

Legal & Contracting Issues in the CDM



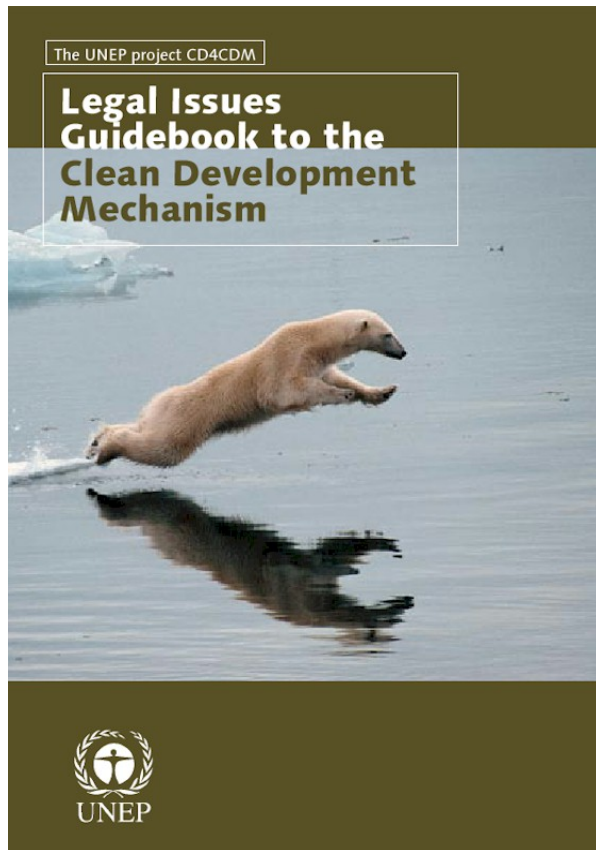
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An Overview of Guidebook

Builds on CD4CDM series with main focus on:

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



Key Legal Issues for Project Developers

- Creating and transacting CERs (i.e. ownership rights)
- Deciding project structure, type of contract
- DNA approval, national laws/permits, and their integration
- Agreements effective to attracting underlying finance (i.e. addressing/allocating risk concerns of potential investors)
- Allocation of transaction costs and potential liabilities or damages

Essential Legal Requirements

- Validated PDD with accepted baseline methodology + EB registration
- Certified periodic verification reports by DOE
- Host country has ratified Kyoto Protocol
- Formal approval from DNA, including authorization of voluntary participation of Participants, statement of non-diversion of ODA
 - helpful if letter indicates clear assignment of title.
- EIA requirements/approvals and all necessary permits
- Project complies to other domestic laws on taxation, property rights, securities and derivatives, FDI and foreign ownership, as applicable.
- Rights, responsibilities and risk allocation documented.

Possible Structures

- Forward sale of expected CERs yet to be generated
- Direct or “spot” sale of issued CERs from a Host Country driven CDM Project (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 in return for CERs
- “Bundling” CERs with other commodities through offtake arrangements

CDM Contracts

- As with project structures, contracts can assign CERs in a variety of ways (e.g. spot transactions, forward sales, options). But forward CER sales, purchase agreements are the most common.
- Variety of approaches to transact/market your carbon (competitive tenders, through third-party brokers, individually contracted negotiations, auctions)
- Current structures largely influenced by major purchasers.
- Major difference between:
 - direct sale of CERs, purchaser not involved in underlying CDM Project
 - purchaser has underlying financial interest, CERs only part of the contractual arrangements

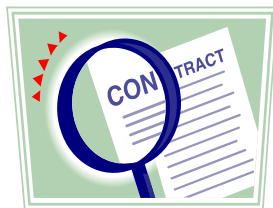
Comparison of forward and spot transactions

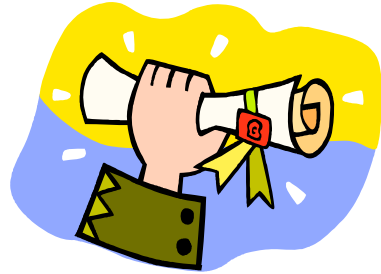
	Forward contract	Spot market contracts
Financing	Allows for advance payments Future CERs can serve as collateral for bridge financiers	Some financier may take the prospect of future CER spot sales into account
Market and price risk	Price risk normally shared An advance payment adds risk for the buyer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

Management of Key Project Risks

- Generally parties will allocate risk to the party which is best able to control that risk.
- The allocation of risks which neither party is able to control should be reflected in the price paid for CERs.
- Risk allocation can be dealt with through measures such as:
 - Conditions precedent to the entry into force of a contract
 - Guarantees from Host Countries or parent companies
 - Force majeure clauses
 - Laying off risks to third parties such as contractors or DOEs
 - Warranties, indemnities and rights of termination in a contract

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
- Not UNFCCC requirement

2. Letter of Approval

- Between Host Country and Project Developer
- 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
- Cost recovery in case the project sponsor unilaterally decides not to move forward with the negotiations
- Helps the project sponsor to obtain financing

4. Emission Reduction Purchase Agreement (ERPA)

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