

Using EMA'S Master Agreement With the EEI'S New Master Netting Agreement to Enhance Trading Liquidity

By Jeremy Weinstein



OVER THE PAST year, trading liquidity has dried up dramatically. This article will provide you some background, and tell you of two tools that you can use together to enhance your liquidity in the current environment.

Most trading relationships include collateral agreements or annexes under which the parties secure their positions with each other by cash or other liquid collateral above "collateral thresholds" tied to their credit ratings. Generally, the lower a party's credit rating, the lower the collateral threshold, and the lower the dollar amount of an adverse position that may be left unsecured. For example, a collateral annex may provide that a party with an AA rating may need only post collateral as the market is more than \$20,000,000 against its positions, but at BBB+, that leeway declines to \$5,000,000, and to zero if the party drops below investment grade. The worse a company's credit, the more cash it needs to secure its trading positions.

Enron went bankrupt four days after a steep ratings downgrade. The rating agencies recognized that the sudden, broad requirement to post cash on a downgrade could push a company over a "credit cliff" into bankruptcy, and responded with further downgrades throughout the industry. Corporate credit departments responded by being parsimonious with collateral thresholds overall. Added to the scandals and other problems rocking the energy industry, this has helped take many players out of action, and dried up liquidity with the counterparties that are left.

A few months ago, the EMA unveiled its new form of Master Agreement for the Purchase and Sale of Emissions Products, available at the EMA's website, www.emissions.org. A master trading agreement reduces many risks. If trades are done on separate contracts, a bankrupt counterparty could stick you with unsecured claims, on which you might receive nothing, for contracts in the money for you, but keep the full dollar value of other contracts that are in the money for it. Combining these trades into a single master agreement, however, generally lets you recoup the winners against the losers, so you are not stuck holding the bag while at the same time owing money to the bankrupt company.

Additionally, the non-bankrupt party to certain categories of contracts is exempted from the broad "time-out" that kicks in on a bankruptcy filing, the restrictions on improving collateral positions in the 90 days before filing, and other inconveniences. Two categories of such exempt contracts are financial derivatives and commodity forwards. The non-bankrupt party to a master agreement in an exempt category can generally immediately close out all the transactions under it.

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EMA Calendar of Events

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Companies often trade under multiple master agreements-financial derivatives under the ISDA Master Agreement, physical power under the EEI Master Agreement, natural gas under the NAESB or GISB Base Contract, and of course emissions under the EMA Master Agreement. Each of these can have its own separate sets of collateral thresholds. The Edison Electric Institute's contracts committee suggested that trading liquidity could be enhanced, and risks reduced, if parties could integrate all these master agreements into a single trading relationship. The EEI Master Netting Agreement contains a separate collateral annex under which all trading relationships are aggregated for margining purposes and one collateral threshold is used. That way, instead of a party posting margin under an ISDA while receiving it under an EEI, these are netted into a single requirement. Some members of the EMA Master Agreement drafting committee also served on the EEI's, and we worked to ensure that the two documents properly integrated.

No court has yet ruled on whether one can net across exempt categories of contracts in bankruptcy in a fashion that is itself entitled to all the exemptions. However, since master netting agreements mitigate systemic risk, they are highly favored by financial regulators, and amendments to the Bankruptcy Code specifically blessing them were included in the recently failed omnibus bankruptcy reform bill. These provisions will be back soon.

The new EEI Master Netting Agreement is very useful, both in mitigating risk and enhancing liquidity, but like any powerful tool, it should be used with caution and as directed. It contains new covenants, and can alter, by making uniform, various provisions of the underlying master agreements. To that end, the EEI has published a User's Guide, walking users through the document section-by-section, and a Legal Landscape providing excellent background on the legal issues. The drafting subcommittee is also preparing a form of Master Netting Agreement without the Collateral Annex. All these materials can be found on the web at www.eei.org/issues/contract/mna/

About the Author

Jeremy Weinstein is Senior Counsel to PacifiCorp and PPM Energy, Inc., working in corporate and commercial finance, derivatives and trading, climate change strategies, and renewable resource development. He has been particularly active in developing areas of environmental finance, including high-profile carbon sequestration projects and the standardization of markets and contract language.

e-mail: jeremy.weinstein@pacificorp.com

Mr. Weinstein's views are not necessarily those of PacifiCorp or PPM Energy, Inc.



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