The nature of the thing

Failure to distinguish between environmental instruments and the cash-settled contracts based on them could impose crippling costs, warn Christopher Berendt and Jeremy Weinstein

The environmental markets community often takes for granted the distinction between the environmental instrument or commodity itself – for example, the allowance, the green certificate, the offset – and financial products that can package these things as securities or use them as the underliers for derivatives.

If the distinction between such instruments/commodities and financial products that exchange cashflows based on changes to the prices of such instruments is not kept in mind and reinforced, there is a risk certain environmental market transactions could be caught in the regulatory reflex to the credit crisis. They might thereby be forced to bear significant additional regulatory, reporting, legal risk and collateral costs arising out of the Dodd-Frank Wall Street Reform and Consumer Protection Act (see box). Now is the time for the environmental markets to maintain vigilant focus on the nature of the thing.

When trading environmental instruments today in the spot or forward markets, physical settlement with physical delivery via a registry or exchange of paperwork is standard. Cash is paid and something other than money is delivered in return. The environmental instruments and commodities are eventually consumed through retirement for compliance or voluntary stewardship. Alternatively, when purchasing a futures contract, financial product or security that is linked to the price of such instruments in environmental markets, cash settlement is standard without any physical delivery, as is the case with any other instrument underlying a derivative transaction. Unfortunately, it is not surprising that in markets with a 'teenage' level of maturity, what is often viewed internally as convention is seen externally as anything but.

There is a risk environmental market transactions could be caught in the regulatory reflex to the credit crisis

In many cases, those unacquainted with the environmental markets confuse the 'corpus' or body of environmental instruments for the purpose. The confusion is understandable. The corpus of an environmental instrument or commodity is intangible; they cannot be held in the hand, like a bushel of corn; instead they exist on pieces of paper and in data on registries.

This intangibility can be mistaken as a *prima facie* case for categorising environmental instruments as financial products that share a lack of corpus. However, there is a purpose to which environmental instruments and commodities are put when delivered, which is squarely different from what can be done with the mere cash that is exchanged in financial products. Like many traditional commodities, they are physically settled with something being delivered and consumed. Whether consumption is for compliance, stewardship or a tortilla dinner, the commodity is used to satisfy an end that cash cannot.

Financial products, derivative contracts, and securities use the environmental commodity markets for pricing the exchange of cash flowing both ways, without physical delivery of anything. Some say everything is for sale, but cash can never meet the same purpose as commodities – as things that get directly used.

The blurring of corpus and purpose is compounded by the difficulty of articulating the express nature of environmental instruments and commodities. There is a reason we often speak of 'instruments' in the environmental markets. For instance, compliance emission allowances can be called governmental permissions to emit.

In the US, for constitutional 'takings' doctrine reasons, emissions allowances are expressly stated in enabling statutes not to be private property. However, emissions allowances can also be characterised as quasi or *de facto* private property because they can be bought and sold like property. Some have argued that allowances are more like liquor or communications licences or fishing quotas – intangible assets having market value, but at risk of being taken back or changed by governments at any time.

Another example can be found in project-originated environmental instruments and commodities, such as Renewable Energy Certificates (RECs) and carbon offsets, for which both compliance and voluntary markets exist. One could argue that these activity-based instruments are clearly private property. This private property may be used for compliance, but its existence is not dependent on a governmental body issuing the environmental instrument as with allowances.

If one originates a REC from a wind generation facility that has obtained a Renewable Portfolio Standard compliance certification number from a state public utility commission, that number represents access to the compliance market, it does not 'create' the REC itself or enable the claim that 1MWh of renewable energy generation has occurred. It does not allow for the issuance of the REC in general, as one could potentially create and sell that same REC into the voluntary markets without any government involvement. Double-counting would obviously be a problem if one tried to send the same REC into both markets. The REC exists as property, having been created and existing independent of a government compliance requirement, even if it may be used to fulfil one.

Thus, when 'the nature of the thing' is still a matter that can be helped by further legal clarification within our community, we should not be surprised when the lines get blurred between foundational environmental instruments and commodities (representing intangible, exchangeable rights and ownerships) and financially-settled product structures built over the top of the physical environmental markets.

Although environmental instruments and commodities are not securities pursuant to the standards of prevailing US case law, their potential

Dodd-Frank and derivatives

On 21 July 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which targets a number of the sources of the 2008 global financial crisis. Title VII of the Act notes sub-prime loans were repackaged for resale as derivatives, and requires that, to the maximum extent possible, all derivatives transactions be removed from the over-the-counter (OTC) markets, which were previously lightly regulated and provided unsecured credit, to highly regulated exchanges with full collateralisation requirements.

Title VII also adds extensive new regulation to remaining OTC markets. One of the most critical components of Title VII is the definition of the word 'swap', which is what falls within the jurisdiction of the appointed regulator, the Commodity Futures Trading Commission and under its extensive subsequent rule-makings.

classification as a 'swap' under Dodd-Frank rule-making is currently a risk. The risk is not only to the US environmental markets – if the birthplace of the environmental markets gets this wrong, it will have global implications.

In the backlash to the financial crisis, every complex market is suspected of being a credit default swap, with a cascading market failure waiting in the shadows. The US regulatory net being cast is wide. For instance, if environmental instruments and commodities themselves are caught in the broad definition of 'swaps' in the joint rule-making of the Securities and Exchange Commission and the Commodity Futures Trading Commission (CFTC), or otherwise snagged in the new regulatory net, then bilateral over-the-counter forward contracts for these instruments could face significant compliance overhead, legal risk and an additional 5–15% liquid collateral requirement for clearing. When an environmental instrument sale is a core component of project finance, as with renewables and offset projects, an additional cash requirement could doom many projects.

For those of us working to educate regulators and drive home the reality of physical delivery and consumption of intangible environmental instruments and commodities, the aim has been to get an express exemption from the swap definition for environmental instruments and commodities. Unfortunately, in the Notice of Proposed Rulemaking released by the CFTC at the end of April, no such exemption was present; in fact, the CFTC merely asks whether their lack of corporeal existence qualifies environmental instruments/commodities as swaps. We should not leave it to hope that the conclusions of the CFTC's preceding carbon market study pursuant to Section 750 of the Dodd-Frank Act, which said 'no swap' for carbon allowances, combined with exemptions for end-users and forward contracts as well as public interest waivers, will thoroughly inoculate the primary environmental markets from collateral cost and other risks.

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We need to redouble our efforts as a community on this issue. All of us must maintain consistent definitional clarity. By this we mean simply always identifying environmental instruments and commodities as such, and avoiding spinning the definitions of wholesale and retail environmental market-linked products. As with other environmental market issues, creative marketing in the secondary markets is putting the primary markets that directly support project finance at risk from significantly heightened transaction costs. If you hear someone speaking about RECs or offsets themselves as 'eco-securities' or 'green financial products' correct them. The line between environmental instruments and the financially-settled products linked to them must be kept as clear as possible. **EF**

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