

Getting in on the Green:

The Benefits of Carbon Credits in the Leasing Context

The driving force underlying climate change initiatives worldwide is the emergence of a lucrative greenhouse gas emissions trading scheme whereby carbon credits are becoming a market commodity for large industry emitters. As a result market prices for carbon credits are rising and creative ways to benefit from this market are emerging. This article will explore how carbon credits can be used in the leasing context.

Carbon Credits - Background

Since the Kyoto protocol was entered into force in 2005, there has been a global movement towards creating “green” and “carbon-neutral” economies by reducing greenhouse gases emissions in an effort to curb global warming. 182 parties, including Canada, have ratified the protocol including 36 developed countries that have agreed to reduce greenhouse gas emissions. For example, the European Union (EU) has committed to reduce its overall emissions to at least 20% below 1990 levels by 2020 by a cap-and-trade system implemented through the European Union Emissions Trading Scheme (EU ETS).

A cap-and-trade system operates by a government or international body setting a limit or cap on the amount of greenhouse gases that can be emitted. The cap will vary by industry and depend on national budgets for reaching carbon emission reduction targets (CERTs). Companies are issued allowances or credits, representing the right to emit a certain amount. Companies that exceed their emissions cap must buy credits from those who pollute less. This cap coupled with high CERTs, has created a commodity for carbon credits in Europe resulting in the emergence of emissions trading. Each carbon credit represents a reduction of one metric tonne of carbon dioxide, or its equivalent in other greenhouse gases. Similarly, Renewable Energy Certificates (RECs), are tradable commodities which represent proof that 1 megawatt-hour of electricity has been generated from an eligible renewable energy resource.

Emissions trading can occur bilaterally between counterparties or on an exchange such as the European Climate Exchange (ECX) or its sister company, the Chicago Climate Exchange (CCX). In Canada the Montréal Climate Exchange (MCeX), a joint venture of the Montréal Exchange and the CCX, officially launched the trading of carbon credits on May 30, 2008. Currently, carbon credits are being exchanged worldwide at a rate of between CAN\$15-25, with projected increases as the Kyoto protocol is more widely established and the demands thereunder increase.

North American

In North America, the cap-and-trade system has not yet been implemented except in a few jurisdictions. Further, those jurisdictions that have established cap-and-trade programs (such as the Province of Alberta in Canada) have adopted an intensity-based system.

This means that instead of capping the number of units of carbon industry can emit, companies will be capped based on their emissions intensity level, allowing for increases in emissions as production increases. Generally speaking, a hard cap, rather than an intensity-based one creates a greater demand for carbon credits to offset emissions and as such, the value of a carbon credit is likely to not have the same value as under a pure cap and trade system.

Unlike the EU, the North American carbon market is currently a voluntary one. This means that while no national regulatory system is in place, commercial and individual customers are purchasing credits in order to lower their carbon footprint on a voluntary basis. These are either purchased directly from the stock exchanges or from companies who are in the business of buying credits that can be sold to the individual in order to offset their carbon footprint. As a result, even in Canada the market demand for credits is growing and possession of carbon credits is becoming an increasingly valuable asset for companies to acquire.

Becoming Green

If a finance company wishes to obtain a “green” or “carbon neutral” label, then one method may be to finance equipment that will reduce the lessee’s/borrower’s carbon footprint and then as part of payment for the use of the equipment under the lease have the lessee transfer those credits acquired with the equipment to the lessor. The lessor could then either apply the credit to reduce its own carbon emissions or trade the credit on the market. The finance company could also be in a position to “trade” the credits themselves within their client base.

The issue of ownership

Under the EU ETS, carbon credits are an asset that can be traded between individuals and corporations. Credits can be acquired either by an allowance given by a regulatory body or through carbon reduction projects. In the first scenario, companies that implement carbon reduction techniques that pollute less can retain unused credits from their allowances. In the second, green energy projects such as producing wind or solar energy can result in a company receiving credits for the equivalent of carbon that would otherwise have been emitted. The company/individual that acquires the credits effectively has ownership over them and the ability to transfer or sell the credit as an asset. Ownership is established by the legislation that creates the system in North America, as the legislation establishing, these programs has for the most part, not as yet been drafted. It is not yet clear what rights will be associated with the credits and how freely tradable they will be. To the extent that the system is voluntary, it is clear that the right is as the parties establish.

In the leasing context, the question becomes whether the company who leases equipment to be used for either carbon reduction techniques or green energy projects, or the lessee who undertakes those techniques or projects, owns the carbon credits acquired. Under current carbon market models, the credits would be given to the lessee undertaking to reduce carbon emissions. However, provided that the credit is freely tradable, then a lessor could cause the credit to be transferred to the lessee as part of payment of the debt.

This may be particularly useful if the asset being financed is a renewable energy project. If the REC's can be established for the project, then these REC's can be an asset that the lessee could use in part payment or the lease payment. This may allow, depending on the timing and market for the REC, the lessor to receive non-cash consideration at a time when cash flow tends to be poorest for the lessee. Typically, large green projects are cash flow negative in the early stages and, the transferring of the REC may allow non-cash consideration to be paid at the very time it is needed most allowing projects to be financed.

The issue still arises as to whether these credits and REC's are tradable. As noted, it will depend on the legislation. It is suggested to the extent that they are more akin to a property right and less a license, then the more likely they would have value. It should also be noted that certain government renewable energy initiatives, such as the creation of wind power in Ontario may require that in order to produce wind power, the REC needs to be transferred to the governmental authority.

Presuming that market prices for carbon credits are on the rise, including this asset to the leasing price could confer a great benefit to a lessor interested in participating in this market. However, there would be some element of risk as the value of the credits is largely impacted by fluctuations in market demand and changes in the regulatory framework. Since the carbon credit could be used as an incentive for a leasing company to approve/ finance equipment at a lower interest rate, lessees might benefit from a rate lower than what they would otherwise pay or enter into the in the first place. The remaining value could be conferred to the leasing company through future credits acquired. This would be particularly advantageous in a venture leasing situation, since carbon credits can be used as an equity kicker to attract financiers.

Factors both parties should consider

1. Who has ownership of the credits? The lessor would benefit by having the lessee make representation in the agreement as to ownership of the credits and the authority of the lessee to transfer/sell the carbon credits. and that no other party has a claim to the credit.
2. Are the offset credits being measured/quantified with scientifically acceptable methods? For instance, in Canada, the Canadian Standards Association has approved a quantification protocol in its series of standards on Greenhouse Gases – the ISO 14064 series. Parties should consider whether the quantification protocol being used has been approved by the applicable governmental authority
3. What third party is going to verify the carbon credits? A verifier is a company that has been certified to ensure that proper protocol has been followed for all carbon projects in order to ensure the validity of the credits being traded. It would be advantageous for a lessor to have the lessee warrant that the credits are approved by a reliable verifier. This will ensure a maximum return for the lessor who wishes to then sell the credits on the open market.

4. Does the price in the agreement account for changes in the market price of carbon credits? The price will vary over time depending on market demand and on policy development. At this stage of uncertainty, it might be wise to consider a flexible pricing program.
5. From a credit standpoint, has the lessee set out the potential obligations to pay a price for emissions beyond any emissions cap that may be put in place.
6. The agreement should also specify the project or emission reduction techniques to be implemented as well as the protocol standards to be followed in order to carry that project out.

A sample clause that could be included in a lease to achieve this goal might include the following:

“The lessee agrees to transfer to the lessor free from liens and encumbrances the rights to any carbon credits acquired during the years of 20__ to 20__ through the application of (project or emission reduction technique description) as further described in Schedule “A” and verified by (state the agreed-upon third-party verifier).

The above list is not exhaustive, but rather represents some of the issues a leasing company would want to consider in entering into this type of agreement.