

# Getting Your Carbon Credits Voluntarily

Article

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Carbon credits can be generated by entities that successfully reduce their carbon emissions or remove greenhouse gases from the environment. Carbon reduction projects that create carbon credits can sell them on the voluntary market to generate revenue. The ability to purchase carbon credits voluntarily (VCCs) from a project that has generated and accumulated them provides voluntary market participants with a means to offset their greenhouse gas emissions outside a formal regulatory or compliance framework.

Because they are tradable in this way, carbon credits can be thought of as a type of commodity. However, a credit generated by a particular project is inherently tied to the characteristics of that particular project – there is no uniformity or particular commonality between credits or between projects, so the common characteristics of this commodity are hard to ascertain. This means that the voluntary market is illiquid and non-uniform, creating hurdles for carbon-reduction projects that wish to raise debt finance, and obliging financiers to look through the generated credits to the robustness of the project itself in making the decision to lend and structure financing, which significantly reduces the ability of aggregators or traders to finance large pools of VCCs.

## Market Aspirations

However, the appetite and the use-case for debt financing in this area are manifest. In a January 2021 article, McKinsey estimated that the overall market for carbon credits could be worth more than US\$50bn by 2030 and predicted that the market would help drive private financing towards climate-action projects and foreign direct investment in the global south, where the potential for emission-reduction projects is strongest. So the VCC market has the potential to achieve powerful results in the fight against climate change.

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Thus, many have aspirations for the VCC market to function with sufficient efficiency and liquidity to make it financeable on similar terms to other commodity markets, giving it the potential exponentially to increase the capital available for carbon reduction projects and thereby speeding up global decarbonisation efforts. This article will look at some of the impediments to significant scaling of financing for VCCs by reference to the bankability features of other classic commodity and certificated/derivative finance structures.

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## Types of Commodity Finance

There are many types of structured commodity finance, but some of the more sophisticated include borrowing base, pre-export and prepayment facilities. Borrowing base – known in the case of hydrocarbon financings as reserve-based – facilities operate by linking the amount of available finance to the value of a fluctuating pool of underlying assets – in the case of a reserve-based facility the commodity forming the “borrowing base” will be hydrocarbon reserves, but a borrowing base could also be built around metal ore, for example.

The lenders in these types of facility will take security over the assets forming the borrowing base, and are thus assured that in an enforcement scenario, there are sufficient assets that can be sold to discharge the debt. Because the debt is sized by reference to the borrowing base, lenders can also be comfortable that at any given time sufficient commodity is available for the borrower to sell, generating revenue for debt service.

In a pre-export facility, a lender will provide working capital finance to a producer to enable it to produce and then sell commodities. A pre-export facility is discharged by the proceeds of sale of those commodities. Lenders will look to take security over the borrower’s rights under the offtake contracts between the borrower and its buyer counterparties, as well as over the commodities themselves and the bank account(s) into which the proceeds of sale are paid.

In prepayment facility structures, a trader will often prepay the miner/producer in advance for the commodity, with the delivery of cargos then discharging the prepayment debt facility. This prepayment facility between trading house and producer, is often then back-to-back financed by third party banks lending to the trader with a limited recourse model focused on the underlying prepayment facility between the trader and producer.

All of the above financing solutions are built around the relevant commodities but allow for finance to flow through to support the underlying projects that generate them – they are thus widely used where the type of commodity, the subject of the financing, its market and the financing structure, are considered “bankable”.

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## Financing Certificates

While the financing of projects producing VCCs is often referred to as carbon financing, a VCC is not a physical commodity itself. Its value is derived from its certificated form as a representation of the physical carbon removed or abated from the atmosphere.

The voluntary nature, and the associated free market determination of price for VCCs means that the temptation to draw analogies with the financing of other carbon credits such as EU ETS or Renewable Obligation Certificates or the US tax equivalent Q45s, falls short.

A better comparison to draw is the financing secured against share certificates that are held or cleared through the accounts of depositories. The depositories and clearing houses providing the necessary market infrastructure to facilitate the title-based financing of bundles of shares of different companies as collateral for lending (rather than the direct share security more familiar to project financiers).

The certainty of the legal title in the share instrument, together with the robust accounting of each instrument, provides the basis on which the shares can form acceptable collateral to support the associated financing.

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## Features of Commodity Financing

There are many features of commodity markets that make them bankable:

- Fungibility of commodities – Commodities of the same type can be fungible or mutually interchangeable, easing supply chains and trade flows. Agreed audit and testing methodologies exist to ascertain grades of commodity being financed, for example assaying methodologies to determine the quality of metal ore. Assets that are fungible can be easily sold to liquidate a debt, or in a security enforcement scenario.
- Contracts and documentation – Many instruments that are used to facilitate global trade, such as bills of lading or letters of credit and related contractual frameworks such as Incoterms or Uniform Customs and Practice for Documentary Credits (UCP), are understood and recognised in the international commodity markets and in courtrooms worldwide. Commonality and consistency of documentation gives financiers comfort that they will get good title to secured assets and that they are lending against or on the basis of legally enforceable documentation, as well as opening up opportunities for secondary market participants to participate in financings on terms that are widely recognised and therefore portable.

- Data transparency and pricing – International indices are widely available to provide transparent data points, assisting market participants in accurately determining the relative value of underlying commodities.
- Market infrastructure and clearing – A multitude of exchanges and clearing houses such as ICE or the LME exist for the trading of commodities, in the same way that other platforms such as CREST exist for the settlement of dematerialised shares. This infrastructure provides certainty for market participants and a free, regulated exchange on which to trade and liquidate financed assets.

All of these features provide reassurance to financiers who wish to take asset-based security to reduce their financing risk. Financiers that participate in the commodity markets are able to take security over physical commodities or, in the case of derivative instruments such as shares, over the representative instrument that is cleared through an exchange or held in accounts.

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## Features of the VCC Market

In contrast with other types of commodity, certain features of VCCs make them harder to bank:

- Fungibility of VCCs – Most VCCs are currently traded directly or over-the-counter between the buyer and the seller. This is because there is no common standard or taxonomy that defines a carbon credit on the voluntary market. There are various verification standards and auditing bodies whose role is to assess emission reductions and the quality of underlying projects, but each has a different set of standards that make it difficult for a third-party financier to treat any particular VCC as a fungible asset. The robustness of verification and audit processes needs to be significantly improved and harmonised to improve the fungibility of VCCs.
- Contracts and documentation – Although in 2023 the International Emissions Trading Association (IETA) published model form documents relating to the sale and purchase of carbon credits, there is little consistency in the terms that sellers and buyers negotiate in the VCC market, and it is therefore harder for financiers to get comfortable with, for example, the enforceability of the parties' respective rights in or title to the VCC(s) being transferred. Standardisation of contracts would allow for improved aggregation of price signals, which can then form a reliable valuation basis against which financiers can lend.
- Data transparency and pricing – Having standardised audit parameters for each type of VCC-producing project would allow for much better pricing of each VCC produced – this doesn't necessarily mean that all VCCs would have the same price, but a common approach in the market would allow for consistent pricing differentiation between different grades of VCC.

- Market infrastructure and clearing – Market infrastructure needs to develop further to facilitate liquidity of trading. A liquid market provides comfort to financiers that the asset base they are financing can freely be converted into cash to repay the debt. To create liquidity for VCC holders, clearing houses for VCCs need to be developed and financially supported in the same way that share exchanges or commodity exchanges are. Such developments are already taking place (for example the Global Carbon Market Utility which aims to address exactly this issue).

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## Security/Collateral Considerations

The availability of debt finance in the global commodity markets is possible because borrowers and lenders customarily create security to support the debt. In a typical structured commodity financing, the financier will expect to receive a security interest from the borrower in the underlying assets, which will principally be the financed commodity, relevant bank accounts and/or the rights of the borrower in any commercial contract(s).

Broadly speaking, under English law an asset will be capable of being secured whether or not it is tangible or intangible, as long as title to it is capable of transfer by way of security to a creditor, or if it is otherwise capable of being encumbered in the creditor's favour. In practice, there is little difference between a transfer of title or an encumbrance in this context – the effect, for example, of an English law mortgage and a fixed charge is largely the same, even if the legal nature of these security interests is quite different; in the case of an English law mortgage, the secured creditor will receive either “equitable” or “legal” title in the secured asset, whereas an English law fixed or floating charge simply creates an encumbrance in the creditor's favour, with no associated title transfer.

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## Impact on Finance

All of the necessary improvements in the VCC market mentioned above will give financiers greater certainty as to the bankability of VCCs and will encourage more financing backed by VCCs.

In particular, the establishment of clearing houses and formal market infrastructure allowing the clear identification and valuation of VCCs will allow the creation of existing forms of security interest over or in connection with this relatively new type of asset – it should be possible for a financier to take a security interest over a trader's or carbon credit aggregator's account with the clearing house, in much the same way that it is possible currently to take a charge over a CREST depository account in the case of de-materialised listed shares.

The effect of this will be to allow financiers to base the provision of debt finance solely on VCCs – including lending against large blocks of VCCs aggregated from different projects – rather than having to look through them to the generative emissions-reduction project, cutting down the amount of diligence required and making finance more widely available.

Improvements to liquidity generated by the proper regulation and financing of clearing houses and market infrastructure will allow financiers to be confident that, in the event of a default by the borrower, the underlying assets they are financing can be sold easily, quickly and at a readily determined value.

By the same token, VCCs traded using recognised and largely standardised documentation will permit financiers to syndicate their risk on the secondary market, as well as to have confidence that their borrower has title to the secured VCCs and that that security is enforceable.

Ultimately, increasing the availability of significant amounts of structured debt finance will unlock significantly more carbon reduction projects and thereby help achieve net-zero faster.

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