

Eco-asset risk management – the missing link

As environmental regulations leave companies holding a growing range of tradable eco-assets, there is a mounting need for these assets to be brought within a risk management system which links the environmental compliance programme and the company-wide risk function. **Michael Canterbury** explains

Allowances, credits, and other tradable environmental assets created as a result of compliance programmes – collectively known as the ecoAsset portfolio – introduce financial uncertainty as their balance sheet values rise and fall with emissions market prices. Like other commodity markets characterised by forward price uncertainty, ecoAsset portfolio risk is manageable using commodity risk management techniques. But, despite the availability of risk mitigation tools, environmental programme managers have traditionally focused exclusively upon compliance risk. Today, however, the increasing focus on the impact of the environment on the corporate bottom line is encouraging companies to raise the priority of their ecoAssets and search for tools and techniques to incorporate the compliance programme into their enterprise risk management efforts.

What does it take to develop an emissions management programme capable of balancing the sometimes competing objectives of protecting economic value, meeting compliance objectives, and interfacing with corporate programmes? The answer is implementation of an ecoAsset risk management practice that works in tandem with the compliance function. A properly implemented risk management programme provides protection against financial uncertainty and helps identify economic opportunity in the portfolio. Since risk management is widely accepted in portfolio management for power, financial contracts, fuels and other energy commodities, an ecoAsset risk management function creates a natural segue between enterprise risk and

compliance programmes. To implement ecoAsset risk management and link it to corporate risk management efforts requires planning the two points of common ground: organisational and technical interfaces.

Organisational interface

Luckily, environmental programme managers within most organisations do not need to reinvent the risk management wheel. If not from the gas market then certainly from power, these companies have learned the rigours of daily mark-to-market reports, profit & loss, value-at-risk (VaR), and other risk measures. This means that supporting roles and guidelines already established for energy trading are extendable to ecoAsset risk management. The organisational footprint established by the energy risk management group serves as the basis for new risk management programmes. Developing the organisational interface between energy and ecoAssets is often a matter of training, policy revision, system adjustments and maybe a new staff position or two.

What the energy programme lacks as a complete model for ecoAssets is a compliance management function. Regulated environmental programmes are mandatory for many firms and compliance management may already exist. This compliance function easily fits into the back-office with some minor adaptations to energy trading support functions. Compliance activities in themselves are not the linkages. The risk measured by the forward commitments to deliver ecoAssets when needed for compliance forms the basis for risk management, and it is the process of managing the risk that provides the interface to the enterprise.

Technical interface

The first issue for developing the technical interface between compliance and enterprise risk is to resolve risk measurement questions. For commoditised ecoAssets such as the allowances created in the US sulphur dioxide and nitrogen oxide (NOx) programmes, this means adapting VaR and other common commodity measures to the ecoAsset exposure. For non-commoditised assets such as greenhouse gas (GHG) emissions, this means using traditional project analysis to assign risk and to incorporate it into the larger picture.



EMA
6th
ANNUAL

Spring Meeting
MAY 5 - 7, 2002
Hotel Inter-Continental
New Orleans, LA

The second issue for the technical interface centres on data management systems. Emissions markets are in part driven by weather and other energy-related factors, but the regulatory nature of the compliance programmes creates unique risk situations such as progressive flow control in the NOx market. Best-of-class ecoAsset management systems enable robust management and analysis of these unique emissions market characteristics while supporting compliance management needs. A quality ecoAsset risk management system will make available any data needed to roll-up risk to the enterprise level.

Summary

EcoAsset markets are here to stay. Current US compliance programmes alone warrant the application of risk management to control financial uncertainty of the ecoAssets but future markets – in GHGs, for example – will make risk management financially mandatory.

Management of the ecoAsset programmes will require the development of both organisational and technical interfaces to ensure complete coverage and co-ordination of the programme. As organisations form to meet these growing challenges, risk management will emerge as the clear link – both organisationally and technically – between all environmental compliance programmes and company-wide risk control. In implementing ecoAsset risk management, using existing organisational and strategic assets allows for the development of a lower cost, highly effective linkage binding the compliance and risk management areas into a unified programme management effort. EcoAsset risk management does not mean re-inventing risk management, but is simply a strategic adaptation of existing policy and infrastructure. ■

Michael Canterbury is director of emissions portfolio management at ESP.

E-mail: MichaelC@esp-net.com

The opinions expressed in the above article are not necessarily the opinions of the EMA, its members or member companies.

The Emissions Marketing Association consists of more than 270 members from 190 companies worldwide. Its aim is to promote market-based trading solutions for environmental control

