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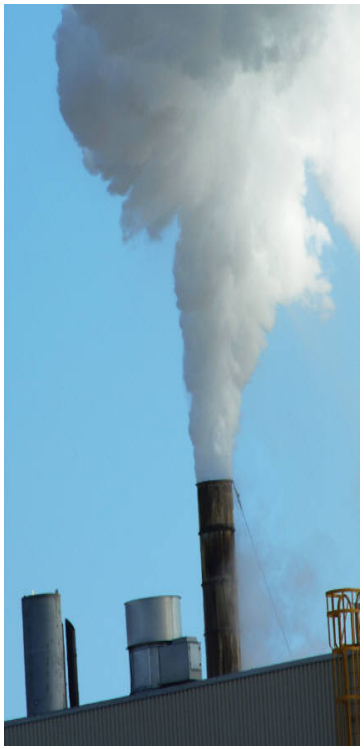
ENERGY, CLIMATE AND SUSTAINABLE DEVELOPMENT



Legal & Contracting Issues in the CDM

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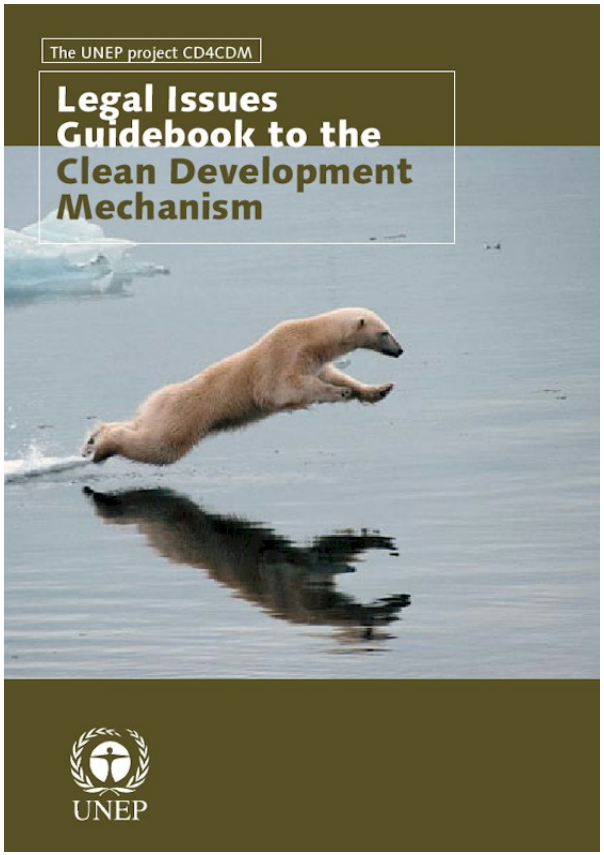
An Overview of Guidebook



Builds on CD4CDM series with main focus on:

- Legal requirements of CDM Projects
- Identifying and managing CDM-related project risks
- Potential approaches to project structuring and contracting CERs
- Contract drafting and negotiation

http://cd4cdm.org/publications.htm

Essential Legal Requirements

- Validated PDD (report) with accepted baseline methodology
- Letter of approval from DNA, including authorization of voluntary participation, statement of non-diversion of ODA
- EIA requirements/approvals and all necessary permits
- Certified periodic monitoring and/or verification reports

- Project complies to other domestic laws

  e.g., taxation, property rights, securities and derivatives,

  FDI and foreign ownership, as applicable

Key Legal Issues for Project Developers (1)

- Creating and transacting CERs
  - Who owns the project, who generates the CERs?
- Deciding project structure, type of contract
- DNA approval
- Agreements effective to attracting underlying finance (i.e. addressing/allocating risk concerns of potential investors)
- Allocation of transaction costs and potential liabilities or damages

Key Legal Issues for Project Developers (2)

CDM rules do not specifically address CER ownership.
Yet only 'Project Participants' entitled to receive CERs

Key steps:

- Establish who has initial CER ownership?

- Do other parties have an interest in the CERs?

- Who do I want as project partner?
  - Buyer: who to buy from
  - Seller: work through an intermediary, partner, parent vs. directly with buyer?

Possible Structures

- Forward sale of expected CERs yet to be generated
- Direct or “spot” sale of issued CERs by Project Sponsor (Unilateral CDM)
- Provision of debt finance in return for (partial) payment in CERs
- Equity investment based on expected revenue stream, including from CERs
- Non-recourse project finance, (partially) secured in forward CERs
- Technology swap/license in return for CERs
- “Bundling” CERs with other commodities through offtake arrangements

CDM Contracts

- Variety of approaches to transact carbon (tenders, third-party brokers, individually negotiated, auctions)
- As with transaction structures, contracts can assign CERs in a variety of ways (e.g. spot transactions, forward sales, options).
- Forward CER sales/purchase agreement most common
- Current structures largely influenced by major purchasers

- Major difference between:

  - direct sale of CERs // purchaser uninvolved in CDM Project

  - purchaser has underlying financial interest, CERs only part of the contractual arrangements

- Other Agreement types:
  - Joint ventures (equity investment);
  - Loans with repayment in CERs
  - Technology Swaps
  - BOOT

Contractual Rights

- **Emission Reduction (ERs)**
  ‘any right, interest, credit, entitlement, benefit or allowance to emit (present or future) arising from or in connection with any GHG Reduction by the Project and includes any right that may be created under any regulatory or legal regime as a result of the GHG Reductions whatsoever’

- **Verified ERs**
  ERs which have been verified and certified by an independent auditor, but have not been formally issued

- **ERs and VERs**
  Less secure than issued emission unit, but still of value

Comparison of forward and spot transactions

	Forward contract	Spot market contracts
Financing	Allows for advance payments Future CERs can serve as collateral for bridge financiers	Some financier may take the prospect of future CER spot sales into account
Market and price risk	Price risk normally shared Advance payment adds risk for buyer	Seller takes price risk Premium CER prices
Cash flow	Guarantees stable cash flow	No predictable cash flow (Seller should not be dependent on CER revenue to meet debt repayments or operational costs)
Production and delivery risk management	To be negotiated Seller should be careful in accepting delivery guarantees	Seller assumes CER production risk
Contractual arrangement with the buyer	Individually negotiated, long term off-take and financing agreements.	Highly standardized spot contracts (once international transaction log allows direct transfer of CERs)
Pricing	Negotiated price that reflects risk sharing and expectation of parties at time of contract signing	Depends on market value of CERs at the time of trade

Source: C. Streck, CD4CDM Perspectives 2007

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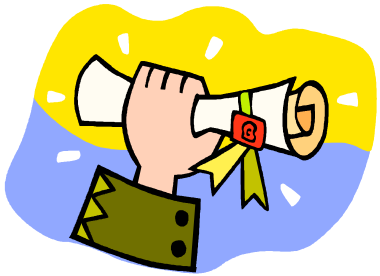
Basic Legal Documentation for Carbon Projects



1. Letter of Endorsement / Non-objection

- Between Seller/Buyer and Host Country
- Expression of Support / Non Objection
- Evidence that the Host Country has been informed and endorses the project
- No binding endorsement which creates a right to any future approval
- <u>Not UNFCCC requirement</u>

2. Letter of Approval

- Between Host Country and Project Sponsor
- But also: between the Host Country and the relevant Annex I country (unless unilateral)
- Should be unconditional
- Not clear whether or under what circumstances can be withdrawn

3. Letter of Intent

- Between Seller and Purchaser
- Early legal document (Mandate Letter)
- Secures exclusivity – right but not obligation
  - Usually via Exclusivity and Confidentiality Agreement
- Cost recovery in case the project sponsor unilaterally decides not to move forward with the negotiations
- Helps the project sponsor to obtain financing

4. Certified Emission Reduction Sales or Purchase Agreement (CERSPA)

Allocation of risk, rights, and responsibilities

Defines the Product

Monitoring

Verification

Certification

Delivery

Project Operation

Implementing MP

Enabling Verification

Establishes Price + Payment Terms

Calculation

Timing

Deduction of Costs