Financing and taking security over emission allowances

By Patrick Sutton

Takeaways

- Carbon market participants are increasingly looking to monetize allowances as an asset capable of raising finance
- Legal regimes for allowances vary by jurisdiction
- Seek local legal advice regarding optimal security arrangements
- It should be possible to assign or charge UK allowances under English law

Carbon trading is increasingly prevalent. While traditional commodity market participants (for example, oil and gas majors, hedge funds, and banks) remain very active in this space, players from other economic sectors are joining as they seek to reduce their carbon footprints. The Taskforce on Scaling Voluntary Carbon Markets estimates that the market for carbon credits could be worth more than $50 billion as soon as 2030.

Participants pledge to offset their greenhouse gas emissions by trading voluntary carbon credits, such as UK allowances (UKAs) and EU allowances (EUAs). Both can be traded before being used (that is, applied to compensate for the emission of CO_2 or equivalent gases).

Voluntary allowances are generally eligible for trading by all economic sectors, not just sectors that are historically seen as emitting the most CO_2.

As with many types of assets, owners of carbon credits may wish to use them to obtain finance. This article considers how carbon credit owners may be able to secure their carbon credits in favor of a financier as security for a loan, just as a borrower would secure inventory over "physical" commodities – for example, oil in tanks or metals in warehouses – as collateral for a loan from its lender(s). However, given the intangible nature of carbon credits and their relative novelty as an asset class, legal regimes around carbon credits differ from those around physical commodities. Financiers should get themselves comfortable with these regimes in order to determine whether they are capable of having a valid and enforceable security interest over the relevant financed carbon credits.

The type of security that is capable of being taken over a particular asset will generally depend on the location of that asset, and the legal regime in that location, but as a starting point, it would generally be recommended that the governing law of the relevant security document would be the legal regime where the asset is located. This article primarily considers the position in respect of UKAs under English law.

The English courts have determined that EUAs are a form of "other intangible property." However, since the creation of the UK Emissions Trading Scheme (UK ETS), the English courts have not considered the legal nature of UKAs, nor have they determined whether the EUA is a "chose in action" (that is, a debt or rights under contract).

Given that the UK ETS largely mirrors the EU Emissions Trading Scheme (EU ETS) framework, and in absence of anything further in the UK statutory framework that elaborates on the legal nature of UKAs, we believe English courts are likely to adopt the same approach as the Europeans when considering the legal nature of UKAs.

If UKAs can be characterized as a chose in action, a security interest can be taken over them by an assignment by way of security. This assignment can be legal or equitable.

Should the English courts decide that UKAs in a UK Registry account are not choses in action, the assignment of the UKAs would be invalid. Accordingly, the financier would wish to have a charge in respect of the UKAs in the counterparty's UK Registry account, as well as the account itself.

Any asset that is recognized as "property" can be subject to a charge, including intangible property. Charges can either be fixed or floating.

In order to take an effective fixed charge over the UKAs in a UK Registry account, and the account itself, the financier would require strict restrictions on the counterparty's ability to deal with the UKAs and the account. Based on our understanding of the UKAs and the UK Registry account from a practical perspective, we do not believe that a financier would have adequate factual control to achieve a fixed charge over these assets. In this situation, the lender can take security over the UKAs in the UK Registry account, and the account, by way of a floating charge.

An alternative approach worth possible consideration is that the counterparty place the UKAs with a custodian and the financier take security over the counterparty's rights against the custodian.

Under this arrangement, the counterparty would enter into a custody agreement with the proposed custodian. The lender would then take an assignment (by way of security) of such a custody agreement. In this case, the UKAs would be held in a UK Registry account in the name of the custodian and the lender's security would be over the counterparty's rights against the custodian under the custody agreement, including rights to require the custodian to deliver up the EUAs held for it in custody. In order to perfect such an assignment, notice must be given to the custodian.

If the financier wished to enforce the security assignment, the financier would request the custodian to deliver to the financier the UKAs held for the counterparty.

Whilst we are aware that some companies offer custodian services for EUAs, we are not currently aware of any companies offering these services for UKAs.

In each instance, security granted by an English entity generally should be perfected by registering the security document at Companies House within 21 days of the creation of the security. Otherwise, the security will be void on the insolvency of the counterparty.

We look forward to seeing how different legal regimes continue to characterize carbon credits and to assisting lenders and borrowers in navigating these challenges.

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Patrick is a partner in the firm's global Energy & Natural Resources Group in London. He focuses on trade and commodity finance, and sports finance, and his practice covers a variety of financing structures across emerging and developed markets. Patrick's work in the commodity finance area covers a range of products, including: borrowing base, pre-export, and prepayment facilities, receivables structures (including receivables discounting and supply chain finance), and title based structures (including repos and inventory monetization). Increasingly, Patrick works on structured finance products in the trade and commodity space, and was a leading adviser on the market's first trade finance lending ABS program. Patrick is a member of the firm's ESG Group, and has a particular focus on sustainable finance, the energy transition, and the financing of carbon.