

The Emerging Greenhouse Gas Emissions Cap and Trade Market

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A variety of greenhouse gas (GHG) emissions reduction programs are being created in the United States. Understanding the products offered is key to assessing the risk and value of an investment in this emerging market. Congress and the President have both committed to pass legislation mandating regulation of GHG emissions. Democrats and the Administration are favoring a “cap and trade” (CAT) approach that would place a ceiling or “cap” on GHG emissions and establish a marketplace for trading the right to emit GHG emissions under the cap. The recently introduced Waxman-Markey draft legislation, entitled “The American Clean Energy and Security Act of 2009,” is the starting point for coming Congressional action that would impose a mandatory cap on GHG emissions. The U.S. Environmental Protection Agency (EPA) may also be moving toward regulation of GHG emissions under the Clean Air Act, having submitted to the White House a proposed “endangerment finding” concluding that global warming endangers public health and welfare. If approved by the President, this finding would require the EPA to regulate emissions of GHG from sectors such as power plants and automobiles.

In the meantime, a number of regional and voluntary emissions reduction programs have emerged in the U.S. as potential mechanisms for trading GHG emissions-related products. The largest and most liquid U.S. GHG markets include CAT programs under the Regional Greenhouse Gas Initiative (RGGI) and the Chicago Climate Exchange (CCX). RGGI, a mandatory emissions reduction program requiring power plants to hold credits covering their emissions of carbon dioxide, held its third auction of GHG credits in March 2009. The price of a RGGI credit has risen steadily since the first auction in September 2008, currently up by 15%. The New York Mercantile Exchange (NYMEX) and the Chicago Climate Futures Exchange (CCFE) each launched RGGI futures contracts in summer 2008. CCX, which is a voluntary emissions reduction program, has been around for much longer. The price of CCX credits climbed from less than \$1 per contract in March 2004 to almost \$6 in March 2008. However, in the wake of the first RGGI auction in September 2008 the price of CCX credits fell to under \$2.

While there are a number of questions to be addressed when assessing the risks and value of products being offered on these markets, a fundamental question is whether the product being traded is properly defined in the trading agreement.

Is the product being traded properly defined?

The cap in a CAT program must be divided into small, tradable units. These units are referred to as *allowances*. An allowance is similar to a license or a permit in that it grants the owner the authority to act. In this case, the action taken is the emission of a pollutant equivalent to the fraction of the cap that the allowance represents. For example, an emissions trading program with a cap of 100 tons of carbon dioxide might have 100 allowances, each of which grants the owner the authority to emit one ton of carbon dioxide.

Another tradable unit often included in an emissions trading program is an *offset*. An offset is a credit that is generated from a source not covered by the CAT program. When an entity subject to a CAT program uses an offset for compliance, it is able to meet its obligation under the CAT program without a reduction of GHG emissions occurring in the capped sector. For example, if a CAT program capping power plants authorizes the use of offsets from agricultural projects for compliance purposes, the power plants may pay farmers to reduce their emissions (creating an offset) in lieu of the power plants reducing their own emissions. Pollution will be reduced overall, but the reductions may not have come from the electric generating sector.

In many CAT programs, both allowances and offsets may be used to meet an entity's compliance obligation under the cap. 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. However, this distinction is crucial in assessing the value of an emissions credit for at least two basic reasons:

1. A regulator may limit the ratio of offsets to allowances that may be submitted for compliance; and
2. Offsets may only be valid if the underlying activity complies with all the requirements of the regulatory authority. These requirements may include continued (or sustained) reduction of emissions after the offset is created. Under the model rule developed by states for implementation of RGGI, for example, a regulatory authority may revoke offsets if it determines the underlying project does not comply with required standards. It is unclear how this provision may operate in practice; however it is possible that a regulator could revoke an offset after its sale.

International markets such as the European Union Greenhouse Gas Emissions Trading Scheme recognize the differences between offsets and allowances, and this recognition is reflected in the lower pricing of offsets in relation to allowances. In contrast, the U.S. markets do not yet clearly make the distinction. When trading GHG credits in the over-the-counter market, whether through a bespoke document, the U.S. Emissions Annex published by the International Swaps and Derivatives Association, Inc. (the "ISDA Annex"), or the recently released Barclays Capital set of terms for use with the ISDA Annex for trading RGGI credits, parties must ensure that they have defined the deliverable product with certainty. Defining the deliverable product when trading standardized futures contracts on electronic facilities such as NYMEX or CCFE raises

different problems, as there is no ability to amend the standard form contract. However, the benefit of a standardized product and centralized clearing makes exchange-traded futures contract attractive to market participants. It will be interesting to see how this issue will be dealt with by the various exchanges.

U.S. GHG emissions trading markets are growing steadily and the industry is poised for take-off. Given the new Administration's commitment to reducing GHG emissions, a federal CAT program may be on the horizon. Prudent investment in these markets requires careful assessment of the regulatory and legal risks associated with the product being traded. This assessment should undoubtedly include a thorough analysis of the product to be delivered as well as careful negotiation of trading documentation.

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