



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

May 21 2010 [Teigland-Hunt LLP](#) recommended

Mitigating definitional risks inherent to environmental commodity trades

[Part one](#) discussed several examples of the specific risks that can arise from using vague or improper product definitions when documenting OTC trades involving environmental commodities such as renewable energy certificates (RECs) and greenhouse gas credits issued pursuant to a CAT emissions trading program. The following section outlines some of the methods used in trading documentation to mitigate these definitional risks.

Product "vintage": A REC or allowance credit under a CAT program can be submitted for compliance purposes typically only during a certain time period that is dictated by the "vintage" of the particular credit. The vintage of an environmental commodity typically refers to the year the product was generated or created; for example, depending on the precise terms of the relevant program, a credit with a vintage of 2012 may be submitted and used for compliance in 2012. Sometimes credits may be saved for future use (or "banked"), but under some programs the value of a credit may be reduced over time or the credit may even expire. The risk of obtaining credits that are not yet useable (or that may have expired) can be addressed by clearly defining the vintage of the product to be delivered in trading documentation.

An "allowance" is generally created by the administrator of a CAT program and represents a portion of the total cap imposed on emissions. "Offsets" are generally created by activity that reduces emissions of the relevant pollutant in a particular way. Both are referred to as "credits."

In addition it is important to review the relevant provisions of the governing regulatory program to determine how a particular credit will be treated or counted based on its vintage. The buyer should be aware of the specific regulatory deadlines within each program and manage the risk that credits delivered may not be usable in the intended compliance years at the same ratio as other years. To reduce this risk, parties to a transaction may consider specifying that, upon delivery, a product must be useable for compliance in a specified year at a one-to-one ratio, for example.

Product type: With environmental commodities, a buyer may run the risk of receiving an unusable credit if the needed deliverable is not properly defined. For example, a utility that contracts for the purchase of "credits" to meet a compliance obligation under RGGI may receive delivery of offsets instead of allowances. While both offsets and allowances can be submitted for compliance at a one-to-one ratio, RGGI caps the percentage of offsets that may be submitted for compliance by an entity in a compliance period. Consequently, a trade that permits a seller to deliver offsets may result in the buyer receiving offset credits that it cannot submit for compliance if the buyer has already reached the limitation on offset submissions under the relevant program. Parties must therefore review their own compliance needs and the governing program terms to determine what types of credits should and should not be eligible for delivery.

Credits may also be discounted over time. Under the Clean Air Interstate Rule (CAIR), Title IV Acid Rain Trading Program allowances were discounted in the later years of the program in order to strengthen its environmental parameters. Parties can address this risk by specifying a vintage or range of vintages to be delivered; however, there may still be a risk of discounting after the trade date. Alternatively, parties may address this issue in trading documentation by including language requiring delivery of a credit that may be submitted for compliance at a one-to-one ratio at a particular time.

Under RGGI, the use of greenhouse gas offset credits is initially limited to 3.3 percent of a regulated entity's total compliance obligation during a control period. This cap may be expanded to 5 percent and 10 percent if certain events occur in the future.

Noncompliant credits: A credit providing the right to emit one ton of carbon dioxide under a trading program in the United States generally cannot be used for compliance purposes under the Emission Trading System in Europe. Parties should

therefore ensure that the credits they are trading can be used for compliance in the intended market by referencing the correct trading program and legal/regulatory authority generating the credit in their trading documentation. Specifying these details should be fairly straightforward, but in some cases it can be more complex. For example, parties trading RGGI credits may reference the memorandum of understanding (MOU) that outlined the provisions of the program; however, the legal authority for RGGI credits originates from the adoption of state laws implementing the RGGI MOU by individual participating states.

In addition, parties should be mindful of the fact that certain credits may be invalidated prior to their being submitted for compliance. For example, an offset that was generated through the planting of trees can be invalidated due to a forest fire. While these types of occurrences may be unlikely and impossible to foresee, parties may choose to assign the risk of such occurrences to either the buyer or the seller in their trading documentation.

Mitigating regulatory risks associated with environmental commodity trades

The regulatory program governing an environmental commodity credit may be modified over time, and the exact nature and likelihood of such changes can be difficult to anticipate. These unique regulatory risks are inherent to the trading of environmental commodities. In part one, we discussed some forms of regulatory risk associated with trading environmental commodities. The following section outlines some of the methods used in trading documentation to mitigate and allocate regulatory risks.

Cancellation of a scheme/replacement or preemption: If the administrators of a given environmental program determine that the program's goal has been met or that the program is not working, the program may be discontinued. In addition, a regional program may be replaced or preempted by a federal scheme. Some parties address this risk in their trading documentation by including provisions that state that the parties may "walk away" from their obligations under the trade upon the cancellation or replacement of the relevant program, i.e., the trade is cancelled without payment or delivery by either party.

Other parties may seek to provide that one party will pay a termination or settlement payment to the other party upon a program's cancellation or preemption. While it may be possible to use the last quoted price for the product in question to calculate such a payment, quotes may be dated or not readily available in such circumstances. To provide more guidance to the valuation process and minimize disputes, parties may consider designating an agreed price source for quotations or a valuation methodology that will apply upon cancellation or replacement of a program.

Modification of program: Although a deliverable credit specified in a trade may be compliant with the relevant program as of the trade date, parties should consider how to address changes to the governing program that occur after the trade date but prior to delivery. For example, some parties assign this risk by specifying the date upon which a deliverable credit must be useable for compliance under a particular regulatory program. If neither party is willing to accept the risk of changes to a program, parties might agree to include a "walk away" termination provision that applies in the event certain material changes to the program occur.

In drafting such provisions, parties also need to recognize that while certain modifications to environmental programs will impact the value of the associated environmental commodity, other changes will have little or no impact on the value of their trades. For example, it is possible for programs to be renamed or otherwise modified in nonmaterial ways but continued in all other respects. Therefore, it is important to ensure that a "walk away" right is not applicable upon the occurrence of immaterial modifications. In determining the appropriate approach for addressing potential program modifications, parties will likely need to consider their own specific needs and objectives relative to the trade.

Administrative failure/temporary suspension: An administrative failure by a program administrator to transfer or keep track of retired credits may cause a delivery delay or a delivery of invalid credits where neither the buyer nor seller is at fault. To address this situation, parties may wish to treat such an occurrence similar to a typical force majeure event, including a grace period for resolution with a fall back to termination of the transaction. Alternatively, buyers may be inclined to assign the burden of delivering compliant credits to the seller, regardless of administrative failure.

Conclusion

Over-the-counter trading of environmental commodities involves a set of unique risks. An understanding of the governing regulatory program is essential to managing these risks. Informed professionals can mitigate or allocate many of these risks through careful drafting of provisions in their trading documentation, taking into account the particulars of a given program and their own needs and objectives.



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