

INSIGHTS

## Voluntary Carbon Credits – A Free Market Solution

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### OVERVIEW

In February of this year, the International Emissions Trading Association (“**IETA**”) published a comprehensive set of standardised agreements for the sale and purchase of voluntary carbon credits (“**VCCs**”). The international market for VCCs has been growing at a substantial rate, however, there has been increasing scrutiny in respect of the transparency and consistency of the VCC market.

The IETA is an international body established to create a functional global framework for the trading of greenhouse gas emission reductions and, the issuance of these standard form documents represents a significant advance in the legitimisation and regularisation of the VCC market.

This article provides a brief overview of the primary standardised sale agreement and how it, and the other new standard form documents, fit into the continuing development of the VCC market and its financing.

### BACKGROUND

The history of the global decarbonisation effort is well documented and the rise of VCCs and other emission reduction products roughly tracks the same path.

In parallel with the commitments made under the Kyoto and Paris frameworks, national and supra-national legislation was introduced to regulate the emission of greenhouse gases. For example, the European Union introduced a “cap-and-trade” system in the form of the EU ETS applicable, on a mandatory basis, to certain industry participants. However, alongside these mandatory government regulated carbon emissions schemes, a voluntary market for emission reduction products emerged.

Distinct from the regulated mandatory market, the voluntary market is administered by private participants, the key participants being: (i) the verification standards bodies (the entities who manage the assessment of the projects against a set of standards to determine the nature and quality of the emission reductions), (ii) the independent validation and verification bodies (auditors that verify the integrity of the projects), and (iii) the credit registries (the platforms through which buyers and sellers hold and transfer their emission reduction credits – and which are often the same as the standards bodies).

There are a variety of different types of VCC being produced, with each individual VCC representing 1 ton of Co<sub>2</sub> equivalent emissions reduced. Set out below are the key attributes that make each VCC unique:

- **Certification Standard:** As referenced above, the verification standards bodies play a key role in the VCC market.
- **Vintage:** Each credit production cycle produces VCCs specific to that year, which can in some instances indicate the quality of the VCCs.
- **Project:** Credits will relate back to the specific project from which they were produced. There are a vast number of different projects producing VCCs, but at a high-level, projects are either avoidance credits (e.g. renewable energy, land management) or capture/removal credits (e.g. direct air capture, reforestation, afforestation). Boston Consulting Group recently estimated that approximately 80% of the current supply of VCCs are avoidance credits.

## STANDARDISATION

A wide range of actors have been involved in transactions for the sale and purchase of VCCs, resulting in significant variance in the terms of sale negotiated.

The introduction of a market standard for the key commercial parameters of such sale arrangements provides an invaluable reference point or base for negotiating and finalising VCC sales.

## IETA MODEL FORMS

The IETA's February publication included three standard documents and accompanying guidance notes. The standard documents comprise: (i) a primary sale agreement for a direct sale of carbon credits from a project owner to an initial buyer, and (ii) two forms of secondary market sale agreement. There are similarities throughout all three documents, so for the purposes of this note we have considered only the key terms of the primary sale agreement (the "**Model Form**").

### KEY TERMS: PRIMARY SALE AGREEMENT

**Conditions to Sale:** The Model Form has a conditions precedent structure baked-in, reflecting the general practice of entering into a 'futures' sales arrangement. As such, parties often agree to include conditions relating to registration of the project with the relevant standard and associated legal opinions confirming the seller is the project proponent and holds rights and title in the VCCs.

**Contract Quantity and Payment:** The provisions regarding contract quantity are straightforward, with the VCC quantity being set out in the commercial terms and transfer schedule appended to the Model Form. This includes details of the indicative transfer date for the relevant vintage, and, of course, the relevant number of VCCs and price. There is also optional drafting which can be incorporated to provide clarity that the contract quantity is to be net of: (i) any "Buffer VCCs" (the stock of VCCs that provides a mitigant in the event of a 'reversal', i.e. an undoing of

the carbon removal, for example as a result of logging or a forest fire in the case of forestry projects), or (ii) other deductions under applicable law.

There is currently no index-based pricing mechanic included, so any such terms (for example if you're contracting on an index less discount basis) would need to be bespoke.

**VCC Shortfall:** Where the seller becomes unable to transfer the required quantity of VCCs, the seller is required to use reasonable endeavours to remedy or minimise the anticipated shortfall. If there is a cancellation, retraction or revocation of any contract VCCs, the seller is obliged to transfer an equivalent amount of comparable VCCs to the buyer.

Any shortfall resulting from fraud, wilful misconduct, gross negligence or non-performance under the agreement by the seller will permit the buyer to elect to receive equivalent VCCs or its costs of obtaining equivalent VCCs.

**Commissioning and Validation:** The Model Form requires that the seller develop and finalise the project documents and commission the project. However, there is additional optional language included that would require the buyer to do all things reasonably requested to assist the seller in developing the project documents.

The Model Form provisions around the monitoring and verification terms rely heavily on the relevant carbon standard as the evaluative basis external to the contract and as such, we would emphasise the importance of the relevant carbon standard and the need for a purchaser to be confident in the legitimacy and stability of the verification standard for credits issued thereunder.

**Events of Default, Termination and Damages:** The agreement contains standard events of default covering, *inter alia*, failure to pay or perform, breach of representations and warranties, revocation of relevant authorisations, encumbrance or transfer of the contract VCCs, and change of control of the seller.

Following an event of default, the non-defaulting party's obligations are suspended, and they will have the right to terminate. A termination on an event of default by the seller will oblige the seller to pay contractually determined damages to the buyer, which are essentially calculated as the amount by which the market price on termination is greater than (if at all) the contract price multiplied by the remaining undelivered VCCs under the agreement, plus default interest plus costs. On termination in an event of default by the purchaser, this calculation is reversed.

**Additional Seller Liabilities:** The Model Form makes provision for the uncertainties that surround the regulatory and tax treatment of VCCs by way of the "Additional Seller Liabilities" clause. The clause includes optionality such that either the seller alone, or the parties between them, wear the risk of policy changes that result in additional costs. We would note the particular value of these terms in light of the introduction of new taxation regimes in certain countries with existing developed carbon credit projects.

**Representations and Warranties:** The Model Form includes extensive representations and warranties from the seller covering a broad range of issues related to the credits, including provisions related to proper operation of the project, title to the credits and proper validation

of the credits.

**Compliance, Governing Law and Disputes:** As would be expected given the nature of the market participants, the Model Form includes broad market standard terms regarding sanctions, ABC and human rights compliance. The document is governed by English law and the template dispute resolution clause provides for LCIA arbitration - a drafting decision that underpins the UK's position as the legal centre for the growing voluntary carbon market.

## **FINANCING**

The primary sale agreement would ideally provide a benchmark "off-take" contract as typically underpin most project financings, such as power purchase agreement or commodity sale and purchase agreement.

Structured as a forward sale agreement, it could potentially support construction risk project finance to be raised against it. Particularly where the price is structured as a fixed price for the VCCs, allowing would-be lenders to look through to the credit risk of the offtaker without being required to take a view on a long-term forward price curve for the VCCs over the tenor of the debt.

To date however, the VCC projects have predominantly been financed on an equity only or prepay basis. Whilst many banks and, in the emerging markets where VCC projects could potentially provide useful sources of hard currency, the DFIs, are showing a keen interest in these projects, reservations remain as to the value of the VCCs themselves.

Where debt-like instruments are being used in the financing of development of VCC projects, is akin to the pre-pay facilities used by commodity trading houses.

This is not unsurprising given the high levels of interest and involvement by miners, traders and oil majors who have long been used to evaluating forward price curves and the risks associated. This commercial acumen coupled with continued pressure to decarbonise their own operations makes them natural first movers for this asset class.

Given the familiarity of the banking market with contractually limited recourse prepay financing arrangements we expect initially to see bank finance for VCC projects being raised not by the project developers as the borrowers, but by the purchaser of the VCCs that in turn is on-lending the proceeds of the bank loan to the project by way of a pre-pay facility rather than through traditional project finance.

## **CONCLUSION**

The publication of the new IETA standard form documents is a fundamental step for the evolving credit market. For high-volume operations, we expect these terms will provide a common base precedent, and for more bespoke projects, offer a reference point for the balance of risk in negotiations.

The key risk factor for participants in the voluntary carbon credit market will continue to be the demand side risk that the VCCs themselves are still not an entirely fungible commodity that can rely on global price benchmarking and transferability.

The key to unlocking significant amounts of capital for projects to produce VCCs will be the actual and perceived robustness of the Certification Standards underpinning the relevant VCCs, which in turn will provide better fungibility of VCCs and its ability to be treated as a commodity to be financed in the traditional way.

However the public availability of the contract will undoubtedly assist in commoditising the participation in the carbon market, helping to clarify the carbon sales process for all, and with it, helping to increase access to capital.

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