Article

Understanding emissions trading: navigating the regional greenhouse gas initiative

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Most emissions products are, by nature, creatures of regulation. When a firm sells an emissions product, the seller does not deliver a quantity of the regulated pollutant itself; rather, the seller effectively transfers to the buyer a "credit" representing an authorization to emit a quantity of the regulated pollutant. So, unlike traditional commodities, such as natural gas or soybeans, the demand for and supply of emissions products are significantly impacted by environmental compliance obligations imposed by a governmental authority or program administrator. These compliance obligations can evolve over time as regulations change, which can further impact the supply and demand for emissions products. The characteristics of emissions products necessitate an analysis of a unique set of regulatory and legal risks. In particular, when investing in this area, it is important that market participants have an understanding of the relevant compliance obligations shaping supply and demand and the underlying regulations that define the emissions products.

Although a federal emissions reduction program targeting greenhouse gases has yet to be implemented in the United States, a number of regional and voluntary emissions reduction programs have emerged and created markets for the trading of US greenhouse gas emissions products. The program with one of the largest and most liquid of these markets is the regional greenhouse gas initiative. This article provides an overview of the RGGI program, followed by a discussion of various methods for participating in this market and some of the risks unique to RGGI products.

Overview of the RGGI program

RGGI is a mandatory emissions reduction program requiring electricity generating units in the northeast United States to obtain and submit credits equivalent to their emissions of carbon dioxide, a primary greenhouse gas that is a byproduct of burning fossil fuels. The program functions as a regional emissions trading program; however, the legal authority for the program comes from each participating state's adoption of the RGGI program.

RGGI specifically targets fossil fuel-fired electricity generating units that are 25 megawatts or larger. The first compliance period for the program is 2009-2012. By the end of each compliance period, regulated entities must have obtained and submitted a sufficient number of emissions credits to account for their carbon dioxide emissions during the previous three-year period.

The initial emissions reduction target, or "cap," is said to represent a reduction of 2009 emissions by ten percent — even though the cap was calculated by averaging emissions from the three highest emitting years between 2000 and 2004. Beginning in 2015, this cap will decline annually by 2.5 percent per year until a ten percent reduction from the 2009 cap is reached in 2018.

The bulk of the emissions credits under RGGI are referred to as "allowances." An allowance represents a grant of authority to emit a fraction of the cap. For example, the initial stage of the RGGI program caps emissions of carbon dioxide from regulated entities at 188,000,000 tons. This initial cap is divided into 188,000,000 allowances, so each allowance grants its owner the authority to emit one ton of carbon dioxide.

Another type of RGGI credit is an "offset." An offset is generated by a reduction in greenhouse gas emissions that occurs at an emissions source that is not regulated by the RGGI program. The RGGI program lists a variety of projects that are eligible for the grant of offsets, including the capture of methane emissions from landfills and farming operations, or from afforestation (the transition of land from a non-forested to forested state). To be granted offsets, a project developer must submit an application requesting an award of offsets based on emissions reductions (measured in carbon dioxide equivalents, such as methane or nitrous oxide) that meet the parameters outlined in the RGGI regulations of the authorizing state.

The RGGI CO2 Allowance Tracking System (RGGI COATS) is the platform that records and tracks credits and other data related to each state's CO2 Budget Trading Program. Once a credit is granted to or otherwise obtained by an entity, the entity is free to hold or sell it. To sell a credit, the entity holding the credit must request a transfer of designated RGGI credits from its COATS account into the account of the buyer of the credit.

Participating in the RGGI market

There are a number of methods by which parties may participate in the RGGI market. Entities that are required to submit RGGI credits pursuant to a compliance obligation may receive some allowances via a free allocation. Alternatively, several participating states have sought to generate revenue by auctioning allowances. The fifth auction of RGGI allowances was held on September 9, 2009. Auction participants need not be regulated entities. States participating in RGGI have implemented a regional auction platform to sell credits.

An over-the-counter market for RGGI credits has also developed. In fact the International Swaps and Derivatives Association published in 2006 an annex to its ISDA Master Agreement (most commonly used for derivatives trading) that allows parties to document over-the-counter transactions in certain types of emissions credits under the master agreement. ISDA's US Emissions Allowance Transaction Annex (Annex) is designed for use in documenting transactions for the purchase, sale or exchange of an emissions product on a spot or forward basis, as well as options to purchase, sell or exchange an emissions product. However, the Annex did not originally contemplate the trading of RGGI credits; therefore, ISDA is currently in the process of revising the Annex to include provisions specifically for trading RGGI credits. In the interim, Barclays Capital has released a set of terms for trading RGGI credits that are intended to be used in conjunction with the existing ISDA documentation.

Parties may also participate in the RGGI market by buying and selling exchange-traded contracts. The New York Mercantile Exchange Green Exchange and the Chicago Climate Futures Exchange (PDF) each launched RGGI futures and options contracts in the summer of 2008.

Understanding the risks

There are a number of risks unique to emissions products. A complete analysis of the risks associated with an emissions product transaction needs to be done on a case-by-case basis. The following section provides examples of two common risks faced by market participants trading RGGI products.

Product uncertainty: When an entity uses an offset for compliance, it is able to meet its compliance obligation under the program without a reduction of emissions occurring in the capped sector. For example, the RGGI cap limits emissions from the electricity generating sector and authorizes the creation of offsets from certain agricultural projects. An electricity generator may pay a farmer to reduce her emissions (creating an offset), reducing pollution, but not from the electricity generating sector.

RGGI generally permits the submission of offsets for compliance obligations on a one-to-one basis; however, there are important limitations on the amount of offsets that can be submitted for compliance purposes. Specifically, RGGI restricts the ratio of offsets to allowances that a regulated entity may use for compliance to 3.3 percent of the total allowances submitted for compliance in a given compliance period. This restriction will change if the price of credits exceeds certain levels. For example, if the price for credits exceeds $7, offsets can total five percent of the credits submitted for compliance; if the price of credits exceeds $10, ten percent of the credits submitted for compliance may come from offsets.

These limitations have material implications for the value of RGGI offsets relative to allowances. However, distinguishing between these two types of credits can be difficult, particularly in the secondary market where the underlying source of the credit may be unknown. For example, the NYMEX Regional Greenhouse Gas Initiative (RGGI) CO2 Allowance Futures contract ("NYMEX RGGI contract") defines "RGGI CO2 Allowance" as "a limited authorization under [the] RGGI program to emit up to one ton of CO2." Based on this language, it appears that physical delivery obligations under the NYMEX RGGI contract can be met by supplying offsets as well as allowances issued under the RGGI cap. Similarly, the RGGI futures contract offered by the Chicago Climate Futures Exchange, LLC does not appear to clearly distinguish between an offset and an allowance for settlement purposes.

Until this issue is resolved, buyers wishing to receive physical delivery of RGGI allowances (as opposed to offsets)

should use an over-the-counter agreement that carefully defines the deliverable product to exclude offsets.

Regulatory uncertainty: As noted above, the supply and demand for emissions products emerge from a compliance obligation imposed on regulated entities. Consequently, changes in the relevant regulations and compliance obligations can have a material impact on the value of an emissions product. While RGGI products are actively trading and the program is slated to continue at least through 2018, there is a possibility that RGGI may be preempted by a national "cap and trade" program. President Obama has committed to implementing a national program capping emissions of greenhouse gases, and the Environmental Protection Agency is currently moving forward with an endangerment finding that would trigger regulation of greenhouse gases under the Clean Air Act.

Furthermore, a national cap and trade program has been a key issue for Congress this year. Earlier this summer, the House passed the American Clean Energy and Security Act of 2009. ACES proposes a national cap and trade program for regulating greenhouse gas emissions from a wide range of sectors. The cap would come into effect in 2012 and would represent a three percent reduction in emissions from the 2005 base year. In 2020, the cap would be ratcheted down to achieve a reduction of 17 percent from 2005 emissions. Under the current proposal, the majority of the total budgeted allowances would be distributed in a free allocation, at no cost, to the electricity generating sector, energy-intensive and trade-exposed industries, and local natural gas distribution companies, among others. It is unclear what will happen when the Senate takes up this issue.

Other regulatory agencies are active in this area as well. Commissioner Bart Chilton of the US Commodity Futures Trading Commission recently gave a speech at the Chicago Climate Exchange asserting that a national cap and trade program regulating greenhouse gases would preempt regional cap and trade programs such as RGGI but would compensate the holders of allowances from those programs.

Regardless of whether a national program is implemented by an agency or through a legislative mandate, the precise treatment of existing RGGI credits under a new federal regime remains uncertain. Parties have addressed this regulatory uncertainty in a number of ways. For example, some over-the-counter trades in emissions products incorporate provisions that permit parties to "walk away" in the event of termination of the RGGI program, while others require parties to attempt to amend or replace a transaction if RGGI is preempted by a national emissions trading scheme. The best option will often depend on a party's position in the transaction (buyer or seller) as well as the party's risk profile. While there may not be an obvious right answer, parties should attempt to ensure that the provisions they choose for addressing a termination or preemption of the RGGI program meet their specific needs and interests.

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