PRACTICAL CARBON
PROBLEMS, SOLUTIONS AND OPPORTUNITIES

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The Kyoto Protocol and the EU Emissions Trading Scheme are having an immediate financial impact for businesses and their insurers around the world. Carbon emissions are no longer a theoretical problem. The ETS has led to a systemic change in the way carbon emitting business operates in the EU. Significant changes have also taken place at commercial facilities in the developing world where green credits are generated. Accordingly, there is a high degree of carbon sophistication within carbon emitting businesses. The issue is complicated and involves substantial sums of money which present both mitigation opportunities and, conversely, new liabilities for insurers.

The Future of Carbon and Insurance

Kyoto expires in 2012. Negotiations for a replacement global agreement on carbon reductions are underway. In any case, after the expiry of the Kyoto Protocol, the ETS renews every five years. Accordingly, in the EU, carbon emission controls look to be a permanent feature.

The ETS already anticipates the inclusion of additional carbon emitting businesses. It is likely that additional industries will be included in the mandatory emission reduction controls. Airlines and road transport have been regular topics of speculation in mainstream news for inclusion in carbon controls.

It is widely thought the value of carbon credits will significantly increase over the next two years. This underlines the need for insurers to create certainty in respect of carbon.

Carbon Underwriting

Carbon mitigation opportunities and liabilities result in a range of unique carbon claim scenarios. Insurers should consider how best to include carbon issues in underwriting and claims management. Carbon wording should be included in every policy which concerns a carbon emitting business in the EU and where risks generate green carbon credits. For new policies carbon wording can be incorporated, for existing policies carbon endorsements can be inserted.

Excluding carbon from policies will not necessarily eliminate new liabilities or allow mitigation opportunities. Key to effective wording is the transparent accounting treatment of carbon credits. Ideally, carbon should be a standard issue raised in risk surveys and proposal forms. The carbon wording must be commercially viable but sufficiently flexible to accommodate legislative changes, the predicted increase in the value of credits, the possible inclusion of new industries in carbon capping and the incorporation of other carbon reduction schemes.

With no established market practice or legal precedent, resolution of carbon disputes may require arbitration or litigation. Carbon wording will permit the various carbon claim permutations to be taken into account when a policy is placed so that risks are understood and correctly rated. Whilst carbon wordings are as yet untested they should put insurers in a better position to resolve such disputes.

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Effective carbon underwriting should specify the accounting treatment of carbon credits and whether carbon credits are a subject of indemnity. The wording should allocate and value credits to particular outages. Allocating credits to an outage involves distinguishing freely allocated credits from credits which have been purchased by an installation. It should be clear how to determine the number of carbon credits not burned due to an outage. Thought should also be given to wording which assists in determining the value of outage credits in light of the fluctuating market.

Carbon Audit

Insurers can limit exposure to carbon issues by conducting a carbon audit of their business. Every insurer who insures commercial property in the EU should investigate whether they insure any of the 12,000 installations covered by the ETS. Insurers who insure risks outside the EU should confirm whether the risks generate green credits. Risk surveys, proposal forms and adjustments could include a carbon section. Where policy wordings do not encompass carbon issues a carbon endorsement may be adopted. Particular care should be given to global or master policy wordings which concern a range of installations. For such policies, transparency should be sought concerning the transfer of both allocated and green carbon credits between installations. Every claim and adjustment presented since 1 January 2005 should be reviewed for carbon issues.

US Position

US business and insurers involved with any carbon emitting business outside the US are, knowingly or unknowingly, already involved with the Kyoto Protocol. Further, notwithstanding the White House's position, the political landscape in the US appears to be shifting in respect of carbon reduction legislation. From mid-January 2007, there has been unprecedented support in the US from big business and both major political parties for mandatory carbon reduction legislation. While the draft bills are still being discussed, one of the leading draft bills is supported by both a Democratic and a Republican Presidential nominee. The most popular draft bill mirrors the EU 'cap and trade' model and appears to be Kyoto compatible. It appears for the first time that carbon reduction controls are seriously on the US agenda and are likely to feature as a shared position in the 2008 Presidential elections. US inclusion in a global cap and trade scheme will strengthen efforts to reduce carbon and make the issues set out in this article a regular feature of most commercial insurance policies.

Claims

The adjustment of every claim must look beyond the submitted claim and investigate carbon mitigation possibilities. It is attractive but overly simplistic for insurers to argue that an assured is obliged to mitigate their loss and use outage credits where possible to do so. However, the very nature of the outage credits is legally unresolved.

Carbon Pools

To assist in managing claims and writing new product lines some insurers may acquire and build a pool of carbon credits. A carbon pool could address an assured's claim for a deficit of carbon credits. Such a claim could be presented on a carbon guarantee policy or where an installation is unable to stay below its cap due to an outage or other reasons. A carbon indemnity may take the form of a transfer of carbon credits rather than a payment of money for an equivalent amount of carbon credits to an assured. Carbon mitigation opportunities may present an opportunity to insurers to build a pool of carbon credits by taking an assignment of outage credits. This may allow new carbon products discussed below to be partially self funding through other business lines. A carbon pool would allow insurers to profit by obtaining credits at more competitive prices than when a loss occurs and selling credits when the market is high. Carbon pools would also assist in managing exposure to the volatility of the carbon market and will assist insurers with a range of indemnity, hedging and financial purposes.

Reinsurance

It is likely that there are two ways carbon will be formally introduced to the global reinsurance insurance industry but both will probably involve litigation. The first scenario is likely to concern an attempt by a reinsured to mitigate an assured's loss using freely allocated carbon credits. An assured will probably argue its freely allocated carbon credits are not an issue relevant to their insurance. The second, perhaps more realistic, scenario is likely to concern a reinsurers' refusal to cover a reinsured's outwards claim concerning carbon. This may involve a direct insurer who is unaware of how carbon may impact a particular claim. Effective carbon wording can help limit the scope of such disputes.

Modelling and Forecasting

For accuracy, inwards and outwards modelling should contemplate carbon. It is easy to suggest modelling but more difficult when there is an entirely new and volatile carbon market in operation. However, losses at carbon emitting installations from previous years can be reviewed to assist in forecasting future carbon exposures. Knowledge of carbon exposures through risk surveys and a carbon review means that risks can be more accurately rated and appropriate reinsurance purchased. Modelling will become easier as the carbon market develops and carbon's cost relationship to the variable costs of coal, gas and oil in production is more fully understood.

New Carbon Products

The increased value of carbon credits is likely to create a demand for new insurance products exclusively catering for carbon. The unique legal and accounting aspects of carbon have similarities to traditional soft commodities or shares. Therefore, policies concerning carbon and carbon specific policies are likely to blend traditional property underwriting while incorporating a financial lines component. The idea of carbon guarantee policies may eventually be more than a niche growth area for insurers.

Conclusion

The geographical scope of carbon reduction schemes is almost certain to be enlarged with the expected addition of the US. The group of businesses subject to carbon controls in the ETS is almost certain to be widened. The market value of allocated and green credits is forecasted to increase. The scale and rate of investment in green technology is expected to escalate.

Carbon reduction schemes are now a fact of life and can not be ignored. They are already impacting some businesses and their BI insurers. As carbon schemes are widened, additional businesses and their insurers will be impacted. Carbon reduction schemes have, for the first time, altered the way business interruption insurance responds to a loss as carbon schemes have altered the way installations conduct business. There is a substantial amount of money involved in carbon trading. It is possible to save substantial sums by mitigating losses with credits. There are new carbon liabilities which insurers must anticipate. New mitigation opportunities and carbon liabilities highlight new lines of carbon related insurance.