

On the Path to Renewable Energy Certificate Derivatives

By Jeremy D. Weinstein¹

In February 2007, a working group organized by committees of the American Bar Association's Section of Environment, Energy and Resources,² the Environmental Markets Association, and the American Council On Renewable Energy, released version 1.0 of a standard form master trading agreement for trading Renewable Energy Certificates (RECs, or "green tags"). This Master Renewable Energy Certificate Purchase and Sale Agreement is the product of a two year effort³ by 80 individuals from 70 law firms, brokerages, energy marketers, utilities, renewable resource developers, and regulators. It is available online at <http://www.acore.org/programs/rectrading.php> and <http://environmentalmarkets.org>. The posted document contains an explanatory Introduction for Users and Guidance Notes. This article will introduce and discuss facets of the contract that are likely to be of special interest to readers of this periodical.

RECs represent aspects of the renewable energy nature of generation from renewable resources, separated from the electricity itself. Trading in RECs is an important market mechanism to optimize and promote renewable resource use and development. Since 2000 or so, in the absence of federal leadership, individual states have been legislating programs mandating the use of electricity from renewable resources, generally called Renewable Portfolio Standards (RPSs). These RPSs often use RECs as accounting or compliance instruments. All along, there have been voluntary RECs purchase programs, for those interested in promoting renewable resources, or reducing their own environmental "footprint." The need for a working group to come together to promote a national master trading contract became urgent as it grew apparent that many states were in need of tools to assist them in implementing RECs that could be fungible across state programs, and to provide a legal structure to accompany the development of the physical infrastructure of generation information systems that track renewable resource output to assure RECs legitimacy across borders and prevent double counting of the same environmental benefit.⁴

The resulting contract provides market participants and policy makers strong tools to fight balkanization of U.S. RECs markets. The contract is technology neutral, and not only usable in both the voluntary and

compliance markets, but also across different voluntary and compliance markets.

The contract achieves this through a disclosure driven-model. It does not mandate what is in a REC, but provides mechanics that enable full and accurate disclosure of what is in fact bought and sold by the parties. It provides a selection of definitions for RECs. In between the bookends of a "standard REC", which includes all environmental attributes, and a "basic REC", which includes only the generation attributes, sits the "specified REC." The seller of a "specified REC" completes a Disclosure Document that drags a user along what exactly needs to be disclosed in terms of the attributes of a REC that are or are not being sold, from the specific components, to the verification methodology. However, which methodologies and verifiers are required is not mandated- merely their disclosure. The Disclosure Document, once prepared, travels downstream in further transactions of the REC, which may be broken apart further. Use of the Disclosure Document by the parties is optional, but it is a powerful tool for unlocking the potential future value in RECs, wherever that value turns out to lie as REC and Carbon markets develop.

As for meeting the requirements of the various, differing state programs for RECs, the disclosure model provides a way for parties to represent the programs with which the RECs sold comply, rather than including each state's different definition of a REC. To analogize, a certain grade of cement can be defined in a contract, and the seller can either represent that it meets the defined grade and leave it to the buyer to figure out if it meets a particular building code, or also represent that it meets one or more particular building codes. Event though the contract's definitions seek to avoid fragmentation by focusing on the grade of cement, rather than the building codes, the contract recognizes that parties are often transacting to meet specific building codes, and so would naturally want to make representations respecting them.

Building codes, and RPS programs, can change over time, and RECs are commonly pre-sold in long-term streams as part of project development or otherwise on a forward basis, and so a new concept was introduced concerning the effective time of the representation that a seller could make concerning compliance. The seller could represent that the cement meets the building code that is in effect today, and the seller can also promise that the cement will meet the building code in effect

when the cement is delivered. Under the contract, a seller's representation concerning RECs compliance with any particular jurisdiction's program is effective as of the trade date, with the buyer taking on the change in law risk, but if the seller warrants the RECs sold as "Regulatorily Continuing," the seller is representing that they will comply as of the delivery date as well, thereby taking on the change in law risk.⁵ This concept was shared with the International Swaps and Derivatives Association's US Emissions Trading Annex drafting committee, whose membership overlapped with that of the RECs contract working group, and appears in the final ISDA document.⁶ Insurance companies have entered the market to provide compliance insurance products in European Carbon markets, such as Carbon Re's Carbon Compliance Guaranty, and one can envision the growth of RECs compliance insurance products that interact with this ability of the parties to more precisely allocate change in law risk.

Standardizing RECs based on their inherent characteristics and leaving it to the parties to disclose what they are doing and allocate the risks of compliance, as opposed to parroting in minute detail multiple regulatory definitions that can often vary and change in many small respects for many different reasons, not only is more conducive to developing environmental commodities that are fungible across programs, it is also a clearer path to potential development of futures contracts in environmental commodities.

Additionally, the drafters of the contract recognized that a key to the development of deep and successful RECs markets, including options, derivatives and other hedging products for RECs, was successful enabling of speculative participation and the ability to take short positions. To facilitate this, the contract provides a mechanism for later designating a complying renewable resource after the trade date, instead of requiring a known and complying renewable resource on the trade date.⁷

Most likely, REC markets are the appetizers; the real meal is going to be Carbon markets, as adoption of global warming legislation in the United States snowballs at the state, regional and federal levels. A strength of the contract is that it provides multiple entry points for RECs into those Carbon markets, however they turn out to develop.⁸

The contract works much like a typical master trading agreement, and includes a cover sheet to fill in with identifying information and core elections, many

relating to payment and credit arrangements, as well as allowing additional terms to be custom negotiated between the parties. Options are also provided to enable collateral margining, if elected, to hook into existing master energy or derivatives trading agreements in place between the parties.⁹

The parties may also select the applicable governing law, and given the intended use of the contract by those seeking to comply with RPS obligations, it is not improbable that some may show a propensity for selecting their local law. However, many local jurisdictions do not have qualified financial contract exemptions to their Statute of Frauds, such as are provided under New York law and California law.¹⁰ Therefore, the parties are alerted to this issue in the body of the contract, with waivers of the right to assert the Statute of Frauds as a defense, which waiver itself would no doubt have varying success at enforcement across various jurisdictions.¹¹

The contract contains many other examples of clauses drafted for the needs of a very diverse potential user group, who are themselves seeking to transact under requirements that are far from fully developed. The next step will be to review marketplace response. This is release 1.0. The working group will remain in place, intending to keep the document current and responsive to further developments and comments received. Those who are interested in the group and its work are encouraged to contact the author or any of the group's co-chairs, who are listed on the Environmental Markets Association's website.

Notes

- 1 Jeremy Weinstein is an attorney in Walnut Creek, California, with the Law Offices of Jeremy D. Weinstein. He was a co-chair of the working group that developed the contract. Email: jweinstein@prodigy.net
- 2 Through its Renewable Energy Resources Committee and Special Committee on Energy and Environmental Finance.
- 3 See Weinstein and Chartier, *Standardising RECs Contracting*, Environmental Finance p. 21 (May 2005) and Weinstein, *Contracting for a Unified RECs Market*, Environmental Finance p. 20 (Nov. 2006).
- 4 See, e.g., Weinstein, *A Western Renewables Marketplace*, Environmental Finance p. 15 (Apr. 2004).
- 5 There are also implications with respect to allocation of limitations of liability, verification responsibilities, and Force Majeure. Master Renewable Energy Certificate Purchase and Sale Agreement §§1.53, 1.76, 2.7, 2.8, 3.2, 3.3, 5.7, and Articles 6 and 7.
- 6 See US Emissions Allowance Transaction Documents, published December 21, 2006, available at <https://www.isdadocs.org/docsindex.html>.

- 7 Master Renewable Energy Certificate Purchase and Sale Agreement §2.8.
- 8 Master Renewable Energy Certificate Purchase and Sale Agreement, Disclosure Document.
- 9 Master Renewable Energy Certificate Purchase and Sale Agreement §4.3.
- 10 New York General Obligations Law §5-701(b) and California Civil Code §1624(b)(2), respectively. Compare the Western Systems Power Pool Agreement, which elects the law of a jurisdiction without such an exemption (Utah), without alerting the users; see Weinstein, *Practical Considerations Regarding Electricity and its Regulation When Using the EEl/ISDA Power Annex*, Futures and Derivatives Law Report, p. 7 n. 12 (Jul./Aug. 2006).
- 11 Master Renewable Energy Certificate Purchase and Sale Agreement Article 8.

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terms of another CDS, each CDS will be strictly construed according to its own terms without consideration of the terms of any other CDS or any other evidence outside the contract itself. As applied to determining credit default risk correlation between two CDSs, this principle requires that the determination of what events will constitute a credit default triggering an obligation to pay under each CDS will be controlled by the separate and strict construction of the unambiguous terms of each CDS alone.

The Second Circuit's opinion also is a telling reminder of the careful scrutiny that may be required to correctly discern the legal differences between different, although similar, CDSs. In this regard, the court of appeals and the district court came to *diametrically opposing views* on the CDS in question *even though each court declared its decision to be grounded in the "plain reading" of the contract.*

CDS fundamentals and contract standardization in the CDS market. A CDS is a bilateral contract by which one party (the protection buyer) transfers risk to another party (the protection seller) with respect to a "Credit Event" as defined in the contract (*e.g.*, a default) on one or more particular types of credit obligations, as defined in the contract. In its simplest form, the protection buyer makes periodic payments to the protection seller in return for a contingent payment if the Credit Event occurs. Protection buyers can use CDSs to manage particular market exposure and return-on-investment, and protection sellers use CDSs to earn income from their periodic payments received and to diversify their own investment portfolio.³

The global CDS market rests on the near ubiquitous use of standard form contracts developed by the International Swaps and Derivatives Association, Inc. ("ISDA"). As ISDA's *amicus curiae* brief in the case (in support of Societe Generale's position) explained, "Master Agreements" govern "the legal and credit relationship between the counterparties, including representations and warranties, events of default and termination, covenants and choice of law."⁴ Negotiated "Schedules" make "counterparty-specific elections and changes to the standard provisions in the Master Agreements."⁵ And "Confirmations" document the precise risk that the parties wish to transfer, by setting forth "the economic terms and transaction-specific modifications to the ISDA Master Agreement and Schedule, and indicate which set of ISDA definitions (if any) are applicable."⁶ Confirmations define, among other things, the specific terms of the "Credit Event," the "Reference Entity," and the underlying credit obligation that is the subject of the CDS.⁷

Contract standardization has facilitated CDS formation by providing legal certainty to commonly used CDS terms, thereby permitting global counterparties to enter into these complex agreements confident that both parties share a common understanding of the terms and obligations involved. Standardization has streamlined the negotiation process to a focus on the terms of the Confirmation. And it has galvanized the growth of trading credit default risk by facilitating the creation of highly similar and correlated CDSs, which enhances CDS portfolio risk management. In short, a *protection seller* in one CDS may effectively offset or hedge its risk in one CDS by entering into a second, highly correlated CDS as a *protection buyer*.

The Aon facts. In 1999, Aon Financial Products, Inc. ("Aon") entered into two separate CDSs – one with Bear Stearns International Limited ("BSIL") and one with Societe Generale ("SG"). Each CDS concerned risks of default on credit obligations related to the Republic of the Philippines. In the BSIL/Aon CDS, which was entered into February 4, 1999, Aon was the *protection seller*. That CDS obligated Aon to pay \$10 million to BSIL in the event of a particular "Credit Event" as defined in the contract – a default on a surety bond issued by the Government Service Insurance System ("GSIS"), an agency of the Philippine government. The GSIS surety bond served as a guaranty for the repayment of a \$10 million loan that BSIL had made to a Philippine condominium developer. The only