



It ain't easy being green: understanding the unique risks of transacting in environmental commodities

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This is the first article in a series about trading of environmental commodities. This article discusses documentation risks inherent in trading these products. The second article in the series will describe practical approaches to mitigating the risks discussed below.

Introduction

Over-the-counter (OTC) trading of environmental commodities, such as emission allowances and renewable energy certificates poses unique risks. The extent of these risks depends on a range of variables, including the type of product traded and the design and evolution of the governing regulatory scheme. This article describes some of the risks that are generally applicable to the OTC trading of environmental commodities. The second article in this series will address methods for mitigating these risks in trading documentation.

Similar to traditional commodity trades, environmental commodity trades may require physical delivery of the underlying product at some date in the future. However, unlike traditional commodities, environmental commodities such as emission allowances are not tangible goods. Rather, they represent a legal authorization or right to emit a pollutant, and the transfer of that right from one party to another constitutes physical delivery. For example, under a cap and trade (CAT) program, an allowance typically represents an authorization to emit a specified quantity of the regulated pollutant and can be transferred from a seller to a buyer through a system managed by the program's administrator. Under a renewable portfolio standard (RPS), a renewable energy certificate (REC) generally represents that a certain amount of clean energy has been generated and may be used by a holder to satisfy its compliance obligations.

As discussed below, the failure to adequately define an environmental commodity to be delivered can present material risk to a transacting party. We will also address how regulatory changes can compromise the value of an environmental commodity.

Definitional risks inherent to documenting environmental commodity trades

An essential component of an OTC environmental commodity trade is the identification of the product to be delivered. In the United States, there is no national CAT program for regulating greenhouse gases, but a patchwork of state and regional programs have emerged. Similarly, there is no federal renewable portfolio standard; however, a variety of REC trading programs has been adopted by individual states. The lack of a national standard in these areas has led to

a range of products and programs. The resulting variety of products and standards makes precise definition of the deliverable product particularly important. Improper product definition in a trade could result in a buyer paying for something that it cannot use or a seller holding a product it cannot sell. The following are examples of the specific risks that can arise from vague or improper environmental product definitions.

Product "vintage": If a buyer discovers that it received a physical commodity that does not meet its specific needs (e.g., it received oil that is too sour or coal that has too much sulfur), the commodity may nonetheless retain some monetary value and may be capable of storage for future sale or sold in other markets. In contrast, there are often specific time constraints within which a particular environmental commodity may be submitted for compliance. For example, the "vintage" of a greenhouse gas emission allowance typically dictates the time during which such allowance may be used for compliance in the underlying CAT program. If the proper vintage is not specified in the relevant trading documentation, a buyer purchasing emission allowances to meet compliance obligations in a particular CAT program might receive credits that have expired or have not yet become useable.

Product type: Within a given program there may be multiple products that seem similar, but each may carry important compliance distinctions. For example, CAT programs typically distinguish an "allowance" from an "offset." An allowance is created by the administrator of the CAT program and represents a portion of the total cap on emissions. Offsets are credits that may also be submitted for compliance under a CAT program, but are typically generated through pollution reductions outside of the regulated sector. For example, a CAT program that seeks to reduce greenhouse gas emissions in the electricity generating sector might allow for the submission of certain offsets created by the planting of trees that result in a reduction of carbon dioxide in the atmosphere.

When a government implements a "cap-and-trade" scheme, it limits pollution by setting a "cap" on the total amount of a regulated pollutant that can be emitted by a group of polluting entities and divides the cap into tradable pollution permits. Each pollution permit, or allowance, typically authorizes the holder to emit the equivalent of one ton of the regulated pollutant. The total amount of allowances cannot exceed the cap, limiting total emissions to that level.

Polluters are often able to satisfy a specified percentage of their compliance obligations by submitting offset credits in the place of allowances. However, to encourage greater emissions reductions within the regulated sector of a given CAT program, regulators may decrease the percentage of offsets that may be submitted to meet an entity's compliance obligation. Therefore, trading documentation that fails to precisely identify the product to be delivered can have significant consequences for an unwary buyer.

Noncompliant credits: Parties also need to ensure that the credits they are trading can be used in the intended market. An allowance representing the right to emit one ton of carbon dioxide in Europe may not provide the right to emit one ton of carbon dioxide in the northeast United States. Similarly, a REC generated in Texas might not satisfy the RPS in California.

Regulatory risks associated with documenting environmental commodity trades

The value and usefulness of an environmental commodity is closely linked to the regulatory program that governs its creation and use. For example, supply of, and demand for, a given type of emissions credit will vary depending on the rules of the applicable CAT program. If the cap in the European Union Emission Trading System (EU ETS) were lowered, the demand for credits in that program would likely increase. While a variety of modifications to an underlying CAT program are possible, the exact changes that will occur can be difficult to anticipate. The potential for changes to the underlying regulatory program thereby create unique regulatory risk associated with the trading of an environmental commodity. Below, we discuss some of the types of changes that present this form of regulatory risk.

Many US states mandate that a certain percentage of electricity generated or sold within the jurisdiction come from renewable energy sources also known as a renewable portfolio standard (RPS). Regulated entities may comply with these obligations by submitting renewable energy certificates (RECs) that represent that a certain amount of clean energy has been generated.

Cancellation of a scheme: Unlike demand for traditional commodities, which is largely driven by market forces, demand for environmental commodities is driven largely by the environmental goals of the relevant regulatory programs. If the program administrators determine that the environmental goal has been met or that the program is not working, the program may be cancelled. If the terms of an environmental commodity trade do not release a buyer from its obligations to purchase credits in this circumstance, the buyer may be required to purchase the credits even though the program no longer exists.

Replacement or preemption: Replacement or preemption of an existing regulatory program by a new program is an additional regulatory risk. For example, there is continued speculation that federal legislation may preempt the existing regional CAT programs such as the Regional Greenhouse Gas Initiative (RGGI). How existing RGGI credits will be treated under such a scenario is uncertain. Existing credits may or may not be transferable into a new program. Even if they are transferable or convertible, they may be discounted at a rate to be determined in the future.

Modification of program: As environmental goals and policies shift, environmental programs may be modified. A range of modifications are possible such as shifting of compliance deadlines, increasing or decreasing of caps, changes to the universe of regulated sources or linking of programs. For example, when the US Environmental Protection Agency's Clean Air Interstate Rule (CAIR) was adopted, it retained existing CAT programs for NOX (nitrogen dioxide) and SO2 (sulfur oxide), but significantly altered a variety of the provisions associated with those programs. Material program modifications are likely to impact the value of an environmental commodity trade. In extreme situations, a modification could leave a seller holding credits that have become useless or discounted while maintaining a delivery obligation that cannot be met by transferring the credits it holds.

Administrative failure/temporary suspension: The intangible nature of environmental commodities makes proper tracking and recordkeeping by program administrators essential. Administrative and operational errors, such as the failure by an administrator to keep track of credits properly or make the transfers of credits from one account to another in a timely manner, can threaten the integrity of the entire market. For example, in a well-publicized incident in the EU ETS, Hungary recently mistakenly sold millions of offset credits that had already been surrendered for compliance and were mistakenly resold into the market. The existence of these invalid, recycled credits temporarily shut down the entire market. Given the technical nature and novelty of many CAT programs, additional growing pains can be expected.



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