Risks in the Climate Finance Markets

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Special to The Digest

Risks often act as barriers to investment and trading in the climate finance market – the systems designed to reduce greenhouse gas emissions such as the Renewable Fuel Standard (RFS), California's Cap & Trade and Low Carbon Fuel Standard (LCFS) – because Federal and State programs have created areas of uncertainty. The risk of invalidation of credits and the political pressures that threaten to repeal the legislation worry market participants – but insurance risk capital can be used to mitigate these concerns and in fact already works successfully in several markets. One example of this is in the California program, where "buyer liability" has created a price differential between carbon offsets depending on the level of risk associated with them. By removing this risk from both offset buyers (typically refineries and utilities) and sellers (project developers), insurance adds certainty to the market because it's a guarantee with investment-grade A+ security.

Similar solutions are available in Federal RFS and State LCFS markets, allowing refiners, producers, marketers and other parties that assume RIN invalidation risk in sales contracts to offer clear title. For refiners incurring significant RFS compliance costs as regulated parties, RIN insurance reinforces their due diligence programs at relatively small additional expense. For biofuel producers, using insurance adds liquidity to the market, leveling the playing field and facilitating deals that might not otherwise be possible.

But the role of insurance in Climate Finance Market isn't limited to the risk of invalidation and revocation. Buyers of long-term, fixed price offtake of RINs and LCFS credits often look for a "reg out" clause – they want to be able to cancel their purchases of RINs if the RFS2 or LCFS is repealed. There is a common risk factor: the fear of buyers that the programs will not be in place when credits are delivered to them, leaving a worthless commodity at a later date; and the seller being unable to truly represent their cash flows as dependable, and a significantly lower likelihood of raising the debt capital needed to build out large, efficient projects.

The revenue generating capability of many renewable fuel facilities would be negatively affected if one of these programs is eliminated, but if both happened to be eliminated at the same time it would mean certain death to the industry – so we have created a pool of insurance capital that underwrites the continued existence of the RFS and LCFS markets.

The climate finance markets are big (the size of the RIN market is $6 billion while the LCFS market currently sits at $2.3 billion and is expected to grow to $10.5B by 2030), but the insurance industry is even bigger. It takes that level of capital to ensure market liquidity and at Parhelion, we use the capital in the global insurance and reinsurance industry to take the risks that other forms of capital (debt and equity) can't or won't take.

The Problem of Invalidated RINs in the Renewable Fuel Standard

Under the Renewable Fuel Standard, the EPA imposed a "buyer beware" approach to the purchase and sale of RINs. This creates a liability for any buyer of RINs, making them responsible for purchases of invalid RINS, even if it's done inadvertently.   The liability includes the replacement cost of invalidated RINs as well as civil fines and penalties imposed by the EPA. The EPA has prosecuted millions of US$ worth of fraudulent RIN transactions, yet fraud continues to be a significant risk – and it's a risk that is not covered by standard property and liability insurance policies; neither are RINs considered "goods" under the Uniform Commercial Code (UCC), so the Code's warranty provisions do not apply.

The EPA sought to address the potential for fraudulent RIN transactions by encouraging third-party verification of the generation of RINs, the Quality Assurance Program (QAP) under which third-party auditors evaluate producers of renewable fuel to certify they were in fact producing the required product in compliance with RFS regulations.

The success of the QAP, though, has been limited. Only about 12% of all RINs are Q-RINs because the process is expensive and numerous administrative steps are required for any party replacing RINs, claiming an affirmative defense to an alleged civil violation, requesting corrective action, and notifying EPA of the existence of a potentially invalid RIN (PIR) – so market participants have relied on other risk management strategies: only purchasing RINs from parties who have long established and trusted trading relationships; implementing their own auditing processes or only purchasing ethanol-based RINs. This development hurt smaller renewable fuel producers and reduced the RIN market's overall liquidity.

A recently-introduced solution to this problem is to insure the risk, creating a risk-free RIN known as a Platinum-RIN. The insurance can be bought by any of the parties in the transaction, enabling biofuel producers to increase the number of buyers they can sell to; and allowing marketers that assume RIN invalidation risk in sales contracts to offer clear title. For refiners incurring significant RFS compliance costs as obligated parties, Platinum RIN insurance reinforces their due diligence programs at relatively small additional expense.

The beneficiary of the insurance is the owner of the RIN, the policy Loss Payee. First-party fraud is excluded – so a fraudulent party will not be able to make a claim – but the policy has a 'Multiple Insured Clause' which means that even if the original insured is responsible for the fraud, a separate and unrelated third party (usually the obligated party) can still benefit from the coverage and be paid as the Loss Payee.

The pricing reflects the relative exposure to loss: firstly, between RINs and Q-RINs (a Q-RIN can be insured at a reduced cost); and secondly, between fuel types (D3 to D7).

The policy is underwritten by first-class insurers, so it’s a guarantee with investment-grade AAA security, completely removing the invalidation risk and the associated civil fines and penalties. The coverage matches the invalidation triggers defined in the RFS regulations, eliminating the invalidation risk over a three-year period by replacing the insured RINS at future market prices. The program, managed by Parhelion Underwriting, is flexible: policies can be purchased by any participant and the coverage travels with the covered RIN and, although Q-RINs can be insured at a discounted rate, there’s no requirement for a QAP and the Platinum-RIN can be a cost-effective alternative to a Q-RIN.

Parhelion Underwriting is a Lloyds, London-backed risk finance company specializing in risks impacting investment in clean energy and climate finance markets.