



IN THE ERA OF SUSTAINABILITY, CAN COMMODITIES JUSTIFY A GREEN PREMIUM?

Being green is different from being seen to be green. In the context of commodities that are green, this isn't currently being awarded, at least not consistently. Instead, more effort is going into being seen to be green.

This briefing argues that, absent regulation, without a premium being paid for greened commodity products, sustainability efforts will always be watered down in an effort to reduce the compliance and cost burden on the producer. This briefing argues that delivering environmental attributes is the key to justifying a premium for a commodity product, whether that is a carbon neutral commodity, a low-carbon commodity or a sustainable commodity.

Introduction

Environmental, Social and Governance (**ESG**) standards and practices are not new. However, since the global pandemic induced by COVID-19, ESG has been elevated into the mainstream as never before.

This is a good thing. However, the rush to embrace the ESG mantra, whether by policy makers, multinational corporations, small to medium sized companies, financial institutions, commodity producers or suppliers, has exposed ESG practices to a level of detailed attention and scrutiny that it has never had before. Overnight, the demand for ESG products and ESG themed commodities has skyrocketed. Commodity products now badge themselves as 'carbon-neutral', 'low-carbon', 'sustainable' or 'green' with a view to catering for this demand.

However, as the plethora of terms used highlight, it isn't always clear what environmental benefits are being associated with the commodity product to justify the badge. Why is a product called carbon neutral but not sustainable? What is the point of the product – is it to allow a seller to distinguish its product from the competition or is it something that genuinely benefits the buyer's environmental objectives? In what circumstances does a 'badged' commodity product justify a price differential (even a premium) over a non-badged commodity product?

What is driving the demand for carbon neutral commodities?

The failure by governments to demonstrate the requisite ambition to reduce greenhouse gases in a manner consistent with the objectives of the Paris Agreement, has forced civil society to take matters into its own hands. Large multinationals with global carbon footprints are making voluntary pledges towards becoming net zero or carbon neutral by 2050, along with setting interim targets for 2030.

These pledges invite the corporations to measure or assess their own carbon footprint, set

targets for reductions and deliver implementation plans to identify how such objectives will be achieved. Armed with the awareness of where their emissions are occurring, corporations seek to reduce the greenhouse gas (**GHG**) emissions for which they are directly responsible (i.e. their Scope 1 emissions) and manage the impact of the GHG emissions that arise as a result of activities that are caused by their supply chain (i.e. their Scope 3 emissions).

What are the different categories of lower or no carbon emission commodities?

It is in this context of the supply chain where the demand for lower or no carbon emission commodities arises. The idea is that if the reporting corporate can reduce its GHG inventory by purchasing commodity products with lower associated GHG emissions (arising from some reduction efforts by the producer or refiner), then that reduction in its GHG inventory helps towards the overall achievement of its carbon reduction interim targets (**Low Carbon Commodities**). For example, a car manufacturer might wish to purchase low carbon aluminium to use in the electric vehicles that it plans to produce¹.

A variation of this same idea is where the commodity itself doesn't benefit from any particular low carbon features (i.e. it is produced the way it has always been produced) but is sold as a 'carbon neutral' commodity relying on retiring carbon offset units against corresponding amounts of GHG emissions arising from the production and use of that product (**Carbon Neutral Commodities**).

Another type of commodity product is one that is produced according to certain voluntary sustainability standards. These may not be focused on the GHG emissions aspects but on other criteria such as environmental impact and biodiversity loss, or compliance with best practices on avoidance of using commodities to finance conflicts (**Sustainable Commodities**). Examples of this

include the London Metal Exchange (**LME**) applying responsible sourcing requirements to base metals pursuant to the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas (**OECD Requirements**) or palm oil producers ensuring their commodity is produced pursuant to the Round Table for Sustainable Palm Oil² standards. These commodities are in demand either because an exchange has required it (e.g. the LME's responsible sourcing requirements) or because the buyer of the retail product produced from that commodity wishes to make sustainable or ethical claims about their products.

Whether the commodity in question is sold as a Carbon Neutral Commodity, Low Carbon Commodity or Sustainable Commodity, a common question that applies to all is, do they attract a different price from the commodities in their class that do not carry the additional/notional environmental tag? We use the term 'greened commodity' in a generic way below to refer to one of a Carbon Neutral Commodity, Low Carbon Commodity or Sustainable Commodity.

What is a "Green Premium"?

Bill Gates recently defined a 'green premium' as "the differences in cost between a fossil-fuel-based way of doing something and the clean, non-emitting way of doing the same thing."³ Under his definition, a green premium tells the market how much more it will cost to reduce or eliminate emissions by switching to renewable energy in the production of a product.

Although that is a legitimate definition, it isn't one that we will rely on here. In the commodity trading context, a green premium may not only be measured via a direct increase in price of a greened commodity compared to a non-greened commodity but also as an avoidance of a discount for the non-greened commodity against the greened commodity. For example,

1 BMW's purchase of low carbon aluminium aims to reduce the company's CO2 emissions by 20% by 2030, with the aluminium going towards production of electric vehicles. "Harnessing the power of the desert sun: BMW Group sources aluminium produced using solar energy", 2 February 2021 at: <https://www.press.bmwgroup.com/global/article/detail/T0325353EN/harnessing-the-power-of-the-desert-sun-bmw-group-sources-aluminium-produced-using-solar-energy?language=en>.

2 RSPO Supply Chain Certification Standard, For Organisations Seeking or Holding Certification 2020 (Endorsed by the RSPO Board of Governors on 1 February 2020).

3 Bill Gates, 'Bill Gates: My green manifesto', the Financial Times, February 19 2021. See also Bill Gates, *How to Avoid a Climate Disaster: The Solutions we have and the Breakthroughs we need*, (Alfred A. Knopf, New York, Toronto, 2021).



as a result of the introduction by the LME of the application of the OECD Requirements to all brands listed for 'good delivery' on the LME against physically settled contracts (aluminium, aluminium alloy, cobalt, copper, lead, nickel, tin, zinc, etc.), the 'market price' for such 'sustainable' metals will be the LME price⁴ once the OECD criteria has been fully implemented.⁵ It is expected that metals that cannot meet that criteria will be sold at a discount against the LME market price. Arguably therefore, the effect of regulating the criteria for 'good delivery' of such metals may create a price differential between LME 'good delivery' grade and other metals where the only differentiating feature between the two products is the ability to satisfy the OECD Requirements.

This is not the case for every green product however. Anecdotally, we hear that large conglomerates with unequal bargaining power that fuel much of the demand for Sustainable Commodities, demand that their suppliers meet the relevant sustainability criteria without paying any differential to a market price. Essentially this is the equivalent of a producer of retail goods demanding that their suppliers' raw or refined products meet their criteria in

order to access the bulk purchase market that they dominate. This unwillingness to pay more for a product that satisfies particular sustainability criteria has often led to suppliers looking to water down their sustainability obligations. After all, why would a supplier take on greater obligations voluntarily that may, in turn, reduce their return; especially when the buyer isn't willing to pay for it? It may also explain why in some commodity sectors, there have been as many as seven different sustainability standards applied to a single commodity, with each standard reflecting a different point in the spectrum of obligations linked to sustainability criteria.⁶ This has led to confusion among market participants, a dilution of liquidity and, in some cases, accusations of greenwashing.

This challenge is not exclusive to Sustainable Commodities, Carbon Neutral Commodities suffer a similar fate but with more variations in theme. In some markets (e.g. where there is a glut of supply), sellers are seeking to differentiate themselves from other sellers by selling the commodity with a carbon neutral badge to achieve a marketing benefit. In such circumstances, the seller retires the carbon offsets and

bears the cost of doing so. But does the supply of such a Carbon Neutral Commodity really benefit the buyer?

Taking LNG as an example, at a molecular level, a carbon neutral LNG product supplied does not differ from ordinary LNG. So what exactly is the buyer receiving from the seller for which it should pay any more? Arguably, it is the benefit that the buyer attains from being able to claim that the purchase of the carbon neutral LNG has reduced its GHG inventory. From a GHG accounting perspective, if the commodity would have contributed a total of X tons of CO₂ equivalent once offset by a corresponding amount of carbon offset units, this should result in a GHG accounting number of zero in terms of that buyer's GHG inventory. Therefore, the material difference is the ability to recognise the lower carbon impact of that carbon neutral LNG in the hands of the buyer's GHG inventory. This cost is directly measurable in the price of the carbon offsets retired to achieve the carbon neutral claim. This price will be effected by the calculation of the GHG content of the LNG, the choice of carbon offsets used and the market price of such offsets. Clearly, where the buyer does not bear the cost of the carbon offsets retired,

⁴ The price for such metals that is published through the price discovery process on the LME for each metal.

⁵ The first reporting period runs for the calendar year 2021 but the LME allows some brands to follow alternative reporting periods. As such, it may be almost two years before clear price transparency for 'sustainable' metals is achieved.

⁶ For example, for palm oil there are at least seven such standards.

the seller is incentivised to use the cheapest carbon offsets available. Such offsets are often associated with the least environmental integrity, rather than those carbon offsets that might attract a higher price tag. A greenwashing concern may therefore arise in this context.

A similar principle will apply in respect of Low Carbon Commodities where a lower GHG discount (but a discount nonetheless) would be available to the buyer's GHG inventory as a result of the purchase of a Low Carbon Commodity. However, unlike Carbon Neutral Commodities, the cost of production of the low carbon product is not a simple measurement of the cost of carbon offsets. Factors such as whether the industry is subject to a regulatory obligation (e.g. refiners that are compliance entities within the EU emissions trading scheme) or if the reduction activity is done purely voluntarily, should feature as factors in the cost of production versus the environmental gain in that product and how that benefit should be valued. If there is a true environmental value gain⁷, would a producer not expect the cost that it has incurred to be rewarded by the market? For example, if a seller of bunker fuel were to blend the fuel with biofuels to create a lower carbon impact for the charterer of a vessel, the charterer would be expected to pay more for that bunker fuel than unblended bunker fuels.

As such, where we use the term **Green Premium** in this briefing, we do so recognising that it may be (i) a premium over other market products or (ii) an avoided discount against a market price (the latter being more likely where the product is regulated).

It is fair to say that there is little consistency in the market regarding whether greened commodities attract a Green Premium. For example, the increase in demand for low carbon aluminium in Europe has seen several deals creating premiums

of as much as US\$14 a tonne of CO₂ equivalent⁸. In contrast, the sale of the first carbon neutral certified oil cargo by Lundin Energy to Saras was sold at the regular market price, without attracting a Green Premium⁹.

We also recognise that mostly, at the molecular level, the physical features of a greened commodity and a non-greened commodity are the same. Hence it is legitimate to argue that the differentiating feature lies in the environmental benefit, whether that is in the form of a right to claim a discount on a GHG inventory or a right to claim that a retail consumer product is 'sustainable'. We therefore use the term **Environmental Attribute** in this briefing to refer to that key differentiator.

If the Environmental Attribute is the differentiator, is it the magic ingredient that justifies a Green Premium in a commodity product?

Transferring the Environmental Attribute

As the discussion above highlights, the Environmental Attribute will be different depending on whether a commodity is sold as a Carbon Neutral Commodity, a Low Carbon Commodity or a Sustainable Commodity.

For example, ArcelorMittal has announced that it will offer green certificates, called 'XCarb', to customers willing to pay a premium for low-carbon steel.¹⁰ By using renewable energy in production of its steel ArcelorMittal will reduce its Scope 1 and 2 emissions¹¹. Since ArcelorMittal's Scope 1 emissions are a buyer's Scope 3 emissions, a buyer will, through the use of this steel, benefit from a reduction of its Scope 3 emissions. This XCarb is not a carbon offset but simply a document from the producer confirming the lower CO₂ equivalent content of the steel sold. With the evidence of this reduced CO₂ content, the buyer is able to record a lower GHG inventory

amount for ArcelorMittal's steel compared to other steel. Essentially, in this context, that XCarb certificate seeks to evidence the steel's Environmental Attribute.

According to GHG accounting principles, the buyer cannot unilaterally reflect a reduction of GHG quantity on its inventory without evidence and justification that would satisfy a GHG auditor. If the XCarb is not acceptable to the GHG auditor as evidence, then arguably the Environmental Attribute has not been passed to the buyer and therefore, that steel cannot justify a Green Premium.

The same would be true of carbon neutral commodities. According to the rules of the most popular voluntary standards, as a general description, there is an assumption that the person from whose carbon registry account the offset credits are delivered (i.e. the account holder) for retirement by that standard's registry administrator, is the person who is associated with the benefits of that retirement (i.e. to claim that they have reduced a ton of CO₂ equivalent **(the Offsetting Claim)**). For example, under the Terms of Use of the VERRA registry, VERRA may retire a voluntary carbon offset, at the request of an account holder in whose "*account the unit is recorded to claim the achievement represented by the unit.*"¹² Where the retirement is by an account holder on behalf of a third party, there are express information requirements tied to the benefit of that retirement for that third party.

So, if the purpose of a Carbon Neutral Commodity is to enable the buyer to treat that commodity as zero in its GHG inventory, then a prerequisite to that is that the buyer of a Carbon Neutral Commodity should be entitled to make the Offsetting Claim. Whether the Offsetting Claim is a precondition or an additional element to the accounting discount of the GHG inventory, the Environmental

⁷ In some market segments, this is measured via concepts such as 'additionality'.

⁸ See Business Times article titled "European aluminium buyers are starting to pay up to go green", 8 February 2021 at <https://www.businesstimes.com.sg/energy-commodities/european-aluminium-buyers-are-starting-to-pay-up-to-go-green>.

⁹ See Cyprus Mail's article titled "Lundin sells its first 'carbon neutral' oil as climate activism grows", 28 April 2021 at <https://cyprus-mail.com/2021/04/28/lundin-sells-its-first-carbon-neutral-oil-as-climate-activism-grows/>.

¹⁰ See Reuters' article titled "Steelmaker ArcelorMittal steps up carbon-neutral push", 17 March 2021 at <https://www.reuters.com/business/sustainable-business/steelmaker-arcelormittal-steps-up-carbon-neutral-push-2021-03-17/>.

¹¹ We are not privy to whether the use of renewable energy falls within ArcelorMittal's Scope 1 or 2 emissions under ArcelorMittal's GHG inventory and therefore are unable to conclude whether this reduction is within ArcelorMittal's Scope 1 or Scope 2 emissions.

¹² Verra Registry Terms of Use, definition of "Instrument", accessible at <https://verra.org/wp-content/uploads/2019/07/Verra-Registry-Terms-of-Use-FINAL.pdf>. Last accessed on 17 May 2021.

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Attribute requires the buyer to have the legal benefit of the Offsetting Claim in a carbon neutral commodity. The Offsetting Claim, and therefore the Environmental Attribute, does not pass to the buyer of the commodity unless the carbon offsets have either (i) been retired by that buyer in its own account in the relevant standard's registry or (ii) been retired by the seller, in name of the buyer who is seeking to make the GHG inventory discounting claim.¹³ If a Carbon Neutral Commodity is not effective in passing the Environmental Attribute, why should it justify a Green Premium?

As the above examples highlight, the legal nature of the Environmental Attribute (the accounting discount on the GHG inventory) in the case of a Low Carbon Commodity may be different from the legal nature of the Environmental Attribute (the Offsetting Claim plus the accounting discount on the GHG inventory) in the case of a Carbon Neutral Commodity. Therefore, the method required to ensure the Environmental Attribute is effectively passed to the buyer, whether by contract or by law, will also differ between different types of greened commodities.

Unsurprisingly therefore, the value of each Environmental Attribute may also need to be priced differently.

Pricing the Environmental Attribute

As with all young markets, this market is very much in its developmental stage. There is currently a lack of consistency in

terminology used; difference in expectations and understanding between different market participants around how to build a greened product (especially around Environmental Attributes); difference of approach between different commodity types (e.g. LNG and gasoil may take very different paths to creating similarly intended products); a patchwork of voluntary and regulatory frameworks;¹⁴ and a lack of metrics to capture and calculate the value of Environmental Attributes.

This has resulted in multiple examples of different approaches being adopted in the market to develop greened commodity products. No doubt each example has something unique or different about it and time may judge their relative benefits and value. An indication of a buyer's willingness to pay a premium is a good first sign but whether that premium is objectively determinable is a harder question to answer.

For regulated 'sustainable' products such as 'good delivery' metals meeting the OECD Requirements, the differential to the LME price will be an objective measure since the LME price is transparent. However, for other commodities where the exchange traded price is not the sustainable commodity price, there is no transparent liquid price against which to compare the price of one green commodity against another, let alone a greened commodity against a non-greened commodity.

In the context of a Carbon Neutral Commodity, the problem is less acute because prices for the carbon offsets retired to enable the carbon-neutral claim are capable of being determined. Although the only way to discover the price of voluntary carbon offsets has historically been via carbon or commodity brokers¹⁵, this is changing. In recent times a number of platforms (such as CBL Markets and AirCarbon) have been established thereby creating opportunities for price transparency for voluntary carbon offsets. The CME has recently launched the Global Emissions Offset (GEO) futures contract which *"is a physically settled contract that allows for delivery of CORSIA eligible voluntary carbon offset credits from three registries: Verified Carbon Standard (VCS), American Carbon Registry (ACR), and Climate Action Reserve (CAR). Deliveries will be facilitated through CBL"*.¹⁶

The debate in the carbon offsets market is now focused beyond just the value of a ton of CO₂ equivalent reduced. The challenge there is in trying to determine the best way to attract value for the difference in offset project quality through the pricing of the relative UN Sustainable Development Goal (SDG) benefits that differentiate one voluntary carbon offset project from another. Generally acceptable metrics don't yet exist for that but are on the horizon for development. For example, the Institute of International Finance led Task Force for Scaling

¹³ If the GHG Inventory discount is permitted without the buyer having the benefit of the Offsetting Claim, there is a risk of double claiming.

¹⁴ As an exchange regulated by the Financial Conduct Authority in the UK, the LME is a self-regulating organisation for the purposes of the base and precious metals market it operates.

¹⁵ For example, brokers such as Evolution Markets.

¹⁶ See CME Group's FAQ on CBL's Global Emissions Offset (GEO) futures, at <https://www.cmegroup.com/education/articles-and-reports/cbl-global-emissions-offset-futures-faq.html>. Last accessed on 17 May 2021.

Voluntary Carbon Markets (**TSVCM**) is seeking to create Core Carbon Principles for voluntary offsets that have certain co-benefits that allow variation of pricing between carbon offset credits. These attributes will include many SDGs – for example, clean water and sanitation or affordable and clean energy. The price difference for contracts that track these Core Carbon Principles should enable discovery of some of these SDG elements. Indeed, a recent survey showed that in terms of Verra's Verified Carbon Standard (**VCS**), buyers were more willing to pay more for these credits where they also had Climate, Community & Biodiversity (**CCB**) Standard certification.¹⁷

Conclusion

Whilst we await the full spectrum of tools for pricing Environmental Attributes to develop, the current landscape of greened commodity products remains opaque. Whilst we cannot yet price all greened commodity products accurately, we can certainly build and create better

greened commodity products by recognising that:

- A greened commodity product that does not validly transfer the Environmental Attribute of that commodity product to a buyer has no basis to command a Green Premium.
- The legal nature of an Environmental Attribute will differ between different types of greened commodity products and therefore, the mechanism to effectively transfer that Environmental Attribute will also depend on that legal classification.
- The accusation of 'green washing' will increase in circumstances where the Environmental Attribute is weak or incorrectly described (for example, failing to recognise the difference between a Carbon Neutral Commodity and a Low Carbon Commodity or by achieving carbon offsetting through the use of carbon offset units that lack environmental integrity).

¹⁷ Stephen Donofrio, Patrick Maguire & Kim Myers, Ecosystem Marketplace Insights Brief, Buyers of Voluntary Carbon Offsets, A Regional Analysis, *Third Instalment of the state of the Voluntary Carbon Markets 2020, featuring European & North American Buyers Offsets prices, volumes and insights*, May 2021 at page 8.

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