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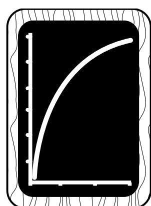

LEARNING CURVE®

# Emissions Allowance Trading Documentation

In Europe, the E.U. Emissions Trading Scheme set up under Directive 2003/87/EC facilitates the trading of greenhouse gas emissions allowances and credits by emitters and third parties, whether for compliance purposes or for financial gain, and now accounts for more than 60% of the global carbon market. The rapid growth of an over-the-counter market has driven the need to develop a standardized set of terms and conditions of trade. Such is the diversity of interests of trading participants that three different but all commonly used sets of terms have now been developed by:

1) The **International Emissions Trading Association**;
2) The **European Federation of Energy Traders**; and
3) The **International Swaps and Derivatives Association**.

For the purpose of this Learning Curve we shall concentrate on the workings of ISDA's provisions for the documentation of E.U. Emissions Allowance Transactions. ISDA's provisions operate as a set of terms that can be attached to the back of either a 1992 or 2002 Master Agreement Schedule.

## ISDA Emissions Provisions

In February, ISDA published two new versions of its documentation that focus primarily on forward and options trades, where the underlying asset is an allowance, being either: 1) an E.U. allowance issued under the Directive; 2) an E.U. credit generated under the Clean Development Mechanism or the Joint Implementation Scheme established by the Kyoto Protocol; or 3) an alternative allowance, which is a general term designed to capture allowances linked to similar non-member state trading schemes. These allowances also relate to a specified compliance period, either the first phase of the ETS from 2005 to 2007, or the second phase from 2008 to 2012, while discussions are still ongoing as to the development of the ETS post-2012.

## Disruption Provisions

The majority of the ISDA provisions deal with circumstances where either the delivering party fails to deliver allowances on the due date, or the receiving party fails to receive them. In the event of either occurrence, the position of the parties is dependent upon the reasons for the failure to deliver or receive. In all cases, ISDA has built in grace periods to ensure the parties have an opportunity to remedy the problem before a right to terminate the transaction arises, although the length of such period is also dependent upon the reason for the failure. Broadly, there are three possible categories of a failure to deliver or receive:

1) Settlement Disruption Event;
2) Suspension Event; and
3) Any failure to deliver/receive which is neither of the above.

## Settlement Disruption Event

A Settlement Disruption Event is any event beyond the control of a party which makes it impossible (after using reasonable efforts) to perform its obligations to deliver or receive allowances. The provisions make clear that this would not extend to circumstances where the failure to deliver is simply as a result of not having enough allowances in the relevant Trading Account of a Member State Registry.

Either party can provide notice of such an event, although the party affected by the event must provide details of both the extent and expected duration of its inability to perform its obligations. Both parties' obligations are then suspended until the disruption ceases to exist. If, however, it continues beyond the stated grace period (which typically ends nine Delivery Business Days after the Delivery Date), then, depending on whether the provisions form part of a 1992 or a 2002 ISDA Master, there will either be an Additional Termination Event or an Illegality, respectively. Both parties are deemed to be Affected Parties, and if either party designates an Early Termination Date, any close-out payment would be determined in accordance with the Section 6(e) provisions.

The parties can elect in the confirmation for "No Payment on Termination for Settlement Disruption" to apply. In this case, it is deemed that the parties had no further obligations after the onset of the disruption. As such, with the exception of any unpaid amounts due before the event occurred, there

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will be no close-out amount payable by either party. If not selected, performance of obligations is deemed to have resumed on the Early Termination Date.

## Suspension Event

A Suspension Event is a special category of Settlement Disruption Event, where a party is unable to perform its obligations due to one of three specific events:

1) the absence of a fully operational link between the International Transaction Log and the Community Independent Transaction Log, both of which are electronic mechanisms that enable delivery and tracking of allowances between registries in different jurisdictions;
2) the Trading Accounts of either party are in Member State Registries which have not met certain eligibility criteria; and
3) the Trading Account of the delivering party is in a Member State Registry which has breached its Commitment Period Reserve (the minimum number of allowances which must be held 'in stock' by an Annex B country to ensure that it will have sufficient allowances to meet its Kyoto emissions reduction targets).

The procedure following a Suspension Event is similar to that for a Settlement Disruption Event, although the key distinctions are that: 1) the suspension of obligations continues until the earlier of either ten Delivery Business Days after the Suspension Event ceases to exist, or three Delivery Business Days prior to April 30, 2013, being the last date for surrendering allowances in the second phase of the ETS. If the Suspension Event continues to exist on the Long-Stop Date (which varies depending on the nature of the Suspension Event although, with a couple of exceptions, it will either be three Delivery Business Days prior to April 30, 2013, or December 1, 2012) then an Additional Termination Event or an Illegality will have occurred and the Long-Stop Date will automatically be the Early Termination Date; and 2) all obligations are automatically deemed to have ceased following the onset of the Suspension Event, without the need for the parties to have made any specific election in the confirmation.

## Other Failure To Deliver Or Receive

Any other failure to deliver or receive allowances not falling within the above is treated differently. It is not treated as an Event of Default, but instead, the payment and delivery date is postponed and the non-defaulting party can give notice to the defaulting party to remedy its failure to deliver or receive allowances and pay default interest, in each case by no later than the first Delivery Business Day after that notice. If delivery does not take place by such date, the defaulting party has to pay the non-defaulting party their cost of replacing the transaction. The method of calculating the replacement cost of a non-defaulting party will depend largely on the elections made in the confirmation, as follows:

## Excess Emissions Penalty

If Excess Emissions Penalty is applied in the documentation and the delivering party fails to deliver, on a Delivery Date which falls during an Excess Emissions Risk Period (a period of time, specified in the confirmation, prior to the first succeeding date when allowances have to be surrendered under the ETS), the receiving party must firstly (using reasonable endeavors) attempt to buy replacement allowances elsewhere. To the extent that this process costs the receiving party more than it would have paid under the forward or option, the delivering party must compensate the receiving party for that difference, plus interest. In addition, the delivering party must reimburse the receiving party for costs and penalties incurred by it in circumstances where the receiving party was not able to buy enough replacement allowances to meet its obligations under the ETS. This payment is described in the provisions as an EEP Amount, although the documentation also offers a possible election whereby the receiving party can recoup penalties owed by it to third parties as a result of non-compliance under the ETS resulting from non-delivery of allowances.

In the above example, if Excess Emissions Penalty is not specified, or Excess Emissions Risk Period is not applicable, and the delivering party fails to make delivery of allowances, the replacement cost is the excess of the price per allowance that the receiving party does or would receive in an arms length transaction, over the price per allowance that it would have received under the forward or option, plus interest. In this case, there is no compensation for penalties arising due to non-compliance under the ETS.

## Failure To Deliver (Alternative Method)

Specifying the Alternative Method means that the calculation of replacement cost in the above example will work in a similar way to the basic position where Excess Emissions Penalty is not specified. A key difference, however, relates to the amount of default interest that is paid. In the basic position, default interest is paid on the excess price per allowance, multiplied by the shortfall of allowances. In the Alternative Method, default interest is paid on the total price of allowances as agreed in the forward or option, multiplied by the shortfall of allowances. The Alternative Method will therefore typically generate a higher amount of default interest. Additionally, it is possible, under the Alternative Method, to specify "EEP" in the confirmation such that compensation will be owed for penalties incurred for non-compliance under the ETS, as a result of non-delivery. There are, however, more stringent obligations in this case on the receiving party to demonstrate the validity of any claims for such an "EEP Payment".

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