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The Emerging Market in Black, Green and White Certificates

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As the clean energy movement continues to gain momentum, there has been a corresponding emergence in the market for the various certificates and credits designed to provide economic incentives for the reduction of greenhouse gases (GHG). These credits and certificates fall generally into a tri-color spectrum- Black Certificates, Green Certificates, and White Certificates. As the market for each of these certificates expands, so will the opportunity for these certificates to be pooled and embedded into various types of financial instruments. This process of creating financial products from these certificates will, in turn, contribute to a more liquid certificate market and, thus, a more efficient set of incentives for sustainable energy paradigms. All three certificates have the potential for dynamic growth in the near future, but White Certificates may present a particularly compelling opportunity for the financial markets.

A Black Certificate, or emission allowance, is a permit to emit one tonne of CO2 equivalent during a specific period. The most prominent example of Black Certificates is the system created pursuant to the European Union Emission

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Managing Your Channel Under the PRC Antimonopoly Law

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With the new Antimonopoly Law (AML) effective on August 1, 2008, manufacturers, distributors and others are now subject to new rules that may significantly change their existing ways of doing businesses. Some of the automakers in China reportedly have already started making changes to agreements with their dealers to be in full compliance with the new law. Antimonopoly lawsuits were filed just within a few days after the AML took effect, marking a start of a likely new wave of litigations in China against large corporations, trade associations and even government agencies.

In particular, the AML will likely have a profound impact on channel management. For instance, Article 14 the AML prohibits "monopoly agreements" that fix resale prices or specify minimum resale prices. Now a host of questions emerge: can a company use methods other than "agreements" to impose minimum resale prices on its distributors? Can a company sug-

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Trading Scheme (EU ETS). The EU ETS is a cap and trade system designed to facilitate compliance by the EU nations with their Kyoto Protocol commitment to a reduction of GHG reductions, on average, by 5.2% relative to 1990 by 2012. It is widely assumed the United States will enact emissions reduction legislation and that such legislation will involve the creation of a U.S. market for Black Certificates. Under the EU ETS, the cap on carbon emissions can also be satisfied through the purchase of project-based carbon off-sets issued pursuant to one of the so called flexible mechanisms created under the Kyoto Protocol. If a developing country is the site of the project giving rise to the carbon, then the resulting offset is called a Certified Emission Reduction (CER). Otherwise the resulting project-based credit is called an Emission Reduction Unit (ERU).[1] The types of projects eligible to produce CERs and ERUs are quite broad and include both renewable energy projects and energy efficiency projects as well as projects involving fuel switching, industrial processes, solvent and other product use, and waste management. Currently, there is a large and active market for the trading of the Kyoto credits. In recent years, this Kyoto market has grown substantially, with banks, brokers, funds, arbitrageurs and private traders now participating in the market.

Green Certificates, also known as Renewable Energy Certificates (RECs) or Tradable Renewable Certificates (TRCs), are tradable instruments certifying the creation of renewable energy. Each Green Certificate corresponds to a certain amount of electricity generated from an eligible renewable energy source. Eligible projects include energy created from solar, wind, geothermal, low impact hydropower, biomass, biofuels, landfill gas, and some fuel cells. In the United States, roughly half of the states have enacted regulatory policies known as Renewable Portfolio Standards which mandate that energy distribution companies receive a set percentage of their energy from renewable sources. Similarly, Europe has a program called the Renewable Energy Certificate System. Generally under these programs energy generators earn certificates for every unit of electricity they produce from a renewable source and can sell these certificates along with their electricity to distribution companies. Distribution companies then pass the certificates to some form of regulatory body to demonstrate their compliance with their regulatory obligations. There is also a voluntary market for Green Certificates, whereby individuals or companies attempting to reduce their carbon footprints purchase Green Certificates. The transactions typically occur through brokers or intermediaries who purchase the Green Certificates from the energy suppliers and then sell them into the voluntary market. Non-compliance purchasers can include those who wish to manage their climate change impacts, philanthropic organizations or individuals, public relations arms of large corporations, and individuals or entities which are purchasing for a profit on resale.

Finally, White Certificates, or energy efficiency certificates, are instruments issued by an authorized body certifying that a certain reduction of energy consumption in relation to a defined base line has been attained. Each certificate is a unique and traceable commodity carrying a property right over a fixed amount of additional energy savings and guaranteeing that the benefit of these savings has not been accounted for elsewhere. The type of energy saving projects that are eligible for White Certificates include: (1) energy efficiency in buildings through the use of efficient heating, cooling or lighting systems or sophisticated control systems; (2) cogeneration, the production of both electricity and heat from the same power source; and (3) fuel efficiency projects that replace a combustion device with one which uses less fuel per unit of energy provided Currently, Italy has the most mature compliance market for White Certificates.

In the United States, however, the market for White Certificates is still in its infancy, with Connecticut having gone furthest in creating a mandatory White Certificate regime. Other states, including Pennsylvania and Nevada, have also passed legislation further augmenting the compliance market for White Certificates in the United States. Currently, the buy-side market for White Certificates is simply a smaller version of what exists in the Green Certificate market.. As there are fewer states involved in the compliance market for White Certificates, the market for White Certificates is smaller and less developed than the market for Green Certificates. Like Green Certificates there is also a voluntary market for White Certificates comprised of individuals or companies attempting to reduce their carbon footprints.

Though Black Certificates and the other Kyoto credits, and to a lesser extent Green Certificates, are currently traded in a much more developed market than White Certificates, there are reasons to believe that the market for White Certificates can close this gap in the coming years. The model of reducing GHG emissions through energy efficiency enjoys a number of important benefits over a model of achieving reductions in GHG emissions through a cap-and-trade system or through the use of renewable energy. Ideally, however, all three methods should be implemented simultaneously to achieve the maximum and most efficient reduction in GHG. The single greatest reason to expect a widespread

adoption of mandatory energy efficiency programs is that energy efficiency achieves emissions reductions in the most cost effective manner as compared to other means of achieving such reductions. It is estimated that in the United States increased energy efficiency could cut national energy use by 20% by 2020, with significant net economic benefits. By making end-use energy consumption more efficient, individuals and businesses can maintain the same level and intensity of activity requiring energy, while still achieving significant GHG emissions reduction. And because increases in energy efficiency mean lower energy expenses, it can have an actual net economic benefit in the form of cost savings and increased profits. By contrast, a cap-and-trade system like the EU ETS requires a compromise of economic efficiency to achieve GHG reductions. Accordingly, many scientists and policy makers support establishing a national energy efficiency program as the best short-term approach for significantly and rapidly reducing GHG emissions.

In addition to reducing GHG emissions, other benefits of launching a massive energy efficiency program would include savings to consumers and businesses, changing the energy supply and demand balance that will in turn put downward pressure on energy prices, and decreasing reliance on energy imports. Furthermore, White Certificates may be particularly attractive financial instruments because of their potential for a large, uniform market. This is in part due to the easy standardization of the measurement and verification of White Certificates as illustrated by the deemed savings. Deemed savings are pre-determined energy savings amounts for most of the common energy-efficiency measures. As deemed savings based on standard operating characteristics and efficiencies of particular energy-efficiency measures, no field measurement is required. For instance, the amount of energy saved through the installation of a particular energy-saving light bulb does not require any measurement to establish, thus there is no need for measurement and verification. This also dramatically decreases the transaction costs of an energy efficiency program as compared to renewable energy and carbon off-set projects.

Any program designed in support of energy efficiency should make use of White Certificates. Under the programs in existence now, state and national governments have established an obligation for energy suppliers or distributors to attain certain mandated energy saving targets. Providing for the buying and selling of White Certificates is essential to these programs because economic efficiency is maximized by allowing energy distributors the ability to purchase White Certificates when doing so is less costly than operating their own programs.

The extraordinary potential for energy efficiency to contribute toward the reduction of GHG emissions in the short-term means that we should expect to see the wider implementation of various energy efficiency programs and legislation. In turn the proliferation of programs requiring gains in energy

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efficiency will help to create a robust market for White Certificates. It is also quite possible we will see national legislation mandating energy efficiency in the near future. For example, Barack Obama, the Democratic U.S. presidential nominee, has set an energy efficiency goal to reduce electricity demand 15 percent from DOE's projected levels by 2020. And as this market expands and achieves a certain degree of scale, the financial markets will inevitably become involved and create more liquidity in this market through document standardization, establishment of trading platforms, creation of derivative instruments and insurance products, aggregation into pooling vehicles, and the design and issuance of certificate-backed credit instruments. These certificates will also be monetized to fund a portion of the development costs for energy efficiency projects and programs.

The more developed Kyoto markets provide some insights into the potential for the White Certificate market. Credit Suisse recently launched the first carbon structured product in December in a joint venture with EcoSecurities, a company which manages GHG emission reduction projects. The structured product created by Credit Suisse resembles a CDO but instead of tranching credit default risk, they tranched the carbon delivery risk. In the insurance sector, Munich Re, AIG and Swiss Re have started to offer policies covering the non-delivery of carbon credits. The Carbon Rating Agency, a UK-based rating agency sponsored by IDEAcarbon, has begun to issue ratings for the likelihood of delivery of carbon credits by specific emission reduction projects. Both the financial products and the insurance products are a direct result of and at the same time a driver of the increasing volume of trades in the Kyoto market. There is also an assortment of funds that are targeting international environmental and emissions markets as well as providing direct financing to projects that generate environmental market products and commodities. The Kyoto market illustrates the willingness of traditional financial players to become involved in these markets once the markets reach critical mass.

Given the potential for rapid growth in the White Certificate market, it is very likely that insurers, major financial institutions, and funds will become involved creating a more sophisticated market. Ultimately, we may see the emergence of asset-backed securities from the climate change and renewable energy movement, and White Certificates have the potential to be at the center of this phenomenon. ❑

1. The markets for Black Certificates, CERs, and ERUs will be collectively referred to as the Kyoto market and to the certificates collectively as the Kyoto certificates.

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