

Emission control...

A look at carbon trading and business interruption

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The Kyoto Protocol is designed to cut greenhouse gas emissions by encouraging companies to reduce the pollutants they release into the atmosphere. The pollutants in question are carbon dioxide, methane, nitrous oxide from vehicle exhausts, and other specified man-made gases used in industry.

Under the Protocol, each signatory country is given a legally-binding emissions target that they have to meet by 2012. The European Union, for instance, has set itself the aim of cutting its overall emissions output by 8% from the 1990 levels. As part of the individual country allocation, around 12'000 energy-intensive plants throughout Europe have been given permits allowing them to emit a specific amount per year. As companies face fines of €100 for every tonne above their threshold from 2008, carbon credits are becoming increasingly important and have a direct impact on businesses and their insurers.

As part of the ambitious goal to reduce pollution, the EU's Emissions Trading Scheme allows companies which have reduced their emissions below the required level to sell surplus permits — as carbon credits — to others in need of a larger allocation. This also enables businesses to buy extra units during busy times, and sell them when their machines stand idle due to a drop in demand.

To avoid expensive and inefficient spare capacity, most power generating companies will only buy extra carbon credits when absolutely necessary.

During the first phase, from 2005 to 2007, the price of the EU permits fluctuated between €10 and €30, but prices in the second phase are expected to rise in line with the tighter limits.

The volatility of carbon allowance prices under the Emissions Trading Scheme creates new uncertainties. Risk managers need to be aware of changes to their business interruption profiles, especially when settling claims.

The industry consequently faces the challenge of how to deal with carbon trading when assessing the overall claims risk. In this respect different scenarios, as summarised below, should be considered:

– *The insured does not use the allocated allowance due to an outage in production:*

Business interruption insurance covers fixed outage costs, so in most cases the insured can save their unused allowance as they are treated as a variable cost.

– *An incident at a new, efficient plant means that production has to be switched back to an older, less environmentally friendly, operation; for this more carbon*



allowances need to be purchased in the open market:

As part of the business interruption insurance the insurer will cover the costs of buying additional carbon allowances as claims mitigation costs if economically more viable.

With carbon certificate prices expected to rise in 2008 they can quickly have a direct impact on a company's bottom line and a consequence for the claims settlement process.

Insurers underwriting business interruption insurance will usually require an understanding of the scheduled response to an outage at a major plant in order to understand the risk and to calculate the size of the potential carbon assets or liabilities.

As outlined above, plant outages can result in both revenue gains and losses; therefore, risk managers should review existing provisions with respect to their company's exposure to the cost of carbon credits in line with their response to an interruption. It would be advisable to view the business interruption profile in this context, including the need for alternative supply following contractual demands, and to adjust the risk cover if necessary.

