

Navigating carbon trading: implications for insurance claims

As carbon trading continues to gather pace in the EU and more broadly, these fast growing markets can impact insurance claims, particularly around property and business interruption. Yet it is a complex area. From reduced carbon emissions, which can lead to surplus credits that can be sold as a mitigation strategy, to complexities around quantifying and valuing these credits, considering the carbon market's volatility, there are several factors at play. So, what are the key considerations from an insurance perspective, both at the inception of a policy and when a loss occurs?

Background

At the heart of carbon trading lies the EU Emissions Trading Scheme (EU ETS), established in 2005 and subsequently revised in 2018. Designed to curtail greenhouse gas emissions from major emitters, the EU ETS operates across 30 countries, making it the world's largest mandatory cap-and-trade system. While the EU ETS serves as a model for other jurisdictions, such as the UK ETS launched in 2021, similar systems exist in China, Mexico, New Zealand, and Kazakhstan. However, despite these efforts, projections indicate a shortfall in meeting emission reduction targets by 2030.

Mandatory vs. voluntary mechanisms

Carbon trading encompasses both mandatory and voluntary mechanisms, each with distinct characteristics and implications for insurance. The mandatory mechanism establishes legal emission levels for companies, allowing them to trade carbon credits within set limits. In contrast, the voluntary mechanism involves the generation of carbon credits through emissions reduction projects, providing companies with opportunities to offset their carbon footprint. The voluntary market, driven by supply and demand dynamics, often sees fluctuations in credit prices, complicating valuation and risk assessment for insurers.

Insured losses – complexity and transparency

The voluntary carbon credit market presents complexities, with global concerns over measurement accuracy and achievement of claimed sequestration. Despite these challenges, the growing emphasis on reducing carbon footprints and meeting targets significantly impacts property and business interruption claims. However, the adequacy of considering the carbon credit market at policy inception and its scope within insurance policies remain uncertain.

Under a business interruption policy, an insured loss causing production cessation may lead to reduced carbon emissions, resulting in potential savings. Unused carbon credits could be banked or sold, forming part of a mitigation strategy. However, assessing this in loss calculations poses challenges. Determining whether these credits are simply savings or stored for future sale, potentially after the maximum indemnity period (MIP), raises questions regarding the beneficiaries and valuation timing. The lack of specificity in policies further complicates matters, as carbon reduction valuation timing remains unspecified.

A case-by-case approach

Assessment on a case-by-case basis is imperative, especially for large corporations with multiple entities. Allocating

carbon credits within the organisation or against separately insured businesses' carbon footprints requires careful consideration.

In rare instances, such as recommissioning less carbon-friendly machinery to mitigate turnover loss, increased costs may arise from sourcing additional carbon credits, potentially at a premium. While this may mitigate losses, it challenges the economic limit and raises questions about meeting trading scheme obligations versus mitigating turnover losses.

In the voluntary carbon market, scenarios like a biomass boiler failure leading to the inability to produce energy for carbon credit accumulation pose challenges. Purchasing additional credits at a premium constitutes an admissible increased cost, yet quantifying it proves problematic.

Consideration must be given to lead times in acquiring carbon-efficient machinery, impacting the maximum indemnity period. Moreover, the purchase of a more carbon-efficient replacement machine benefiting the insured's financial position throughout the MIP raises questions about loss calculation.

The accounting treatment of carbon credits in financial accounts varies based on their intended use and how the insured entity treats them. This underscores the importance of aligning insurance coverage with business objectives and accounting practices.

Considerations at policy inception

Clearly each claim needs to be considered according to the specific business operation of the Insured and the actual circumstances of loss. However much of the debate may be avoided if at inception of the insurance policy, brokers and insurers consider how carbon credits should be dealt with in the event of a business interruption claim. The key attributes and income dependencies of

the business need to be fully understood by all parties, in particular the definition of business "income" or "turnover" and the risk to expenditure. Those who have combined heat and power plant (CHP), biomass or other such energy centres as part of their business operations need to be particularly alive to this. Once agreement is reached it should be made explicit in the specification and thus the basis of settlement.

Looking forward

Carbon trading's growing prominence presents both challenges and opportunities for insurers and insured entities alike. Navigating the complexities of carbon markets requires a holistic approach. By proactively addressing the implications of carbon trading on insurance claims, stakeholders can better manage risks, enhance resilience, and contribute to broader efforts to combat climate change.

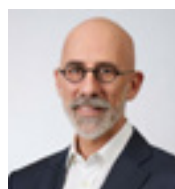
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