Client alert

Sustainable commodities – a new reality?

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ReedSmith

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Sustainable commodities – a new reality?

Introduction

The London Metal Exchange (LME) recently announced that it was exploring the establishment of a new spot trading platform that would allow consumers to source low-carbon aluminium, typically produced using renewable energy.[i] The purpose of this new platform would be to provide market participants, who have greater environmental, social and governance (ESG) awareness or requirements than others, with a venue in which to source low-carbon aluminium and, presumably, to discover a price distinct from that of aluminium produced from less environmentally friendly energy sources, such as coal.

This is not the LME's first sustainability-linked initiative. In October 2019, it announced its responsible sourcing requirements for all brands listed for "good delivery" on the LME against physically settled contracts (aluminium, aluminium alloy, cobalt, copper, lead, nickel, tin, zinc, etc.). The LME's requirements are underpinned by the OECD[ii] Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas (OECD Guidance).[iii] Brands that do not satisfy the relevant due diligence requirements will not satisfy the good delivery requirements for LME metals. The LME is following in the footsteps of the London Bullion Market Association (LBMA), which adopted the OECD Guidance on 15 December 2010[iv] in respect of 'London Good Delivery' of precious metals.

Do these efforts in the base metals and precious metals markets highlight an effort to distinguish one exchange from its competitors, or is it a sign of a more enduring trend towards sustainable commodities? If so, will the momentum towards sustainable initiatives be side-lined by the COVID-19 pandemic or accelerated? These are some of the themes that we explore in this client note.

Why is there a trend towards sustainable commodities?

At the outset, let us be clear – society needs commodities. This is irrespective of whether the economy is green or not. There are many reasons for such need; for example, nickel for the production of electric vehicle batteries, or LNG as a transition fuel away from other fossil fuels. The question is really whether it is possible to source, supply or use commodities differently or more efficiently, such that the demand can be met in a more sustainable manner. This is what is meant in our discussion on 'sustainable commodities'.

Depending on how it is done, the processes of acquiring commodities (e.g., via mining), sourcing them (e.g., from regions or countries where there is war or conflict), supplying them (e.g., transporting them half-way across the world) or using them (e.g., coal or oil as an energy fuel), each can have possible adverse consequences for the environment, be against good governance practices, or be socially/morally unacceptable (e.g., because of destruction of natural habitats or use of child labour). As such, commodity market participants are easy targets for criticism and often not thought of as the obvious flag bearers for good ESG credentials.

Yet, in the context of many commodity products (rubber, palm oil, coffee, base and precious metals, etc.), there has been or is some form of sustainable sourcing or production initiative often led by industry bodies in which key producers are members. As an illustration, please see the various sustainability standards that exist just for palm oil in the text box across. The plethora of standards can also become a problem as they often (i) lead to confusion as to which standard to follow, (ii) are sponsored by different participants (e.g., producer or buyer), and/or (iii) can have the effect of fragmenting adoption in the supply chain, until there is a force driving adoption of a single standard.

It is fair to note that for some commodities (e.g. precious metals), this journey towards sustainability has already been in place for some time. For others, these initiatives are relatively more recent.

Various Standards for Sustainable Palm Oil

- Round table on Sustainable Palm Oil (RSPO)
- Palm Oil Innovation Group (POIG)
- Roundtable on Sustainable Biomaterials (RSB)
- Rainforest Alliance Sustainable Agricultural Standard
- International Sustainability & Carbon Certification (ISCC)
- Malaysian Sustainable Palm Oil (MSPO)
- Indonesian Sustainable Palm Oil (ISPO)

Further, even within sectors or for specific commodities, some companies have been more alive to the issue than others. Yet, the prominence of ESG and sustainability initiatives in the commodity context, even before the COVID-19 pandemic, has never been greater. So why now?

There will be many drivers that are specific to a sector, company or individual business in explaining this. However, at an international level, there are three common drivers:

(a) **The Paris Agreement**: The Paris Agreement obliges its 195 signatories to significantly reduce the risks and impacts of climate change, and take steps to limit the global average temperature rise this century to well below 2°C, while pursuing efforts to limit the temperature rise to 1.5°C. In order to achieve the objectives of the Paris Agreement, countries must peak their emissions "as soon as possible". Essentially, any effort to achieve this objective results in a limit on the amount of carbon that can be emitted (i.e. a global 'carbon budget') as, beyond that, achievement of these objectives will fail. According to scientists, to stay withing this remaining carbon budget, peaking of emissions must occur no later than 2030, and then decline towards net zero through mitgiation and carbon removal efforts by 2050. To increase the chances of achieving the Paris Agreement objectives, these dates should come sooner. This objective is now commonly recognised as "net zero by 2050" and has been adopted by many companies voluntarily. Countries use their Nationally Determined Contrbutions (NDCs) under the Paris Agreement to set their own five-year objectives in response to this target. As a 2018 Special Report from the Intergovernmental Panel on Climate Change highlighted[v], we have another ten years from now to avoid dangerous and catastrophic climate change and make the urgent changes in behaviours, policies and practices needed to limit global warming to 1.5°C above pre-industrial levels.

(b) **The United Nations Principles for Responsible Investment (UN PRI)**: There has been increased recognition by investment managers and asset owners that engagement with companies on ESG issues can create shareholder value. This recognition is reflected in the more than 2500 signatories to the UN PRI representing US $80 trillion of assets under management. Asset owners, investment managers, and service providers to the asset owners and investment managers, can become UN PRI signatories. With the increased number of asset owners and investment managers adopting the UN PRI principles, this has led to the development and enhancement of ESG objectives and policy commitments. Such objectives often include specific investment criteria (e.g., not investing in certain fossil fuels), and increased reporting and disclosure (e.g., regarding the carbon footprint of portfolio companies), and are backed up by specific quantitative and qualitative targets – for example, targets that lead to the reduction of the carbon footprint of investment portfolios.

> "*Responsible investment is an approach to managing assets that see investors include Environmental Social and Governance (ESG) factors in:*
>
> - *Their decisions about what to invest in, and*
> - *The role they play as owners and creditors.*"
>
> (UN PRI)

Practical consequences of the adoption of such principles have included institutional pension funds and other professional investors divesting their investments in coal[vi] and other fossil fuels.[vii]

(c) **The United Nations Sustainable Development Goals (SDGs)**: The SDGs today represent the clearest agreed definitions of the collective broader objectives of society. The SDGs, agreed in 2015 by all the member countries of the United Nations, comprise 17 Sustainable Development Goals with 169 associated (aspirational) targets and indicators for implementation by 2030. The commodity sector is impacted by many of these aspirational targets. For example, Target 12.2 seeks the "sustainable management and efficient use of natural resources", Indicator 12.C.1 measures a reduction in the "amount of fossil-fuel subsidies per unit of GDP (production and consumption) and as a proportion of total national expenditure on fossil fuels", and Target 15.2 seeks to "by 2020, promote the implementation of sustainable management of all types of forests, halt deforestation, restore degraded forests and substantially increase afforestation and reforestation globally".

What are the impacts of these drivers?

There are two factors to highlight in discussing the consequences these drivers have – time and scale.

Time

The 'time' factor is driven by (i) the need for peaking of emissions by no later than 2030 under the Paris Agreement, (ii) the SDGs - many of which are to be achieved by 2030, and (iii) the increased conceptual[viii] acceptance by professional investors that compliance with their fiduciary duties now requires them to incorporate ESG aspects into their investment decisions. Ten years is not a long time to achieve these ambitions.

Some investment managers have had concerns about whether they would be fully discharging their fiduciary duties if they put ESG criteria ahead of return on investment. Much of this concern was predicated on an assumption that ESG funds do not perform as well as non-ESG funds. A recent study by Morningstar[ix], which examined the long-term performance of 745 Europe-based sustainable funds, concluded that the majority of strategies have done better than non-ESG funds over one, three, five and 10 years. The performance of investment funds, tested against the impact of the COVID-19 pandemic, is probably the most extreme test for a fund manager's portfolio. The findings of the study imply that an acceptance of this result would drive greater investment into ESG funds and an increase of ESG related products.

Given the economic fallout resulting from the COVID-19 pandemic, it is not uncommon right now to ask whether the post-pandemic world is going to be more focused on building a sustainable one. It is a question predominantly asked in the context of industries and organisations that are seeking financial assistance from governments. But with livelihoods on the line, can countries afford to focus on the sustainability agenda?

The debate about whether customers or consumers will pay a green premium for more sustainable products has been around for some time. The debate boils down to this – given the choice of a commodity product that is produced in a less sustainable way compared to one that is produced in a more sustainable way, would the market pay more for the more sustainable product? At present, the evidence for the latter is lacking. Those dealing in green bonds have grappled with such challenges for a few years already, and have begun to find some promise in the secondary bond market, but there is little evidence of it in the primary bond markets. Commodity sector initiatives, to gain a price advantage for a more sustainable product, have fared no better. So, left to voluntary efforts or absent regulation by governments, it is fair to ask: will the sustainability agenda lose its pace?

Many argue that the COVID-19 pandemic represents an opportunity for building a more sustainable future[x] instead, and that action in respect of climate change does not need to be deferred. This is because strategic allocation of government spending can spur fundamental changes in industries such as energy and tourism. Arguably therefore, the COVID-19 pandemic could simply accelerate, if not reinforce, these targets and objectives.

The time pressures will necessitate that action be taken now and not be put off for another day. If investments today are focused on creating a "triple bottom line"[xi] of people (social), planet (environmental), and profit (financial), the next 10 years in the economic cycle need not echo the approach of the last decade. However, will voluntary action be enough or is it time for governments to take the lead (see below)?

Scale

Many ESG actions have, historically, been considered voluntary, niche or sector specific. This is not the case today. The focus on ESG is increasingly being led by governments and multilateral organisations and this is finding its way into laws and, in a very few cases, ESG reporting becoming mandatory. Certainly, in the context of listed companies (including many listed commodity companies), climate related risk disclosures are becoming the norm. [xii] Although the Financial Stability Board's 'Recommendations of the Task Force on Climate-related Financial Disclosures' [xiii] are just recommendations, these have been widely adopted by many financial regulators around the world, including in Australia, Belgium, France, Hong Kong, Japan, the Netherlands, Singapore, South Africa, Sweden, and the United Kingdom[xiv].

Just because a commodity company is not a listed company does not mean that it can ignore ESG impacts. Financial institutions that lend to such companies are themselves adopting ESG policies that restrict lending and investment in certain commodities or sectors. By way of example, Barclays Bank has announced that it will "not support project finance transactions for the development of greenfield thermal coal mines or to enable the construction or material expansion of coal-fired power stations, anywhere in the world … [and will] also not provide general corporate financing that is specified as being for new or expanded coal mining or coal-fired power plant development."[xv] Similar positions have been adopted by many other lenders. Green loans and sustainability-linked loans from financial institutions that offer lower lending rates where the borrower achieves certain ESG objectives are, in turn, being accepted by commodity producers and traders to support their own ESG efforts. To be clear, the actions by the financial institutions are mostly driven by investor pressure and their own ESG initiatives; not by mandatory regulation. However, financial institutions see such regulation as inevitable and coming down the pipeline.

Perhaps the most ambitious sustainability initiative anywhere in the world currently (and an example of the mandatory approach that will be coming), is the EU New Green Deal. This plan has been described as a "tectonic shift in the way our society is structured".[xvi] It aims to transform the whole of the EU into a low carbon economy with targets that include a minimum 40 per cent cut in greenhouse gas emissions by 2030, a share of at least 32 per cent renewables in final energy consumption and at least 32.5 per cent in energy savings. The plans also include directing one to two per cent of the EU's annual GDP towards the green economy, including new infrastructure, public procurement, research and development and industrial retooling. In order to protect EU industries from the impact of competition from outside the EU, in particular in respect of energy intensive industries, the initiative includes carbon border-adjustment measures that may impact sectors such as cement, fertilisers, steel, non-ferrous metals, chemicals, pulp and paper, glass and imported electricity.[xvii] These may manifest in carbon taxes on imports into the EU from countries that do not share the EU's climate ambitions.

The effect of the EU's New Green Deal will mean a structural move away from some commodities such as coal and oil, increased use of solar, wind and geothermal energy generation, and investment in new fuel sources such as hydrogen. This means that, in the pecking order of policy developments, some commodities will see reduced demand in some markets, but this will be potentially offset by demand in other markets where such ESG factors will be less determinant. Although such markets may in the short-term include China, given China has committed to peak its emissions by around

2030, over time it is also going to increase the rate of its transition away from some commodities whilst increasing its investments in others.

Possible impact on commodity market participants

Although the trend towards sustainability is not new, the speed at which it is happening is accelerating. In the near term, these sustainability pressures are likely to manifest itself in:

- increasing demand for supply chains to be transparent and where possible, sustainable; and
- the development of increased numbers of sustainable commodity products.

Examples of the former and their effectiveness are already visible in the market. Chinese cobalt producer, Huayou Cobalt recently announced that it will no longer purchase artisanal sourced cobalt in the Democratic Republic of Congo until relevant standards are recognised and supported by the local industry. This announcement followed the addition of Zhejiang Quzhou Huayou Cobalt New Materials by LME to its list of brands approved for good delivery in 2019.

The LME's Responsible Sourcing Guidelines are designed to give users' of LME-grade metals the comfort of knowing that, if such metals have been sourced from conflict-affected and high-risk areas, these have been through risk identification and mapping, and that appropriate action has been taken, therefore respecting human rights and avoiding contributing to conflict through their mineral purchasing decisions and practices. This creates transparency in supply chains as refiners are not permitted to accept metals that fail the due diligence requirements for good delivery. The LME is taking a leadership role to reflect what it, and a growing segment of its customers, considers to be an appropriate commercial position.

In the precious metals markets, the launch of an investigation by the LBMA against the Perth Mint[xviii] for the alleged purchase of gold from artisanal miners in Papua New Guinea who were implicated in allegations of child labour and using mercury to mine gold, highlights the fact that adherence to such good delivery requirements is not merely paying lip service.

Such supply chain concerns will invite other exchanges that list commodity products to consider similar practices on sourcing. Agricultural products like rubber and palm oil are obvious examples of commodities about which end users and large corporate purchasers have supply chain concerns, but for which the relevant exchanges have yet to impose any sustainable supply standards.

Companies that are owned by ESG-conscious businesses or by investors who subscribe to the UN PRI or other equivalent objectives and standards, will require supply chain transparency and information about the carbon cost of the production of commodities. For example, Pavilion Energy's recent LNG tender required bidders to quantify greenhouse gas emissions associated with each LNG cargo produced, transported and imported into Singapore and additionally, included an option for bidders to propose the delivery of carbon credits to offset the actual greenhouse gas emissions from the supply of LNG sold under the terms of the tender[xix].

Investors and businesses will increasingly look for low or no carbon-impact commodities to achieve their respective carbon reduction targets. This will, in turn, incentivise commodity companies, in whom such investments are made or who must borrow from financial markets, to find ways to reduce their carbon impact or to mitigate their carbon impact (e.g., by packaging commodity products with carbon offsets). By way of example, Shell has sold LNG to customers such as China National Offshore Oil Corp and Tokyo Gas, packaged with offsets as 'carbon neutral LNG'.[xx]

As has been the case in the context of the financial sector, questions about the 'greenness' of commodity products labelled in certain ways will arise sooner or later. This will raise the bar for disclosure, transparency and reporting. However, the growth of sustainable commodity products, and thereafter the improvement in the quality of such products, will only continue. As such, it seems inevitable that 'sustainable commodities' could be the new reality.

Endnotes

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[i] ‘London Metal Exchange plans “low-carbon” aluminium trading’, The Financial Times, 5 June 2020.
[ii] Organisation for Economic Co-operation and Development.
[iii] http://mneguidelines.oecd.org/mining.htm.
[iv] This was subsequently supplemented with the OECD Gold Supplement in July 2012.
[v] ‘Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways’, IPCC, 2018.
[vi] https://www.theguardian.com/commentisfree/2020/jan/16/blackrock-coal-divestment-regulation-fund-manager.
[vii] https://www.reuters.com/article/us-climate-change-atp-pensions/danish-pension-provider-atp-to-halt-fossil-fuel-investments-via-external-funds-idUSKBN1ZY2ND.
[viii] A distinction is drawn between this and an investment manager’s legal duties. A project led by the UNEP Finance Initiative concluded: “*as currently defined, fiduciary duties do not require a fiduciary to account for the sustainability impact of their investment activity, beyond its financial performance. In other words, fiduciary duties require consideration of how sustainability issues affect the investment decision, but not how the investment decision affects sustainability issues.*” – ‘A Legal Framework for Impact: A legal framework for the consideration of sustainability impact in investor decision-making’ (October 2019).
[ix] Bioy, H.; Boyadzhiev, D., ‘How Does European Sustainable Funds' Performance Measure Up?’, Morningstar Manager Research (June 2020).
[x] See for example: https://www.theguardian.com/world/commentisfree/2020/apr/23/covid-19-crisis-reset-economies-sustainable-footing.
[xi] https://sustain.wisconsin.edu/sustainability/triple-bottom-line/.
[xii] For example, the UK Companies Act 2006 mandates disclosures by listed companies on how they manage various ESG issues in their annual strategic report. In Singapore, the Singapore Exchange requires annual sustainability reporting by all listed companies on a comply-or-explain basis.
[xiii] Accessible from: https://www.fsb-tcfd.org/publications/final-recommendations-report/.
[xiv] Task Force on Climate-related Financial Disclosures: Status Report 2019.
[xv] Barclays PLC Environmental Social Governance Report 2019.
[xvi] Frans Timmermans, Executive Vice-President, European Commission, The Financial Times (15 January 2020).
[xvii] The EU emissions trading scheme’s carbon leakage list for Phase 4 (2021-30) identifies 63 sectors and sub-sectors covering about 94 per cent of industrial emissions.
[xviii] ‘Metals authority probes Perth Mint over gold sourcing claims’, The Financial Times (15 June 2020).
[xix] https://www.bloomberg.com/news/articles/2020-04-02/world-s-first-lng-tender-with-carbon-neutral-goal-kicks-off.
[xx] https://www.shell.com/business-customers/trading-and-supply/trading/news-and-media-releases/cnooc-to-receive-chinese-mainlands-first-carbon-neutral-lng-cargoes-from-shell.html.

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