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COMMODITIES BULLETIN NOVEMBER 2023

Welcome to the November 2023 edition of the HFW Commodities bulletin.

We have focused this edition on themes and issues with a decarbonisation focus in view of this month's COP28. At COP28 in Dubai, we will see the first global stocktake of the countries' progress towards net zero. In our first piece, Singapore Partner Dan Perera and Senior Associate Justine Barthe Dejean take stock of progress towards ending the use of coal and the factors which have helped and hindered this. In the context of mobilising climate finance, Geneva Senior Associate Jason Marett follows with a piece looking at the growth in popularity of sustainability linked loans, the regulatory response to the risk of greenwashing in this space and the new phenomenon of greenhushing. Regulatory legislation to accelerate progress towards decarbonisation is likely to be a key theme at COP28 and so we include two pieces on this: London Partner Diana France and I cover the implementation

phase of the CBAM, which began on 1 October 2023 and Singapore Associates Christopher Ong, Jefferson Tan and Farah Mahjid introduce EU ETS 2. Finally we look at the situation where good intentions by corporates can nonetheless be attacked by NGOs and regulators and corporations can find themselves defending such actions in court or before tribunals. London Partner Rick Brown and Associate Neil Chauhan consider steps that corporations can take to reduce this risk.

It only remains for me to thank the many clients who made such generous comments about our Commodities practice in the recent editions of the legal directories. We appreciate your support and are grateful to have received top rankings once again. We hope you enjoy reading this edition!

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KILLING COAL: EASIER SAID THAN DONE

Given that it accounts for over 40% of global greenhouse gas emissions from fossil fuel usage, reducing coal consumption is essential to reaching climate change targets, including those established within the Paris Agreement.¹ Notwithstanding this, global coal demand rose above 8.3 billion tonnes in 2022, making it a record-breaking year. Demand continued to grow steadily in the first half of 2023 and coal remains the main energy source for power generation (over 60%) and industrial use (over 30%) globally.

In this article, we consider why coal is breaking global consumption records despite all efforts at a multilateral policy-level to phase it out.

Regional differences

One main reason is regional difference in coal dependency. Emerging markets and developing economies were responsible for 50% of global coal consumption in the early 2000s; today, they are responsible for over 80%. In part, this is because coal consumption has (until recently at least) been on a steady decline in Europe and North America, with greener alternatives on the rise. The recent and rapid industrialisation of emerging markets (the BRICS economies in particular) is also partly responsible. China accounts for over half of global coal demand and in 2022, Indonesia's coal demand soared by around 36%, making it the fifth largest coal consumer globally, largely as a result of its rapidly-developing steel and metallurgy sector.

It is difficult not to see the challenges of phasing out a commodity that is such a fundamental driver for fast-growing emerging markets. Dislodging such a deeply embedded energy source, within even new infrastructure, will require mobilisation of significant levels of climate finance (e.g. via the deployment of renewables) to catch up with existing and future energy demand.

The impact of geopolitics

The global energy crisis of 2022, triggered by the Russian-Ukraine

conflict, boosted coal consumption for a number of reasons:

- Having lost access to Russian natural gas, Europe entered into competition with the rest of the world for LNG and was better placed to outbid and divert this cleaner energy source from less wealthy competitors, particularly in South Asia. As a result, a number of Asian countries faced significant energy security challenges and responded by scrapping or pushing back their energy transition commitments and boosting their coal-fired power capacities. Indonesia and Pakistan are notable examples.²
- Energy security concerns reignited coal consumption in Europe too, with Germany in particular bringing several coal-fired units back online.³
- In Australia, the Albanese government has been approving both the expansion of existing coal mines, and entirely new mines, despite the protests of activists⁴.

Innovation, investment and infrastructure challenges

There are some deeply entrenched barriers to phasing out coal, relating to innovation, investment and infrastructure. Often, these are more of a challenge for developing economies.

- It is estimated that more than USD \$1 trillion of capital is yet to be recovered from the approximately 9,000 existing coal plants globally. Three quarters of these are located in developing economies, most of which are recently built (many in South Asia as part of China's Belt and Road project) and have not yet achieved a return on their initial investment. The geographical differences are stark here: the average coal-fired power plant in developing countries in Asia is less than 15 years old, compared with over 40 years old in North America. Over half of coal-intensive industry sector assets such as blast furnaces and cement kilns are less than 20 years old and are unlikely to undergo any major refurbishment

or repurposing where the switch to cleaner power generation or industrial processes (to co-fired biomass or ammonia for example) could be made. The scale of existing investments and interests are a powerful incentive for a status-quo, at least until the end of these investment-cycles.

- In some heavy-industry sectors, clean and affordable alternatives to coal are not yet readily available. For example, steel and cement are made mostly from burning coking coal, which has a very high carbon content. This process cannot yet be easily and cheaply replaced with cleaner energy sources, despite the efforts of major market participants⁵. To give an order of magnitude, carbon emissions from steelmaking and cement production in China alone are estimated to be higher than the European Union's total carbon dioxide emissions. In these industries, replacing coal requires rethinking entire industrial processes and will depend on technological innovations to offer realistic and affordable clean alternatives.
- Switching to alternative energy sources which generate lower emissions also requires heavy investment: for example, LNG receiving terminals are costly to construct, bespoke pieces of infrastructure.
- The same is true for possible future energy sources: LNG terminals are not constructed to be compatible with receiving ammonia (without significant modification), or liquid hydrogen, should it ever become a seaborne energy source.
- In many states, gas-to-power infrastructure to feed into national grids is sorely lacking, whereas the existing infrastructure for converting coal or oil to energy is in place.
- Reducing coal consumption will require immense international capital investment. It is estimated⁶ that emerging markets and developing economies (excluding China) will require between USD 500 bn and USD 1 trillion in investment to put

them on a path to transition securely away from coal.

Availability of mitigation

In the meantime, mitigating efforts such as carbon capture, utilisation and storage technologies are required. In this space, projects under development are approximately five times in number to those already in place and mitigating technologies are clearly gathering momentum. However, many of these laudable initiatives remain at the mercy of more immediate threats, in particular of energy security, in an increasingly testing and fraught geopolitical climate.

Challenges to coal

Coal is not without its challengers. These come largely from the legal, financial and insurance sectors in wealthier economies.

- In states which permit such actions, there is a concerted legal effort on foot to 'kill coal before it kills us'. This has manifested in a range of high-profile court actions, seeking to hold those who are perceived as being responsible for climate change – governments, corporations and some individuals - accountable for its negative consequences, challenging the expansion of coal mines and other greenhouse gas-emitting activities, and seeking to enforce human rights enshrined at national level or under international conventions. Given the rather unwelcome mass resurrection of coal as an energy source, it is anticipated that this trend is one which will continue. According to the UN Global Climate Litigation Report 2023, the number of all climate change cases has more than doubled since 2017.⁷
- In part because of the risk of legal challenges and shareholder pressure, other sectors have taken action:
 - Last year, the lobby group Reclaim Finance reported that 96 banks had policies to restrict financial services to the coal sector and mining companies report that obtaining financing for new projects is becoming harder. This challenge to coal should be kept in perspective, however. Also last year,

the International Energy Agency reported that global investment in coal supply would rise by around 10%, with China at the forefront.⁸

- A growing number of insurance companies have restricted cover available to the coal industry, increasing the pressure on producers, which in some cases are now self-insuring. This has had knock-on effects: lack of insurance cover can tie up capital and make financing more expensive and where cover remains available, premiums have increased sharply.⁹

The potential for success of these challenges to coal's dominance is uncertain because it depends in part on public policy and public opinion. More certain, however, is the fact that this issue will face us until clean, economically viable energy can be produced and deployed globally, as an alternative to the ubiquitous coal.

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Footnotes:

1. The multilateral international treaty established at the United Nations Climate Change Conference (COP21) in Paris, France, on 12 December 2015, which entered into force on entered into force on 4 November 2016.
2. **Exclusive: Pakistan plans to quadruple domestic coal-fired power, move away from gas | Reuters / Despite a \$20 billion JETP deal Indonesia builds new coal : NPR**
3. **German Coal Plants May Have To Remain On Standby Longer Than Planned | OilPrice.com**
4. **Coalmine approvals in Australia this year could add 150m tonnes of CO2 to atmosphere | Coal | The Guardian; Australian government approves first new coal mine since elected - BBC News**
5. **Mining, BHP Looks to Greener Steelmaking With New Design - Bloomberg**
6. See footnote 1
7. **Law Society Gazette (pagesuite.com)**
8. **Insight: Bankers pour cold water on red hot coal | Reuters**
9. **Insight: Coal miners forced to save for a rainy day by insurance snub | Reuters**



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SUSTAINABILITY LINKED LOANS IN THE COMMODITIES SECTOR: AN INCREASED FOCUS ON GREENWASHING AND THE POTENTIAL FOR 'GREENHUSHING'?

What are SLLs and why have they been successful?

Sustainability linked loans (SLLs) are designed to incentivise the achievement of sustainability targets, most of which are voluntary commitments taken on by corporations. Typically, if the borrower hits the required sustainability target, it benefits from a reduced interest rate on its debt - and vice versa if it misses them. Whilst green loans and other types of sustainable debt are tied to funding for eligible 'green' projects, SLLs offer more flexibility to borrowers because loan proceeds are not tied to particular 'green' projects. This has made SLLs attractive for banks wanting to improve their ESG ratings and for borrowers wanting access to finance. It has helped the SLL market to grow dramatically.¹

Sustainability targets in the commodities sector vary widely across the SLL market and can include targets relating to carbon emissions, traceability of supply chains, sustainability of farming methods, human rights and worker safety, amongst others.

The Loan Market Association has described SLLs as a "transition tool, supporting the borrower as it seeks to improve its overall sustainability performance"² and many of the largest commodities traders are accessing the SLL market. On 23 October 2023, Trafigura, one of the largest commodity traders in the world, announced the successful closing of sustainability-linked facilities worth USD 2.7 billion. Trafigura is not alone: many of the largest traders, including Gunvor, COFCO, Bunge and Louis Dreyfus, have closed large SLL financings in recent years.

This sounds great; what is the problem?

Even as the SLL market continues to grow, there are potential clouds gathering as regulators have identified and begun to focus on greenwashing risks in the finance sector.

In June 2023, the Financial Conduct Authority (FCA), the UK's financial regulator, published an open letter to the heads of ESG of financial firms, signalling that it was preparing to take a tougher stance on greenwashing in the SLL market.

In its letter, the FCA highlighted "*potential market integrity concerns*" in the SLL market and pointed to "*weak incentives, potential conflicts of interest, and suggestions of low ambition and poor design*" in relation to sustainability targets.

Other jurisdictions are following suit:

- The Swiss financial regulator, FINMA, has expressed an intention to clamp down on greenwashing ("*ecoblanchiment*") with a focus on the Swiss asset management sector. On 25 October 2023, the Swiss Federal Department of Finance announced proposals for new federal regulations to tackle greenwashing by August 2024³.
- In June 2023, the European Securities and Markets Authority published a report on the rise of greenwashing in the banking, insurance and investment sectors. The European Commission has called on industry watchdogs to address this.
- A package of EU regulations and directives relating to sustainable finance, including the EU taxonomy⁴, the recently enacted Corporate Sustainability Reporting Directive (CSRD)⁵, and the proposed Green Claims Directive⁶, already provide tools for holding companies to account for their sustainability and green claims.

What is greenhushing?

In its report⁷ published in late October 2023, the International Trade and Forfeiting Association (ITFA), a trade body representing banks and companies involved in global trade and receivables financing, warns of a raft of unforeseen potential consequences from attempts to

regulate greenwashing, which it describes as a “*regulatory paradox*”. It warns that greenwashing is being replaced with ‘greenhushing,’ where companies seek to avoid possible liability for greenwashing by setting sustainability targets which are “*flexible and undemanding*” and by complying with only minimum regulatory reporting requirements. These unforeseen consequences, the report argues, are “*existential for trade and supply chains across the world*” and the current regulatory approach may be holding back longer-term sustainable business models.

Is there guidance on good practice available?

Some guidance is available from the Loan Market Association (LMA). It publishes guidelines with principles for selecting and calibrating targets in SLLs⁸.

In May 2023, the LMA published a set of draft SLL clauses and this was followed, in October 2023, by a model term sheet including SLL terms. This is the first time the SLL market has seen an attempt to create standardised wording. A key aim is to help protect the legitimacy of the SLL market by reducing the risk that loans are susceptible to greenwashing claims.

The LMA clauses include the concept of ‘declassification,’ allowing a lender to declassify a facility as “sustainability linked” on the occurrence of certain events, for example the consecutive non-achievement of sustainability targets. A lender may have a right to prevent the borrower from continuing to refer to the sustainability linkage in its public statements. The LMA stops short of suggesting that borrowers who breach sustainability terms should be at risk of triggering an event of default or acceleration of the loan. However, that is not to say the draft clauses are without teeth: the threat of a ‘declassification’ event may be serious for some borrowers.

These developments may help to address some of the FCA’s market integrity concerns over the SLL market.

What should trade finance professionals do?

In the short term, aside from setting robust and meaningful sustainability targets and complying with any

specific regulations and industry guidance, traders should beware of making broader sustainability assertions in relation to their trade finance products. It is crucial to ensure that any claims made can be backed up.

Discussions and cooperation with banks in the sector are an integral part of the process. However trade finance professionals should take care not to rely on a financier’s own sustainability frameworks when making sustainability or green assertions about a trade finance product or underlying goods.

Until there are common regulatory standards, there will continue to be a risk of greenwashing accusations for users of financial products, including SLLs and other sustainability-linked instruments used in trade finance⁹. Market participants should exercise caution. In short, sustainability targets embedded in these products should be selected extremely carefully to ensure that they are material, robust and meaningful.

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Footnotes:

1. In 2020-2021 the SLL market grew by 244%, The green loan market contracted by 1% (<https://sponsored.bloomberg.com/article/scb/incentivizing-change-with-sustainability-linked-loans>)
2. https://www.lma.eu.com/application/files/7916/9927/2922/LMA__ACT_Getting_Started_in_Sustainable_Finance.pdf
3. <https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-98351.html>
4. Regulation (EU) 2020/852 and amending Regulation (EU) 2019/2088 (<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852>)
5. https://finance.ec.europa.eu/capital-markets-union-and-financial-markets-reporting/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en
6. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023PC0166&from=EN>
7. Too big for us to fail: The Regulatory Paradox - towards a common, consistent and comparable audit standard for sustainability reporting in trade and supply chain finance – action research update (https://itfa.org/wp-content/uploads/2023/10/ITFA_-_The-Regulatory-Paradox-Towards-a-common-audit-standard-Oct-2023.pdf)
8. <https://www.lma.eu.com/sustainable-lending/documents#sustainabilitylinked-loan-principles40>
9. For example, in the agri sector, banks may issue letters of credit with sustainability linkages. These instruments may require the underlying goods to be certified under various sustainability standards, for example palm oil certified under the RSPO Certification scheme or cotton certified under the Better Cotton Initiative.





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Footnotes:

1. <https://www.hfw.com/CBAM-Can-the-EU-achieve-carbon-adjustment-beyond-its-borders-Feb-2023>
2. Russia is now subject to sanctions
3. UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT - Trade and Development Board - Seventy-third executive session - Agenda Item 3 - EU statement | EEAS (europa.eu) See also The African Climate Foundation and LSE Firoz Lalji Institute for Africa Implications of a Carbon Border Adjustment Mechanism in the EU

CBAM TRANSITION PHASE: A MOVE TOWARDS DECARBONISATION IN HARD TO ABATE SECTORS?

Importers into the EU of products in the cement, iron, steel, aluminium, fertiliser, hydrogen and power sectors are currently grappling with the new reporting requirements introduced by the Carbon Border Adjustment Mechanism (CBAM). These came into force on 1 October 2023 – see our previous articles for more information.¹ Although no levy will be due for imports before 1 January 2026, the stakes are already high: unreported emissions attract fines of between EUR10 and EUR50 per tonne.

Importers may feel that an onerous reporting regime has been sprung upon them, in spite of the CBAM's lengthy evolution. After years of discussion, the last twelve months have seen agreement reached between the Commission, Council of Ministers and Parliament, adoption of regulations and the beginning of the transition period.

In this article, we consider some of the challenges to the success of the CBAM and why the reporting regime is so important.

What is being reported?

Cement, iron, steel, aluminium, fertiliser and hydrogen have benefited from free allocation of allowances under the EU Emissions Trading Scheme (EU ETS), in recognition of their vulnerability to competition from imports for which no carbon price has been paid. However, free allocations are to be progressively removed to encourage decarbonisation in these heavy-emitting industries. The aim of the CBAM is to avoid "carbon leakage" (production moving out of the EU to avoid EU allowance (EUA) payments), by imposing a levy on embedded emissions in imports. These CBAM payments will be set at the EUA price at the time the product enters the EU.

However, measuring embedded GHG emissions in imports is more challenging than measuring emissions from facilities, on which the EU ETS is based. Hence the need for an information gathering transition period from 1 October 2023 to 31

December 2025. During this period, quarterly reports are required to be made to the EU on the quantities, location, production route and specific direct emissions of imports, with the option to use estimates in some circumstances. Indirect emissions, by way of consumption of electricity in the production process, must also be reported.

Details of carbon prices paid locally, in the country of production, prior to import must also be reported and those sums will eventually be set off against CBAM payments.

This data will assist the EU in structuring the scheme to apply from 1 January 2026 and also in gauging its success in encouraging other countries to put in place similar measures.

Industry concerns

European producers of cement, iron, steel, aluminium and fertiliser have been concerned about the phasing out of free allocations, coming at a time when their industries are under pressure from high energy prices, increasing indirect costs and inflation. Their industry bodies issued a joint statement at the end of 2022, requesting a test period during which CBAM payments were made on imports before free allocations were phased out. They also wanted rebates on EU ETS payments for exports, to protect them from competition from products with higher carbon footprints, as well as more limited exceptions and default arrangements. Further concerns related to data transparency, verification and review.

These issues have not been addressed by the EU regulators, no doubt reflecting pressures on the EU from World Trade Organisation (WTO) rules, which limit the unfavourable treatment of imports, as well as from importing countries, whose industries will struggle with the CBAM regime. Some less developed countries lack the infrastructure for accurate reporting and are ill-adapted to bear the cost of over-reporting and CBAM fails to recognise the Paris

Agreement principle of common but differentiated responsibilities and respective capabilities, in the light of different national circumstances (CBDR) which is enshrined in Article 4 of the Paris Agreement. This principle allows for certain countries (broadly considered the Global South countries) to take on Paris Agreement commitments at a different pace to those of the developed countries. In that respect, the CBAM fails to acknowledge that Global South countries should not be expected to adopt the same carbon price as those of developed countries under the CBRD principle. This issue was reflected in the European Parliament's June 2022 proposal, which included a commitment by the EU to finance Least Developed Countries' efforts towards the decarbonisation of their manufacturing industries in an amount at least equal to the revenue generated for the EU by the CBAM. The Commission proposal also committed to report annually on the contribution of the CBAM revenues to such decarbonisation efforts. However, although the architects of CBAM have been concerned about a challenge to its legitimacy under WTO rules, the EU's obligations under Article 4 of the Paris Agreement were not addressed in the final agreement between the EU Parliament and the Council on the CBAM.³

We consider specific industry issues below:

Cement

As a high user of electricity already bearing decarbonisation costs, the cement industry has supported CBAM and the inclusion of indirect emissions within its scope, although it is concerned about exports.

Iron and steel

Iron ore production has relatively low emissions and the EU is heavily dependent on imports, so the effect of CBAM on iron is expected to be less significant than on steel.

For some importers, price increases of up to US\$275 per tonne of imported finished steel are anticipated. The cost of Chinese steel is projected to rise by 49% and Indian steel by 56% by 2034. No wonder then that both countries are considering WTO claims. There are also reports that India is contemplating its own carbon border adjustment mechanism– to apply to exports to the EU only.

The other largest producers², South Korea, Turkey, Taiwan and Japan, are consulting with the EU and considering counter-measures.

Nevertheless, producers are also stepping up their decarbonisation efforts, albeit hampered by scrap shortages in more recently industrialised countries and export bans elsewhere, which limit the replacement of traditional blast furnaces with electric arc furnaces.

Meantime, the EU has been criticised by Carbon Market Watch for being unduly lenient in its approach to phasing out free EUAs for steel, which CMW say is as a result of lobbying by the European steel industry.

Aluminium

Indian and Chinese aluminium products are also expected to increase in price, by over 40% and 17% respectively, according to research from ING. China is considering a strategy of relocating production from coal-powered plant in the north to hydro-powered plant in the south. However, this will not help under current CBAM rules.

The EU industry warns that imports may move up the value chain in favour of finished products (such as cars and drinks cans) which fall outside CBAM's scope and lead to an increased focus on scrap generation, as scrap has a zero carbon designation under CBAM, no matter if the original aluminium was produced in a coal or fossil fuel fired furnace. They also caution that resource shuffling may occur, where producers direct low carbon aluminium to the EU, with higher carbon products sent to destinations with more relaxed climate laws.

Fertiliser

Gas is a common feedstock for EU fertiliser production, much of it imported, so producers already have an incentive to be efficient, benefiting their carbon footprint.

Participation in the EU ETS may kick-start investment in electrification of plant with an average industry age of 45 years, but pressure on profit margins from the removal of free allowances could hinder this.

Hydrogen

Most EU hydrogen has its origins in fossil fuels and hydrogen was therefore included in the CBAM to avoid imports from low cost, high carbon producers.

However, the potential for green hydrogen to replace fossil fuels in large scale transportation and the increasing financial viability of green hydrogen as carbon prices rise is a great advantage for the industry, so there is a positive side to the EU's green agenda for the hydrogen industry.

Electricity

Carbon leakage is a risk for electricity, with interconnectors crossing EU borders from countries where generation has a high carbon footprint. Electricity has therefore also been included in the CBAM, although there are no free allowances as there are in other sectors.

Conclusion

Although burdensome for importers, the reports submitted during the transition phase will be key to the CBAM's success. The information which will be generated must be sufficiently reliable as a scaffold on which to develop the final scheme to apply to both products currently covered and new categories in the future.

The EU will also need to consider the points raised by industries inside the bloc and out, though, because these issues may affect the extent to which the CBAM promotes decarbonisation, rather than changes to manufacturing and trading arrangements, in the industries affected. Meanwhile, importers will need to find ways to keep CBAM costs down. These could include:

- reviewing the ability of their supply chains to report and to decarbonise, noting that presently such decarbonisation efforts are not universally recognised within the CBAM rules.
- engaging with them to set expectations and understand hurdles.
- updating standard contracts to cover information requirements and decarbonisation expectations.

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AN INTRODUCTION TO EU ETS 2

The EU has established a new emissions trading system (the “EU ETS 2”). Although it is part of the EU ETS Directive, EU ETS 2 will be separate¹ from the existing EU emissions trading system (the “EU ETS”), which has been in place since 2005.

Timeline Of Implementation

The EU ETS 2 is expected to be implemented in accordance with the following schedule:

- Monitoring, reporting and verification of emissions will commence in 2025.
- Compliance entities will have to surrender a new category of allowances in respect of their emissions from 2027.
- Auctioning of such allowances will commence in 2027.

Scope Of Application

EU ETS 2 is intended to apply to the “release for consumption of fuels” (i.e. the point at which excise duty is payable on the fuel) in the following sectors (collectively the “Covered Sectors”):

- a. Buildings (both commercial / institutional and residential)
- b. Energy generation for (a) above
- c. Road transportation
- d. Manufacturing (unless already covered by the EU ETS)
- e. Construction.

However, the EU ETS 2 compliance obligations are not imposed directly on building owners, vehicle owners, or other entities that are using the fuel. Rather, they are targeted at the “release for consumption of fuels” to Covered Sectors. Each entity subject to EU ETS 2 compliance obligations is described as a “regulated entity”, which is “any natural or legal person, except for any final consumer of the fuels, that engages in (release of consumption of fuels to Covered Sectors) and that falls within one of (several stated categories)”.²

EU ETS 2 compliance obligations generally accompany liability for the excise duty on the relevant fuel under Council Directive (EU) 2020/26 (the “Excise Duty”) and impose

greenhouse gas emission liability on fuel suppliers in relation to what are in effect their Scope 3 emissions.³ This differs from the EU ETS, which targets in effect Scope 1 emissions (and is a material deviation from the polluter pays principle).⁴

The types of fuel that attract EU ETS 2 liability include fuel oils, electricity as well as any product intended for use, offered for sale or used as motor fuel or heating fuel, subject to certain exceptions.

Individual Member States may, from 2027 and, subject to the European Commission’s approval, expand the scope of EU ETS 2 to include other sectors.⁵

In respect of emissions until the end of 2030, there is also an option for an individual member state to exempt regulated entities from the obligation to surrender allowances if that member state has a national carbon tax covering the exempted regulated entity and such tax is higher than the average auction clearing price in relation to the EU ETS 2.⁶ It remains to be seen how many member states will seek to utilise this exemption, noting that certain member states such as Germany already have national carbon pricing mechanisms for buildings and road transport.⁷

The possibility of individual member states extending the scope of EU ETS 2 or granting exemptions may result in non-uniform treatment of similar sectors in different member states.

Allowances and Compliance Cycles

We discuss below some of the other key differences between the EU ETS 2 and the EU ETS.

Under proposed legislation,⁸ allowances (which are to be known as “regulated entity allowances”) created in respect of the EU ETS 2 shall not be fungible with those created in respect of the EU ETS (which are to be known as “general allowances”). In addition, regulated entity allowances cannot be held in compliance accounts opened in relation to the EU ETS, although trading accounts will be able to hold both types of allowances. Instead, a “regulated entity holding account”



will have to be opened by each EU ETS 2 regulated entity.

The compliance cycle for the EU ETS 2 will also be different from the EU ETS in the following ways:

- there will be no free allocation of regulated entity allowances for EU ETS 2.
- there is an additional obligation for regulated entities to report the average share of costs related to the surrender of regulated entity allowances which they pass on to consumers.
- the annual deadline for regulated entities to surrender regulated entity allowances is 31 May, as compared with 30 September for compliance entities under the EU ETS.

In light of the differences between the EU ETS 2 and the EU ETS, documentation used for trading general allowances will require substantial modifications to be used for trading regulated entity allowances.

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Footnotes:

1. By 31 October 2031, the Commission is required to assess the feasibility of integrating the EU ETS 2 and the EU ETS. See the Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a system for greenhouse gas emission allowance trading within the Union and amending Council Directive 96/61/EC (as amended including Directive (EU) 2023/959 of the European Parliament and of the Council of 10 May 2023, the "EU ETS Directive"), Article 30i.
2. See the EU ETS Directive, Annex 3(ae).
3. See the definition of Scope 3 in the GHG Protocol Corporate Accounting and Reporting Standard, <https://ghgprotocol.org/corporate-standard>. Regulated entities are required to identify and document reliably and accurately the precise quantities of fuel released for consumption and the final use of such fuels.
4. See the EU ETS Directive, Annex I; Commission Implementing Regulation (EU) 2018/2066 of 19 December 2018 on the monitoring and reporting of greenhouse gas emissions pursuant to Directive 2003/87/EC of the European Parliament and of the Council and amending Commission Regulation (EU) No 601/2012, Article 20.
5. These exemptions include fuels consumed in sectors already covered by the EU ETS (other than the transportation of greenhouse gases for geological storage or for combustion in small installations with less than 25,000 tonnes of carbon dioxide equivalent), fuels for which the emissions factor is zero, hazardous or municipal waste used as fuel. See the EU ETS Directive, Article 30j.
6. See the EU ETS Directive, Article 30e. There are also certain other requirements that must be met, such as the EU Commission not objecting to the exemption and the relevant member state cancelling an equivalent number of regulated entity allowances from the quantity that it auctions.
7. See <https://www.iea.org/policies/11632-co2-price-for-transport-and-heating>.
8. See the proposed amendments to Commission Delegated Regulation (EU) 2019/1122 (the "Registries Regulation")



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ESG LITIGATION AND CLIMATE RISK

COP 28 will reveal that participating governments do not yet have the levels of ambition needed to achieve the goals set out in the 2015 Paris Agreement (by which member countries agreed to limit the increase in global average temperatures to “well below” 2°C above the pre-industrial average, and ideally to 1.5°C). Accordingly, and in these circumstances, it is highly likely that the private sector will be called on to do better. And, to date, many private corporations have agreed, either voluntarily or otherwise, to make various climate-related pledges, including the pledge to achieve net-zero carbon emissions by 2050. However, as corporations make greater voluntary commitments, the risk of so-called “ESG litigation” increases. In this article, we therefore consider the impact of ESG litigation (with a focus on the Environment) and how corporations might seek to reduce the risk of climate-related claims.

The “E” in ESG Litigation

ESG litigation and, more particularly, climate change litigation, is still in its infancy. However, it is certainly gathering pace and has momentum. Companies, and directors, should therefore be aware of the risks they face and how they can reduce these risks. That is particularly so given that regulations in the UK and elsewhere are only likely to increase, widening the scope for potential breaches of those regulations. Furthermore, an increase in the availability of litigation funding for ESG claims and class actions is making it easier for claimants to bring such claims. Should this trend continue, this will likely lead to an increase in ESG litigation in the coming years.

The recent case of *ClientEarth v Shell*¹ is a good example of what we can expect. ClientEarth, an environmental law charity and a minority shareholder of Shell, brought a claim against the company’s directors for breach of their duties under the UK Companies Act 2006. They alleged that the directors had failed to set appropriate targets or adopt a strategy sufficient to meet the company’s goal of achieving net

zero by 2050. Although the claim was rejected by the English court, the case is illustrative of the type of actions which companies and directors may face in the future.

In a less favourable 2021 decision for Shell, the Dutch courts held that Shell was under an obligation to cut its emissions and that the company’s current climate policies were insufficient to achieve that result. The court ordered Shell to cut their global emissions by 45% by 2030.² Shell has appealed.

The risk from shareholder claims such as ClientEarth should not be underestimated, and the risk of ESG litigation for so-called ‘hard to abate’ sectors is also particularly acute.

These are sectors for which clean alternatives are not technically or economically feasible. International shipping and aviation are prime among these, with Climate Action Tracker rating the policies and actions of these industries as “highly insufficient”³ and “critically insufficient”⁴ respectively.

Advertisements can also be a source of risk for businesses

Regulators, particularly the UK’s Advertising Standards Agency (“ASA”), are increasingly focusing on so called “greenwashing” in publicity materials. Recent examples include the following:

- Ryanair’s advert branding itself as “Europe’s ... Lowest Emissions Airline”. This was based on the airline’s young fleet, its use of fuel-efficient engines and high load factors to substantiate the claim. However, the ASA held that the data used to back up the advert was not sufficiently transparent and robust and prohibited the advert from appearing again.⁵
- HSBC’s advert about its net zero financing goals. The advert promoted the bank’s aim “to provide up to \$1 trillion in financing and investment globally to help ... [its] clients transition to net zero”. The ASA ruled in 2021 that while this aim was contained in HSBC’s annual report, that same report showed that it was financing emissions of at least 65 million tonnes of carbon dioxide a

year, and likely more. The overall message of the advert was therefore misleading, as the bank “was continuing to significantly finance investments in businesses and industries that emitted notable levels of carbon dioxide”.⁶

- 4AIR LLC’s paid-for Google Ad, in which it offered to provide “eco-friendly” and “sustainable” aviation advice and offered businesses the chance to “learn how to turn flying into a force for good.” The ASA concluded that the claims were “likely to mislead businesses in relation to 4AIR’s capability to ensure that aviation operations which purchased its services did not negatively impact the environment.”⁷ What is perhaps most interesting is that the advert was identified by the ASA through its recently launched Active Ad Monitoring System. The system, which uses AI technology to proactively search for online adverts that potentially break the rules, is currently processing more than 100,000 adverts a month.

Conclusions and Key Takeaways

COP 28 is likely to reveal a high level of global underperformance by governments. There will therefore be a call for greater action from the public sector. The magnifying glass will be on companies in all industries to ensure that proper ESG policies are in place and, where they are in place, are being adhered to. And whilst ESG litigation is still in its early stages, the likely rise in regulations will likely lead to a rapid increase in ESG litigation in the next few years.

Companies should therefore be careful to reduce their risk of climate-related claims from shareholders, investors, and others. We have set out below some the key steps companies can take to avoid this:

- Regularly monitoring and checking publications and products – ensuring that reports and products do not contain misstatements or false accreditations is key to guarding against potential ‘greenwashing litigation’.
- Being joined up internationally - ensuring that subsidiaries or operations around the globe are saying the same things on the climate as in the UK, is a key method in ensuring consistency

across the board and not being caught out.

- Taking advice - when making any claims about the environmental benefit of a new product, or a proposed course of action, consider first obtaining the advice of an expert as to whether these claims are verifiable. This is important to avoid accusations of ‘greenwashing’, which is increasingly attracting regulatory attention. Seeking expert scientific and legal advice can also provide strong protection for a director against a shareholder claim, such as that in *ClientEarth*.
- Full and timely compliance with new and emerging regulatory requirements – this will ensure that a company is fully aware of all potential risks in, for example, the supply chain and will allow a company to identify risk and take timely action to resolve it.
- Taking action - genuine and positive engagement on all matters related to ESG can demonstrate goodwill.

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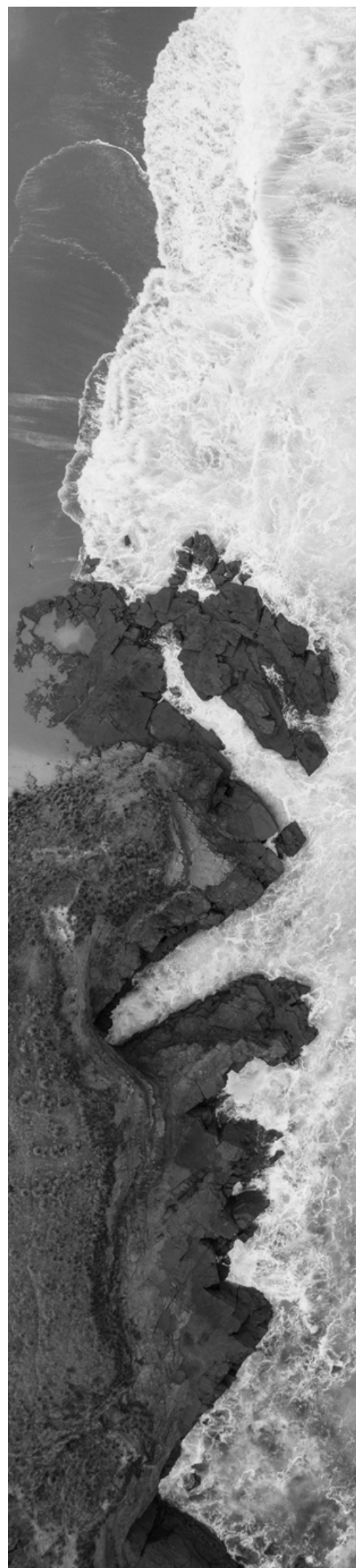
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Footnotes:

1. [2023] EWHC 1897 (Ch)
2. [Rechtbank Den Haag, C/09/571932, 26 May 2021](#)
3. [International Shipping | Climate Action Tracker](#)
4. [International Aviation | Climate Action Tracker](#)
5. [Ryanair Ltd - ASA | CAP](#)
6. [HSBC UK Bank plc - ASA | CAP](#)
7. [20230830_21489_decision.pdf \(climatecasechart.com\)](#)



Where you can meet the team next

- HFW will be hosting a 1/2 day event in Dubai on the fringes of COP28 titled 'Decarbonising our sectors and accelerating the energy transition'. Please register [here](#).
- We will be hosting our third Commodities Global Compliance Forum on 5th December. Guest speaker Gerald Ashley will be joining us to speak about risk and decision making. If this is of interest to you, please register [here](#).
- Join us for an in-person seminar with HFW partners Barry Vitou and Anne-Marie Ottaway on Thursday 7th December 2023, covering reforms introduced by the recently passed Economic Crime and Corporate Transparency Act 2023. Please contact events@hfw.com for more information.
- HFW Disputes will be hosting a party in the new year on 8th February 2024, please email events@hfw.com for more information.

For more information on upcoming HFW events, click [here](#).

Team News

- We are pleased to have achieved 52 practice and lawyer rankings in the [Chambers and Partners UK 2024](#) guide, including Band 1 practice rankings for Commodities: Physicals, Shipping and Transport: Logistics; and a new ranking for Construction: International Arbitration. Click [here](#) to find out more.
 - We are pleased to have been recognised as a leading firm in the 2023-2024 edition of [The Legal 500](#) (Legalease) UK, a guide to the world's best lawyers and law firms.
 - We achieved 21 practice rankings in the 2023-24 guide - including nine in Tier 1 or Tier 2 - covering a wide range of areas including commodities, energy, insurance, shipping, disputes,
- aviation, construction, and finance. Find out more [here](#).
 - We have again been ranked by The Times as one of the UK's top commercial disputes practices. The Times commented that "HFW is regularly instructed on complex and high-value matters in the aerospace, commodities, construction, energy, insurance and shipping sectors." Read more about our ranking [here](#).
 - We were delighted to have more than 250 market participants at our webinar on the new Electronic Trade Documents Act in September. Panellists Prof Sarah Green and Marina Comninos joined Partners Matthew Cox and Matthew Wilmshurst to discuss its impact. Read more [here](#).
 - The September edition of SQ, edited by Partner Jo Garland, focused on the energy transition and critical minerals. Read more [here](#).
 - Partner Dan Perera co-authored an article with S&P Global Commodity Insights' Eric Yep and Shermaine Ang, on the drivers behind the shift in global LNG markets and how LNG market dynamics are changing in Asia. Click [here](#) to read the article.
 - Partner Barry Vitou featured in CityAm recently, sharing his views on the biggest shake up in corporate criminal law this century. Click [here](#) to read the article and [here](#) for HFW's update on the new Economic Crime and Corporate Transparency Act.
 - We recently published our October edition of our Global Investigations and White-Collar Defence bulletin which can be found [here](#).
 - Partner Peter Zaman, Senior Associate Jefferson Tan and Associates Christopher Ong and Farah Majid have published a further piece on the Singapore Carbon Tax, [here](#).
 - Congratulations to Partner Karen Cheung who has been recognised in [LexisNexis 40 under 40](#). You can read more [here](#).

HFW has over 600 lawyers working in offices across the Americas, Europe, the Middle East and Asia Pacific. For further information about our commodities capabilities, please visit hfw.com/Commodities.

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