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Insights

THE RACE TO NET-ZERO:

WHO HOLDS THE KEY TO UNLOCKING BILLIONS OF FURTHER CARBON FUNDING?

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The global carbon credit market is enormous – it is valued between a range in the hundreds of billions to trillions U.S. dollars - and split between two distinct markets, compliance (regulated) and voluntary (corporate/social) markets.

The voluntary carbon market (VCM), which is experiencing significant growth, channels private finance towards climate solutions and was formed to drive investment into activities that reduce greenhouse gas (**GHG**) emissions. It is a market where carbon credits are purchased and sold on a voluntary basis and which allows entities to offset unavoidable emissions by purchasing carbon credits that represent projects which remove or reduce GHG emissions in the atmosphere.

A substantial amount of capital is required to finance the number and scale of carbon projects required to reach net-zero, and it may be the case that debt financing at a significantly greater volume than the market currently features is the only way to drive the carbon removal industry to a gigatonne scale. Is there a golden key that could unlock the further billions of carbon funding required in the VCM?

MEET THE PLAYERS

All of the players in the net-zero game have a common goal in mind - facilitating the environmental benefit of removing, reducing or avoiding tonnes of CO2 equivalent GHG emissions.

Carbon project developing companies (the "Project Developers") develop and implement a wide range of project types, covering both emission reduction and carbon removal activities; these projects involve anything from direct air capture, geological mineralization, nature based solutions (like grasslands and reforestation) and other engineered carbon removal technologies. Instead of relying solely on equity investment to fund their projects, the Project Developers are increasingly looking at institutional debt to play its part in funding projects that would contribute to achieving the net-zero goal.

To win the trust of investors and the public, Project Developers often register their projects with carbon credit standards and certification bodies like, among others, Verra, Gold Standard, American Carbon Registry and Climate Action Reserve (each a “Carbon Credit Registry”). Which Carbon Credit Registry to choose depends on various factors such as the type of project and the geography. These Carbon Credit Registries develop methodologies, certify emission reduction projects, and issue tradeable carbon credits.

A carbon credit is a tradeable unit that represents one tonne of CO2 equivalent GHG emissions; a carbon credit is created each time an issuing registry, such as a Carbon Credit Registry, verifies that the relevant project of the Project Developer has reduced, avoided or destroyed one tonne of GHG emissions. Each carbon credit is issued from a specific project and certified by carbon standard; it represents avoidance, removals or reductions of GHG emissions in the atmosphere. When the Project Developer claims the environmental benefit of removing, reducing or avoiding a tonne of CO2 equivalent GHG emissions, the credit is retired on the registry that issued the credit and will no longer be tradeable.

Being enrolled in a Carbon Credit Registry’s registry signals that a project has passed third-party validation and verification under the relevant registry’s rules. Carbon Credit Registries therefore play an important role in the net-zero journey as registration often makes projects eligible for carbon funding, impact investment, or climate-linked financial instruments. According to Verra’s website , its Verified Carbon Standard Program (the “Verra VCS Program”) is the world’s most widely used GHG crediting program which drives finance towards activities that reduce and remove emissions, improve livelihoods, and protect nature. Verified Carbon Units (VCUs) issued under Verra are trusted world-wide by many industry-players as Verra supports multiple standardised methodologies that are intended to ensure projects follow consistent, transparent, and scientifically sound processes to quantify CO2 reduction or removals. These robust rules and transparency are also aimed at reducing the risk of over-crediting or greenwashing, which is imperative in building trust with investors and the public.

A CLOSER LOOK AT VERRA

Given Verra’s status as one of the most widely used Carbon Credit Registries globally, a closer examination of this key player is worthwhile. The Verra VCS Program’s integrity depends upon the quality of its validation processes. This involves both Verra and independent third parties engaging in project audits with the purpose of validating compliance with the Verra VCS Program’s rules and methodologies as well as local laws and regulations. The third parties that engage in these reviews are referred to as Validation and Verification Bodies (VVBs) in the context of the Verra VCS Program, and their mandate goes beyond confirming that they agree with the Project Developer’s calculations – a VVB’s mandate will extend to reviewing whether a project has negative socio-economic effects for local stakeholders, or is damaging to the natural environment. Currently, Verra lists 38 accredited VVBs on its website, of which 34 are currently permitted to carry out validation/verification oversight.

The role of VVBs and their equivalent in respect of other voluntary registries is critical in providing confidence to investors. Where previous carbon crediting mechanisms have been levied with criticism as to how verifiable the calculations as to GHG reductions they have purported to be entitled to are (see, for example, Carbon Market Watch's work in respect of credits issued under the defunct Clean Development Mechanism (the "CDM"), born of the 1992 Kyoto Protocol), VCM market participants have the comfort of a robust and publicly accessible review of a Project Developer's claims. Investment in these credits then is desirable, particularly as the market for climate finance matures and participants become increasingly live to the risk of greenwashing. What form such investment might take is a question that continues to develop today.

THE CARBON FUNDING MARKET

How does one fund the carbon market? Currently, there is a key issue which funders looking to move into the space must be live to; Carbon Credit Registries do not currently provide for a mechanism to secure credits themselves. As an example, Verra explicitly states in its terms and conditions that it "*does not recognize any interest in [VCUs] other than the interest of the entity named as the holder of the [VCUs] in the Registry*". Third party security interests therefore cannot currently be represented on Carbon Credit Registries, and further the policy of declining to recognise third party interests over VCUs may present serious issues as to the quality of any security purported to be given notwithstanding the registry's policy.

Whilst this treatment of carbon credits as an asset that cannot be secured by Carbon Credit Registries may prove problematic to lenders assessing whether to enter the market, debt funding of carbon credit producing projects is still possible. Currently, this funding necessarily takes on a form closer to project finance. Security can be taken over Project Developer entities and other key companies in their corporate group; assignments of key documents controlling the flow of carbon credits around the group such as Emissions Purchase Reduction Agreements and Offtake Agreements can achieve a structure that provides a lender with security sufficient to invest, albeit the legal cost of negotiating and piecing together such structures will be higher than for a traditional financing, which may be a deterrent to new entrants to the market.

GIVING SECURITY OVER VCUS – WHY IT MATTERS

If it were possible to give security over carbon credits themselves, rather than there being a need to construct a net of security around this key asset class, legal costs for existing and potential carbon market participants could be expected to fall to levels that entice further investment in this area. Currently, the web of security (and level of due diligence) required to be crafted around a project will necessitate substantial legal analysis as to the jurisdictions required to be engaged to ensure a lender is adequately protected in its investment; this may involve share security across the jurisdictions of incorporation of every entity in a Project Developer's corporate group, asset level security in each jurisdiction in which those entities operate (which in projects of this nature can frequently be a different jurisdiction to that of the Project Developer's incorporation), and assignments by way of security (to the extent recognised in the relevant jurisdiction) of key contracts which may be governed by a choice of law which is different again. It is easy to see why the legal cost of such arrangements can be a barrier to entry; Project Developers may find themselves being required to pick up the costs of legal counsel in multiple countries for both themselves and their lenders.

If registries were to change their approach and permit security to be granted over carbon credits themselves, more traditional forms of financing may become available to Project Developers. These could include receivables financing and margin lending products more familiar to financial institutions and funds wishing to expand into the space of climate finance. The practical effect of such potential funders entering this space would have the capability to truly transform the carbon markets; Project Developers could access funding from a greater number of players with legal costs being more affordable, and in turn the development of new projects could be turbocharged. With the guardrails provided by third party verification as to compliance (and the absence of detrimental impact to local stakeholders and the environment), an explosion of activity in this area could represent a significant leap forward in the race to net zero.

ARTICLE 6.4 MECHANISM REGISTRY – IS THIS THE GOLDEN KEY?

Article 6.4 of the Paris Agreement established the Paris Agreement Crediting Mechanism (the "**PACM**"), and work to bring the PACM into operation has been ongoing since. Following the approval by the Article 6.4 Supervisory Body of the two standards on methodology and removals at COP-29 in November 2024, the first credits (Article 6.4 Emissions Reductions, in PACM terminology) which relate to existing projects operating under the CDM which have transitioned to the PACM should be issued this year. New projects are expected to reach this stage as early as next year. The hope for the PACM is that this will set a "baseline" of standards that the VCM will rise up to meet and exceed. The Article 6.4 Supervisory Body's ongoing work to explore the possibility of facilitating security interests over PACM carbon credits is therefore particularly interesting with respect to the future for this space and could be the key to unlocking billions of further carbon funding.

At the fifteenth meeting of the Article 6.4 Supervisory Body, the body considered an information note titled "*Legal, technical and financial implications of providing functionality for the treatment of financial security interests in Article 6.4 emission reductions within the mechanism registry*". This was followed up by a public call for input from 20 February 2025 to 24 March 2025, which was subsequently extended to 7 April 2025.

Responses have engaged legal questions that will need to be answered to move ahead with the possibility of enabling security to be granted over carbon credits – for example, for security to not be defective (and importantly for funders, capable of being opined on as enforceable by their counsel) the question as to ownership of carbon credits is one that the World Bank has argued in its submission needs to be resolved. Registries are reluctant to engage with this at present, given the risk of being pulled into cross-border ownership legal disputes if “ownership” of a carbon credit as a concept is recognised. Alternatively, the International Emissions Trading Association in its submission argued that the question of ownership need not be engaged with, provided a pledge of carbon credits by possession is possible.

WHAT THE FUTURE HOLDS…

The Article 6.4 Supervisory Body will need some time to consider the responses it has received in its public consultation. It is however positive news for the market that this issue is being considered – time will tell how the United Nations opts to address the ability to take security over carbon credits pending the discharge of the debt obligations of Project Developers, and indeed what form that security and those debt obligations may take once the market is unlocked in this respect. It can be expected that if the PACM manages to successfully facilitate a mechanism for security interests, VCM market participants will follow - to ensure they remain competitively desirable options for participants – at which point, the scale of carbon markets could truly be poised to take off for the benefit of the planet.

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