# An allowance to take to the bank

Congress should look to carbon allowance property rights when it revisits the Lieberman-Warner bill – or risk hitting the liquidity of the carbon market, say **Patrick Traylor** and **James Morin**

In a consensus unusual for Washington, there is widespread belief that the Climate Security Act introduced by Senators Joseph Lieberman and John Warner will return in force next year. With a stronger Democratic majority anticipated in Congress and the clear support of both presidential candidates, passage of significant cap-and-trade legislation seems likely. Proponents of such legislation should be encouraged, but must also work to enhance the existing draft legislation, because the law it produces may be with us a long time. Markets flourish on clear property and security interest rights. If the law intends to stimulate a successful carbon finance industry in the US, its advocates must consider how it will be applied in the expanding carbon marketplace.

To temper the dramatic economic impacts that climate change legislation will undoubtedly create, banks and other lenders supporting greenhouse gas (GHG) reduction efforts will need to have absolute comfort in their legal rights over flows of capital derived from emission allowances. Without clear rights to emission allowances as collateral, lenders may discount the allowance-derived revenues in their underwriting of debt financing for GHG projects, be reluctant to engage in such financing, or charge a premium on the interest rates. Along with technology risk, the uncertain regulatory environment, the long time horizons for many projects and the ongoing credit crisis, a lack of clarity over 'lien' rights (security interests) may well serve as the proverbial straw that breaks the camel's back. If it does not block a loan transaction entirely, this question will certainly elevate transaction costs by consuming the time of counsel and investment advisers.

Security interests in the US, known elsewhere as "fixed and floating charges", are primarily governed by Article IX of the Uniform Commercial Code. Lawyers have attempted in various ways to apply this law to sulphur dioxide ($SO_2$) trading, but remain unsure of the enforceability and strength of a lender's claims under bankruptcy. Indeed, ask five experienced American lawyers this question and you are likely to get five different answers. And regarding GHG emission allowances, the code is most clearly read to govern the granting of a lien only in various forms of "property", while Section 1 of the Lieberman-Warner draft legislation specifies that "allowances are not property". Such uncertainty may have been tolerable within $SO_2$ trading. The trading of GHG emission allowances, on the other hand, intends to make profitable technologies and practices that are not otherwise competitive with cheap energy from coal or natural gas.

This absence of a security interest in GHG emission allowances leaves several gaps. One of the most important roles of the lien system is that it provides public notice that the asset is encumbered (that is, is owned by one entity, but subject to a valid claim by another one). Checking with the filing office is the most elemental step in due diligence for a potential lender. Yet, for an emission allowance, the appropriate filing location is unclear, as is the legitimacy of the lien itself. Thus, a lender currently is forced to rely on the covenants of the borrower and, if violated, the rights would have to be enforced by expensive litigation. This procedure contrasts with the automatic "step-in rights" over property with a "perfected security interest" and also presents questions over whether the property will be recognised by a federal bankruptcy court, particularly regarding other creditors.

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This problem is most significant for emission reduction projects that have little else in collateral outside of emission trading revenues. While a wind turbine may be dismantled and reinstalled elsewhere, there is little secondary market value for a used methane digester. At least one planned methane reduction project has been unable to secure debt financing for this very reason. This could also be a problem for energy-efficiency retrofit loans, particularly where the improvements were made on debt-financed property.

By changing the nature of emission allowances, this problem could evaporate. When Congress revisits the Climate Security Act in 2009, it should amend Section 201 to characterise emission allowances as "property, subject to regulation by Congress". This characterisation will send a clear message that government is serious about addressing climate change, while preserving its prerogative in the future. Statutory clarification of the legal nature of allowances will boost confidence in the field of carbon finance and thereby attract many forms of investment. Alternatively, Congress could direct the Department of Energy to promulgate a lien filing system for emission allowances. Either action may well forestall future litigation over this question. It is worth remembering that property rights began as a solution to the tragedy of the commons, but that it is the lien and mortgage systems that underpin the vibrancy and affluence associated with modern capitalism. Ultimately, US cap-and-trade legislation will not meet its goal of translating that vibrancy into greenhouse gas reductions, unless it provides something tangible that green entrepreneurs will be able to take to the bank. EF

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