently not equipped to use it. Further, there is a particularly crucial challenge to be addressed: the production of green ammonia via carbon-neutral methods is, at present, effectively non-existent. Despite there being uncertainty surrounding the availability of ammonia-related technology, this technology is said to be developing rapidly.

There are also regulatory factors to consider in relation to the use of ammonia as fuel, and the applicable frameworks will require development. The IMO's IGC Code, which provides an international standard in respect of the safe carriage of liquefied gases in bulk by sea, currently prohibits the use of cargoes identified as toxic products (which includes ammonia) as fuel. In the long-run, the IGC Code would require amendment so as to become more permissive, but in the short-run, such use would require approval from vessels' flag states. Additionally, organisations such as classification societies are seeking to provide guidelines to facilitate the development of ammonia-based fuel, and to shape new standards and rules.

Over the years, the shipping industry has been consistently steering a path towards greater environmental protections. HFO had traditionally been the dominant marine fuel, but that is certainly no longer the case. Looking beyond IMO 2020, the next steps will likely involve transitioning to cleaner fuels. Whilst this section has briefly touched upon ammonia as a potential option, there are of course alternatives in the running. We will be monitoring developments with interest.

HFW

04

GOVERNMENT AND REGULATORY

ESG AND REGULATORY DEVELOPMENTS

Investors are beginning to rely on ESG factors as non-financial indicators of companies' performance. However, one of the key challenges of relying on ESG indicators is the lack of standardised metrics to compare firms. Various jurisdictions have developed regulations, and environmental concerns related to the Covid-19 Pandemic have led regulators to compress the time scales for regulatory change. This lack of regulatory standards and time within which to make changes are disproportionately affecting mature commodities firms in that they have to adapt business models to comply with developing regulation without a clear picture of the requirements.

UK developments

There are numerous regulatory initiatives in the UK that are putting pressure on firms to reduce capital investment in carbon intensive projects and increase disclosure requirements. This therefore means that commodity trading firms cannot escape revealing their ESG positions. Initiatives include:

- The UK Stewardship Code 2020 ("**the Code"**) took effect on 1 January 2020 and sets out good practice for institutional investors, pension schemes and service providers (advisors, investment consultants and data/research providers). However, the FCA is considering expanding the Code to all listed companies which would have an impact on listed commodity trading firms. This means boards of these firms will have to consider ESG factors when allocating and managing capital and this will inevitably reduce capital investment in carbon intensive projects.
- The UK launched the Green Finance Strategy on 2 July 2019 as part of its target to reach net zero by 2050. The UK was the first major economy to set such a target into law. The UK Government intends to update the Green Finance Strategy in 2022. The UK also recently passed the Environment Act 2021, providing a legal framework for environmental governance. These new laws mean that commodity-trading firms will be legally required to meet government green targets in the lead up to 2050.
- On 9 November 2020, the UK Government's Climate-related Financial Disclosures taskforce ("**TCFD"**) published an interim report and a roadmap on mandatory climate-related disclosures in line with the recommendations of the Financial Stability Board's Taskforce on Climate-related Financial Disclosures. Mandatory disclosures for firms are expected to be in place by 2023.
- On 6 April 2020, the FCA extended the remit of independent governance committees ("**IGCs"**) on ESG and ethical issues. All regulated firms operating workplace personal pension schemes must establish and maintain an IGC and report on ESG issues. This is impactful as most commodity-trading firms operate a workplace personal pension scheme.
- On 1 July 2020, the PRA published a *Dear CEO* letter clarifying expectations for how banks and insurers approach managing climate change risks as set out in a supervisory statement (SS3/19). Firms must have embedded climate risk management by the end of 2021. These changes will mean that commodity-trading firms that rely on banks and insurers for their business activities will be required to provide information on their ESG practices so banks and insurers can make the required ESG disclosures.
- In November 2021, the UK hosted COP26, the UN climate summit in Glasgow. In the run up to COP26, the UK[20] brought forward a series of sectoral strategies and its overarching Net Zero Strategy to set out how it plans to meet net zero targets and carbon budgets. This significant focus on the UK (as the host) means that ESG initiatives have been at the forefront of government policy changes, which will impact trading firms. We can already see the impact of this as recent pressure

[20] See Energy White Paper announcement

on regulated firms, like banks, resulted in less funding to the commodity markets from traditional sources.

- On 19 February 2021, the UK Government announced it is investing £10 million in a new green finance research centre to advise banks, lenders and insurers on clean innovations and green technologies. Hubs will be in London and Leeds and will provide robust global climate and environmental data. These hubs will assist banks, lenders and insurers in evaluating the green credentials of technologies being pitched by commodity firms as emissions reducing, thus limiting the scope for passing off technologies as green when they are not (otherwise known as greenwashing).
- On 19 January 2021 the UK launched a consultation on plans to implement the carbon offsetting and reduction scheme for international aviation ("**CORSIA**"). The scheme's pilot phase began in 2021 and runs to 2023. The success of the aviation industry significantly affects the commodities market through the amount of fuel used and metal employed to build planes. If airlines are unable to offset their carbon emissions efficiently, they are likely to be negatively impacted – and we expect this will flow through to the commodities markets.

EU Developments

The EU plans to mobilise at least €100 billion over the period 2021-2027 towards the green economy, as part of the European Green Deal to be climate neutral by 2050. It includes a sustainability regulation package:

- Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (Disclosure Regulation).
- Regulation (EU) 2019/2089 amending Regulation (EU) 2016/1011 (BMR) which defines EU climate transition benchmarks, EU Paris-aligned benchmarks and sustainability-related disclosures for benchmarks (Low Carbon Benchmark Regulation).
- Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation) introduces an EU-wide taxonomy of environmentally sustainable activities, and new disclosure requirements for financial services firms and large public interest entities.

The aim of the EU Green Deal is to encourage investment flows from the financial sector to companies engaged in or transitioning to more sustainable activities so that the EU is carbon neutral by 2050. The EU Green Deal uses a mix of regulation and incentives to internalise the cost of pollution so that these costs are reflected in investment decisions, i.e., “polluter pays” principle. Regulation and incentive focuses on directing financing rather than limiting commodity firms' trading activities. In the commodities markets where the transition to a sustainable and climate-neutral economy is a significant challenge (e.g., fossil fuel mining and exploration), the EU is proposing mechanisms to support a transition by:

- giving grants to finance transitional products or projects;
- establishing a scheme to increase public investment in transitional products/ industries; and
- developing a new public sector loan facility with the European Investment Bank to mobilise concessional loans to the public sector to finance projects that do not generate sufficient revenue and that otherwise would not get financed without a subsidy element.

This EU support is a significant source of funding for commodities firms, however, commodities firms must be mindful to invest in the type of projects that will align with the EU sustainability goals.

A key aspect of the European Green Deal is the "Fit for 55" package of legislative proposals. This aims to align climate policies with ambitions to reduce net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels. A second tranche of proposals was released by the European Commission in December 2021, in relation to which a number of draft opinions and reports, covering areas such as the EU Emissions Trading System and Carbon Border Adjustment Mechanism, have recently been finalised.

US developments

Commodity firms trading in the US can expect new US ESG regulations targeting climate-related risk disclosures. The Biden Administration marks a potential turning point on climate change. On his first day in office, Biden signed an executive order for the US to re-join the Paris Climate Agreement. The US Treasury also plans to focus resources on climate-change related risks to the financial system. Last October going into COP26, Biden announced the Build Back Better Framework – the largest effort to combat climate change in American history.

Asian developments

Asia is set to become a hub for ESG trading and there have been large sums invested in developing the legislative framework to support these activities to attract customers to these markets. For instance:

- The Hong Kong stock exchange regulator introduced ESG-focused listing requirements, enhancing corporate governance and transparency, and updating its reporting guidelines.
- The Monetary Authority of Singapore laid out plans to invest US$2 billion in developing the country as a green finance hub and promote sustainable financing in the financial markets.
- The GPIF in Japan, the world's largest pension fund, is reported to be investing heavily in ESG and has pledged to be net zero by 2050.

UK CARBON TRADING

Emission Trading Systems **(ETS)** provides a framework under which governments reduce greenhouse gas and CO2 emissions allowances over time through forcing up the price of emissions via, amongst other things:

- cap and trade schemes where market participants are allowed to emit a certain amount of greenhouse gas within the cap and trade (buy or sell) emission allowances, as needed. By restricting the supply of emissions allowances, governments raise revenue by auctioning off credits and reduce the cap the over time, so that price rises cause demand and total emissions fall; and
- tax schemes which charge firms based on the amount of CO2 equivalents emitted. This additional carbon emissions tax encourages market participants to emit less.

The EU operates a cap and trade scheme and, following a consultation last year, the UK settled on a cap and trade scheme. This is a key component of the government's pledge to become net-zero by 2050.

Our regulatory team recently published an article on the UK ETS after Brexit. The UK ETS became operational on 1 January 2021 and largely works in a similar way to the EU ETS. The UK has stated ambition is for the UK ETS to be linked to the EU ETS as soon as possible. The UK Government is facing increased industry pressure to link the two schemes because, in leaving the EU ETS, the UK is exiting the world's largest carbon trading market. The industry has long argued that a standalone UK ETS is unable to deliver a sufficient level of liquidity for market participants to hedge their costs efficiently and this will ultimately be translated into higher carbon prices. After the end of the Brexit transition period, UK firms continued to purchase EU carbon credits in the expectation that the EU and UK schemes would be linked. However, UK-EU linkage negotiations are unlikely to result in linkage in the immediate future. As such, UK entities that had EU ETS obligations prior to 31 December 2020 had to comply with those obligations until the end of the Phase 3 compliance deadline of 30 April 2021, whilst incurring UK ETS obligations from the start of 2021.

Auctioning is the primary means of introducing emission allowances in the market. After much anticipation, the first UK ETS took place on 19 May 2021. The UK ETS has a transitional £22/tonne Auction Reserve Price (ARP) that establishes a minimum price for which allowances can be sold at auctions. Bids below that price will not be successful at auction. The Government does not intend to make any further changes to the level of the ARP before it is likely withdrawn as the UK ETS matures and aligns with a net zero trajectory. Since late last year carbon prices have surged with the EU ETS reaching €90/per tonne as the cost of carbon allowances rose on expectations that the EU would speed up targets for cutting emissions.

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