

Are U.S. Insurers Ready For Cap and Trade?

By Thomas H. Cook Jr. and Jason Reeves
Published in [*Insurance Law360*](#)

Most first party insurers have not anticipated the impact of cap and trade on their business lines either in the U.S. or abroad. First party risks involved in cap and trade systems face unique underwriting and claims issues. How are emission credits treated during a covered loss? Are insurers exposed to volatile cap and trade markets when insured green technology fails? How can first party underwriting provide clarity in this emerging area?

What is Cap and Trade?

“Cap and trade” is a market-based policy tool which controls large amounts of (greenhouse gas) emissions from a group of specific industrial locations. Cap and trade programs set a maximum limit, or cap, on emissions. Sources covered by the program then receive authorizations to emit in the form of emissions allowances, or permits, with the total amount of permits limited by the cap. Permits are effectively a license to pollute within the cap. Each source can design its own compliance strategy to meet the overall reduction requirement, including the sale or purchase of allowances, installation of pollution controls, and/or the implementation of efficiency measures. Each emission source must surrender permits equal to its actual emissions to comply. Sources must accurately measure and report all emissions to guarantee that the overall cap is achieved. The scarcity of permits determines the price of permits. The financial consequence of buying and selling surplus permits creates a market based incentive to reduce emissions.

Is Cap and Trade a U.S. Issue?

Other than through competing (and frequently inaccurate) sound bites, many in the U.S. have not encountered cap and trade. Some insurers may dismiss cap and trade as a substantive issue because the U.S. has not yet passed cap and trade legislation and is not a signatory to the Kyoto Protocol.

Cap and Trade is Here

But cap and trade is already here. Since 2009, ten Mid-Atlantic and Eastern states have been participating in the mandatory Regional Greenhouse Gas Initiative (RGGI). RGGI is concerned with 225 coal fired power stations. The Western Climate Initiative (WCI) commences its first compliance period in 2012 and involves six western U.S. states, along with some Canadian Provinces and

Mexican States. The WCI will, eventually, cover 90 percent of all greenhouse gas emissions in those states. The Midwestern Greenhouse Gas Reduction Accord (MGA) involves nine U.S. states. If the MGA's recommendations are formally adopted, in total, 21 states will compel industrial business to operate under cap and trade measures.

Compulsory federal cap and trade legislation may soon also be in place. The draft American Power Act, along with most other recent draft U.S. energy bills, includes cap and trade provisions. And it is the cap and trade sections which many believe will have the most impact on American energy policy. If legislative attempts fail, there is a realistic prospect of the implementation of a federal cap and trade program through regulatory means.

Following the 2007 Supreme Court decision in *Massachusetts v. EPA*, which found that greenhouse gases are pollutants, the EPA has the power and is legally mandated to regulate carbon emissions. In October 2009, the EPA "issued the *Final Mandatory Reporting of Greenhouse Gases Rule*. The rule requires reporting of greenhouse gas (GHG) emissions from large sources and suppliers in the United States, and is intended to collect accurate and timely emissions data to inform future policy decisions."

International Business Lines

Cap and trade has been a fact of life internationally for several years now. Approximately 18,000 specific locations outside of the U.S., mostly power, cement, steel, heavy industry, and green technology, are involved in mandatory cap and trade provisions under the Kyoto Protocol. Signatories to the Kyoto Protocol entered into a binding global cap and trade system for greenhouse gases; the compliance period is 2008-2012. The Member States of the European Union (EU) complied with their Kyoto obligations by setting up the Emission Trading Scheme (ETS) which commenced in 2005. The ETS automatically renews every five years and has been a volatile new market. The EU ETS involves 15,000 installations in the EU.

Outside the EU, there are approximately 3,000 installations involved in the Kyoto Protocol's cap and trade system. These installations are involved in the Kyoto Protocol's Clean Development Mechanism (CDM) and Joint Implementation (JI). CDM and JI generate "green carbon credits" for use in emission trading in capped emission markets.

Policyholders have grown increasingly sophisticated in their business approach to emission credits, and the financial viability of some projects and facilities rely heavily on critical assumptions about those credits. Nevertheless, the response by insurers to the EU ETS and the Kyoto Protocol has been ad hoc – there is almost no specialized wording, few tailored products and widespread uncertainty as to how to adjust losses involving financial impacts from emissions credits.

First party insurers presently already insure and reinsure risks which operate under a mandatory cap and trade scheme. Some risks are outside the U.S. and are involved in the EU ETS and the Kyoto Protocol. Other domestic risks are part of compulsory regional cap and trade measures. Cap and trade is with us now, and seems likely to continue to expand.

The Intersection between First Party Insurance and Cap and Trade

The intersection between cap and trade and traditional first party insurance issues is complicated. The legislation is often opaque and the particular schemes vary. Some of the key variables include whether emission permits are auctioned or allocated, whether permits can be bought, sold, or traded freely, whether permits are provided on an installation basis or to a corporate “owner” who is free to make intra-company transfers, and whether “windfall” profits attributed to emission permits are allowed. Each of these variables, and others, will impact underwriting and claims handling for large first party risks.

Cap and trade presents unique claim scenarios for traditional first party risks. Insuring industry involved in the volatile cap and trade markets means that “cap and trade scenarios” present a novel hybrid of first party and financial lines issues. Without appropriate consideration of the issues in advance, including potentially clarifying existing wordings, it may be unclear what should be done to address the financial value of the emission credits in certain insured loss scenarios.

As a relatively simple illustration, suppose an insured industrial plant uses clean technology to stay below its emissions cap. A fire results in a 12-month outage. To meet demand, production is increased at a less efficient plant. But the older plant emits more carbon and the insured must buy additional emission permits. Due to the loss, insurers are asked to cover the purchase of additional permits. How does the policy respond? Is there coverage? Do the wordings provide sufficient clarity? How are the permits valued? What is the exposure to market volatility? If the company has “excess” credits available entity-wide, is it required to apply those credits to the loss and, if so, is it then entitled to claim the value of those credits? At what price? Were any of these issues/risks contemplated in the underwriting?

These and other issues should be given appropriate consideration. Suitable first party wordings can provide certainty for many cap and trade scenarios but virtually no policy wordings presently incorporate such wording. In practice, cap and trade issues are often addressed during loss adjustment, without clear guidance, presenting a risk of inconsistency. Currently, there are no significant legal precedents for cap and trade claims issues in the EU or under the Clean Air Act. Insurers still have the ability to shape how this complicated issue will

develop and how they will respond to the risks, challenges and opportunities presented.

-- By Thomas H. Cook, Jr. and Jason Reeves, Zelle Hofmann Voelbel & Mason LLP

Thomas H. Cook, Jr. is a partner with Zelle Hofmann in its Dallas office. Jason Reeves is a Solicitor of the Supreme Court of England & Wales and an associate with Zelle Hofmann in its Dallas office. Jason has worked on cap and trade claims issues in the first party context since 2005.

The views and opinions expressed herein are solely those of the authors and do not reflect the views or opinions of Zelle Hofmann Voelbel & Mason LLP or any of its clients.