Voluntary carbon market trading: Key risks and mitigations

By Adam Hedley and Brett Hillis

Takeaways

- No single global legal position determines the nature of voluntary carbon credits, including what title can be claimed in them and what security can be taken over them
- The lack of market standard trading documentation for voluntary carbon credits is both a hindrance to the growth of the market and an opportunity
- A two-tier voluntary carbon market labeling/pricing structure may develop: one for credits that comply with the new Paris Agreement Article 6 corresponding adjustments rules, and one for credits that do not

The voluntary carbon market (VCM) has been in operation since the 2000s, alongside mandatory/regulated carbon market schemes such as the EU Emissions Trading System and the U.S. Regional Greenhouse Gas Initiative. The two largest VCM programs, Verra's Verified Carbon Standard (VCS) and Gold Standard, have been around since 2006 and 2003 respectively. In that sense, VCM trading is nothing new. However, the VCM has only really taken off in the last few years, with the growth of the market being rapidly accelerated by the adoption of the Paris Agreement in 2016 and, in the shadows of that, the Glasgow Climate Pact in 2021 and the proliferation of governments and corporates making "net-zero" carbon reduction commitments.

The rapid growth of the VCM in recent years has made VCM trading much more mainstream. Nonetheless, because the VCM is largely unregulated, in contrast to the more established mandatory carbon markets, some commentators and participants still see it as the "wild west" of the carbon trading sector.

In this piece, we examine a few of the key issues and opportunities currently faced by the VCM.

The legal nature of voluntary carbon credits

As with any asset or legal instrument, understanding the legal nature of voluntary carbon credits (VCCs) is critical to assessing and documenting how they can be traded and what risks there are to the transacting parties, including what property interest can be claimed over them and what form of security can be taken over them. Their legal nature also impacts their regulatory treatment and what tax implications there are in trading and holding them.

Yet there remains a large degree of uncertainty over the precise legal nature of VCCs, and the VCM program providers largely skirt around this question in their rules and standards. Since a VCC is a creature of contractual law (i.e., the construct of the VCM program it is issued under) and is not an instrument that is created via any legislative or international treaty framework, its nature is determined by the law applicable to its creation, holding and transfer. It is therefore determined by national law(s), having regard to the law applicable to the contractual framework under which the relevant VCM program operates and, potentially, the governing law of any trading documentation. This will differ between VCM programs and transactions, so there is no consistent answer to the question as to the legal nature of VCCs.

Applying an English law analysis to the question, the nature of a VCC would essentially be one of either (i) a property right (in rem) or (ii) a personal right (in personam). Personal rights are generally considered nontransferable as they are so closely tied to the relationship between the obligor and the oblige, that a third party cannot require the obligor to be indebted to the third party in place of the obligee. In contrast, a property right may be enforced against the obligor by a third party if the legal processes for the transfer of the obligee's rights have been duly completed.

English law governed trading documentation generally proceeds on the basis that VCCs are a form of intangible property (although this has not been authoritatively determined by the English courts), which means legal title can be held and transferred to another party. However, as intangible property, this gives rise to complexities around what security can be taken over them. This is compounded by the need to take into account the national law applying to the VCCs and the registry account in which they are held, e.g., in the case of VCCs issued under the VCS, the law of the District of Columbia.

Industry efforts are underway to address the lack of consistency as to the legal nature of VCCs. However, until they come to fruition, it is important when trading and creating security over VCCs to assess the impact of the contractual governing law and the law applicable to the VCCs or registry account.

Standardization of trading documentation

For the same historical reasons as outlined above, in contrast to the regulated carbon markets, there is no industry standard trading documentation for VCCs. That is seen most acutely in "primary offtake" trading documentation, i.e., the first sale and purchase of VCCs from carbon reduction project owners, where documentation has tended to be project- and VCM program-specific. In such circumstances, the contractual documentation under which the VCCs will usually be traded is more similar to an emissions reduction purchase agreement (ERPA), rather than the industry documentation used to trade regulated carbon allowances such as EUAs, e.g., the template trading documentation developed by ISDA, IETA or EFET.

Even at the secondary trading stage, there is very little by way of consistent trading documentation in the market, although there are various forms out there that have their origins in trading documentation used for regulated carbon allowances, oil, metals, power and other forms of commodities or green certificates.

While there is no "magic" to documenting VCM trades, it is important to assess whether the form of contract used is appropriate to the facts of the transaction, the underlying carbon reduction project and the applicable VCM scheme, particularly in regard to primary offtake agreements. This is perhaps less of a concern with secondary spot trading, but there are still important risks/issues that merit bespoke drafting to allocate them appropriately, e.g., the Paris Agreement corresponding adjustments issue outlined below.

The lack of market standardization also presents opportunities; there is clear scope for sophisticated market actors to develop "buyer-friendly" and "seller-friendly" documentation, the scope for which is more limited when documenting trades under industry template documentation.

However, there is clearly an appetite for more standardization in the market, and there is no doubt this would benefit the many new entrants to the market who are looking to acquire VCCs to support ESG or net-zero objectives. Various industry groups (including IETA and ISDA) and working groups are developing template trading documentation, which should subsequently lead to more standardization in the approach to documenting trades in the VCM.

Paris Agreement corresponding adjustments

The long-awaited Paris Agreement Article 6 rulebook was finally approved in November 2021 after intensive negotiations over the course of the UN Climate Change Conference of the Parties in Glasgow (COP26), not to mention several years of prior talks.

The resolution of Article 6 at COP26 was seen as critical to the success of the Paris Agreement; more specifically, finalizing the Article 6 rulebook meant firming up the "corresponding adjustments" accounting rules, which would ultimately define the relationship between Paris Agreement governmental actions and the availability of carbon reductions for use in the VCM. In that regard, Article 6 was seen as both an opportunity and a threat for the VCM: the opportunity being to remove ongoing uncertainty over that relationship; the threat being that the corresponding adjustments rules could significantly reduce the scope for the VCM to operate alongside governmental climate mitigation actions, as codified in their Nationally Determined Contributions (NDCs).

The requirement to make corresponding adjustments in respect of international transfers of emissions reductions was always expected to happen; however it was unclear how far this would go. The outcome of COP26 was to extend the corresponding adjustments rules to cover emissions reductions/removals that are claimed as carbon credits under a voluntary carbon market scheme once those credits are transferred to a private/public entity located in another country. In other words, carbon emissions covered by a country's NDC actions cannot also be claimed as VCCs under a VCM program and traded with a foreign entity, unless the government of that country confirms that it will make a corresponding adjustment to take those underlying carbon emissions outside of its NDC reporting.

The VCM program operators have had to evaluate how to factor this into their rules. Initially, the two main program providers – Verra and Gold Standard – indicated they were going in two different directions. Verra took a stance that the corresponding adjustments requirements would ultimately not affect whether VCCs could be issued, but instead what label/claim could be attached to them: an offset label (for Article 6 compliant units) or an impact label (for non-Article 6 compliant units). Gold Standard initially indicated it would take a more resolute stance by only issuing VCCs where it was demonstrated that corresponding adjustments had been made, where required. However, following a consultation it appears that Gold Standard has softened its stance, bringing it more in line with Verra.

It remains to be seen how the VCM will be impacted by all this, but it seems likely that a two-tier market/pricing structure will develop: one for VCCs that comply with Article 6, and one for VCCs that do not.

Authors

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Adam is a partner in the London office and has 12+ years of experience advising on a broad spectrum of UK, EU and international environmental, health & safety, product compliance, carbon market and climate change law matters. He has a particular focus on the environmental aspects of ESG, and regularly advises on key topics, such as: climate change adaptation and mitigation projects; climate-related corporate reporting; carbon offsetting and neutrality objectives; renewables and alternative/sustainable fuels regulation, compliance and incentive schemes. He also regularly works on EU and international carbon and climate-related transactions, advisory matters and disputes, including emissions regulation, carbon trading and climate financing projects. His experience spans cap-and-trade schemes such as the EU, UK and Swiss ETS and regulatory / voluntary carbon offsetting schemes, including the UNFCCC CDM, the emerging Paris Agreement Article 6 mechanisms, CORSIA, REDD+, Gold Standard, VCS, etc. Adam is also experienced in EU renewable energy/fuel laws, and claiming/trading of UERs, RTFCs and other forms of green certificate. He has regularly been ranked as a "rising star" by *Legal 500* and as "up and coming" by *Chambers UK*.

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