The Emissions Allowance Documentation Experience
Issue Note for the European Financial Markets Lawyers Group (EFMLG)
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The recent efforts to harmonise various documentation standards for European Union emissions allowances trading brought together a contrasting group of market participants. This group consisted of legal representatives primarily from energy companies and banking institutions. Lengthy and at times heated discussions were held within committees of the International Swaps and Derivatives Association (ISDA), the European Federation of Energy Traders (EFET), the International Emissions Trading Association (IETA) and the Association of German Banks (BDB).

It became evident that in relation to several issues there was a significant difference of opinion between energy companies and banks. This was most clearly demonstrated in relation to two issues, namely, termination payments upon a close-out due to force majeure and the payment of excess emissions penalties. As a result various provisions of the emissions allowance trading documentation published by ISDA, EFET, IETA and the BDB provide optionality.

(i) Termination payments upon a close-out due to force majeure

For banks it is standard market practice to make termination payments upon a close-out of any transaction due to the occurrence of force majeure. This termination payment reflects the cash value of the affected transaction. There is no differentiation made between cash and physically settled transactions because banks view these transactions as compatible.

Banks are primarily interested in using both types of transactions to hedge against market price fluctuations as opposed to actually obtaining the underlying under a physically settled commodity transaction for example. Accordingly if any differentiation was made between cash and physically settled transactions in the event of a force majeure, this would create a basis risk for banks. The avoidance of such basis risk was one of the reasons why the Global Documentation Steering Committee (GDSC) recommended that termination payments be made irrespective of whether the transactions are cash or physically settled. A provision to this effect is now contained in various derivatives master agreements such as the 2002 version of the ISDA Master Agreement.

Energy companies on the other hand are interested in physically settled commodity transactions not simply as a hedging tool but rather to actually obtain the underlying commodity. In the event of a force majeure the transaction loses its value for them because they no longer need the commodity. Therefore so-called “walk away” clauses are used in which no termination payments are made upon a close-out due to force majeure.

(ii) The payment of excess emissions penalties (EEP)

An excess emissions penalty, or EEP as it is referred to, is a payment required to be made by an operator, i.e. an emitter of CO2 gas, who fails to surrender sufficient emissions allowances to the relevant government authority by 30 April each year (the reconciliation deadline) to cover its emissions for the previous year[1].

Energy companies are of the opinion that it should be possible to pass on the risk of incurring EEP from a buyer to a seller of emissions allowances. Accordingly if a seller defaults on delivery of emissions allowances and the buyer incurs EEP as a result of not having such allowances to surrender by the reconciliation deadline, then the buyer may charge the seller the amount of the EEP it incurred.

[1] Article 16(3) or 16(4) of the Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, as amended by Directive 2004/101/EC of the European Parliament and of the Council of 27 October 2004

Furthermore, energy companies would like the buyer to have the ability to charge the seller with the amount of any EEP equivalent, or EEPE as it is referred to, that the buyer may have to pay to a third party to whom it defaulted as a result of the seller's original default in delivery. This gives rise to the possibility of EEPE payments along a chain of back to back transactions.

Banks contest that a buyer's consequential losses should be rather limited to its buy-in costs for covering the shortfall of emissions allowances, i.e. the risk of incurring EEP should remain with the buyer. They argue that would be highly unlikely that the buyer could not otherwise purchase this shortfall in the European wide emissions allowance market before the reconciliation deadline. Furthermore, it is possible for an operator to surrender emissions allowances which it has just been issued with for the coming year if they are of the same compliance period[2]. Therefore the risk that a buyer could not cover the shortfall would only exist prior to the reconciliation deadline at the end of each compliance period. There is also the issue of causation in relation to whether the buyer actually incurred the EEP because of the seller's default and not the default of another party or parties. This causation issue is even more evident in the case of EEPE.

[2] The first compliance period is three years in duration and each subsequent period is five years in duration, with the first five year period commencing on 1 January 2008

<u>EFET Allowances Appendix – EEP Provision – § 8.1(b)(ii)</u>

§ 8.1(b)(ii) , if an EEP or EEP Equivalent has been made applicable to the Allowance Transaction and has arisen, and further subject to the fulfillment of all applicable requirements imposed in § 8.3 ***(Excess Emissions Penalty ("EEP") and EEP Equivalent)***, the amount calculated using the following formula:

(A) the price at which the Buyer, using reasonable endeavours and in (an) arm's length transaction(s), is or would be able to purchase, as soon as reasonably possible following the Reconciliation Deadline, replacement Allowances in the quantity of those not delivered to it by Seller (such quantity reduced, if applicable, by the number of Allowances Buyer was able to purchase prior to the Reconciliation Deadline as contemplated by § 8.1(b)(i), damages for the cost of which being recoverable pursuant to element (G) of this formula, herein below)(the net resulting number of Allowances corresponding to the, as applicable, EEP or EEP Equivalent, being referred to hereinafter as the **"Undelivered EEP Amount"** or **"UEA"**);

(B) minus the price that Buyer would have been required to pay Seller for those Allowances comprising UEA, had Seller delivered those Allowances to Buyer in accordance with the terms of the Allowance Transaction;

(C) plus the amount of, as applicable, the EEP or EEP Equivalent on the UEA;

(D) plus interest accrued during the one Delivery Business Day grace period, calculated as provided in §8.1(a);

(E) plus interest, at the Interest Rate specified in § 13.5 ***(Default Interest),*** accrued from (and including) the first date on which Buyer would be able to purchase, following the Reconciliation Deadline, the UEA of next Compliance Year replacement Allowances, to (but excluding) the date of Buyer's receipt of damages for Seller's failure to deliver, on the amount determined using the following formula:

Amount on which interest accrues = UEA x (REP – CP)

where:

UEA has the meaning set forth above;

REP means the Replacement EEP Price, which shall be the (per Allowance) price of next Compliance Year Allowances calculated pursuant to § 8.1(b)(ii)(A), above; and

CP means the per Allowance Contract Price that Buyer would have been required to pay to Seller for each undelivered Allowances comprising the UEA had Seller not defaulted on its delivery obligation;

(F) plus such reasonable additional incidental costs as Buyer incurred in, as applicable, both attempting unsuccessfully to make purchase of replacement Allowances in order to avoid the accrual of an EEP or EEP Equivalent, and in making replacement purchase(s) of next Compliance Year Allowances as described in § 8.1(b)(ii)(A), above; to the extent those costs and expenses are not recovered via § 8.1(b)(i)(A) above (which additional incidental damages, for the avoidance of doubt, may also include interest accrued at the Interest Rate specified in § 13.5 ***(Default Interest),*** from (and including) the date on which an EEP or EEP Equivalent is paid, to (but excluding) the receipt by Buyer of damages for Seller's failure to deliver); and

(G) plus, if applicable, Buyer's Cover Costs incurred in replacing that portion of Allowances not Transferred to Buyer by Seller for which Buyer did not incur an EEP or EEP Equivalent (and thus not comprising the UEA)(such portion of Allowances not Transferred being hereinafter referred to as the **"Non-UEA"**), calculated in accordance with the methodology set forth in § 8.1(b)(i), which methodology shall apply equally to this § 8(b)(ii)(G);

(H) plus interest accrued on the value of the Non-UEA calculated in accordance with the methodology set forth in § 8.1(b)(i)(C), but in this context calculated on the amount of the Non-UEA, rather than the amount of the UA.

provided, always, that in the event that the number calculated through application of elements (A) through (H) of the formula set forth immediately above in this

§ 8.1(b)(ii) results in a negative number, such number shall be deemed to be zero and no damages will be owed in respect of such elements of the this damages formula.