

CDM Legal Issues



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CDM Contract Drafting and Negotiation

The Roles and Nature of Carbon Contracts

- Contracting approaches to sell CERs can include:
 - Competitive tender processes
 - Transacting through independent brokers
 - Individual contractual negotiations (e.g. spot transactions, forward sales of CERs or option contracts)
- Final binding ERPAs are often preceded by some type of Exclusivity Agreement or Letter of Intent which allows the Buyer and Seller time to negotiate appropriate contractual provisions without binding them to reach an agreement.

Perspectives of Host Country seller and CER purchaser

- CER seller and purchaser are likely to have different interests and perspectives on many of the contractual issues.
- The Guidebook provides an analysis of these differing perspectives and possible contractual approaches in relation to:
 - Nature of the right being sold
 - Legal title to CERs (appropriate parties to the contract)
 - Transfer of legal title to CERs
 - Obligations to ensure CERs are issued to the Buyer's account
 - Quantity of CERs being acquired
 - Shortfall provision
 - Purchase price
 - Payment of costs
 - Provision of documents and other information
 - Liability and indemnities
 - Force majeure
 - Dispute resolution

Key lessons learnt in early contract negotiations

- The key legal issues to be considered in drafting a contract to sell CERs are:
 - Defining what is to be sold under the contract and how it will be delivered (i.e. only CERs delivered into a registry account or Verified Emission Reductions delivered through provision of a Verification Report)
 - Establishing and transferring legal title to the CERs
 - Negotiating price and payment terms
 - Transfer of Tilte
 - Managing risks
 - Warranties and indemnities
 - Termination and provisions dealing with breach of contract

Key lessons learnt in early contract negotiations

- **World Bank Carbon Funds** (i.e. PCF, BioCarbon Fund, Community Development Carbon Funds, Netherlands CDM Facility and country specific funds)
 - Tender procurement process through the submission of Project Idea Notes
 - Early contracts transferred “Emission Reductions” with an obligation to work together to create CERs when this was possible (i.e. World Bank took Kyoto Protocol risk)
 - Seller required to follow Marrakech Accords procedures
 - Emission Reduction unit price is fixed for the duration of the agreement
 - Flexible arrangements to remedy shortfall (e.g. alternative delivery arrangements)
 - World Bank generally provides upfront coverage of initial Kyoto Protocol costs which are deducted from future payments
 - World bank retains immunities and privileges
 - No governing law clause

Key lessons learnt in early contract negotiations

- **Netherlands Government Funds (CERUPT)**
 - Approach of each fund managed on behalf of Netherlands Government will vary, although are likely to be of a more commercial nature than World Bank contracts
 - In CERUPT tender process, form of tender constituted offer to enter into binding legal contract
 - New JI fund (ERUPT) has stringent penalties for shortfall – these may be incorporated into CDM contracts
 - Netherlands Government is developing towards only purchasing CERs which are delivered into a registry account (i.e. Kyoto Protocol risk is on Seller)
 - Dutch Civil Code doctrine of reasonableness and fairness will apply
 - Project participants must comply with OECD Guidelines for Multinational Enterprises

CDM Project Risk Identification and Management

Identification of Key Project Risks

- Identifying, allocating and assigning risk in CDM Projects is a process which must be agreed upon commercially and then reflected in contracts.
- The three main risk categories for a CDM Project are:
 - Host Country Political and Sovereign Risks particular to the Host Country
 - General project risks common to all projects

Host Country Political and Sovereign Risks

- Potential investors and project developers will carefully assess the perceived level of sovereign and political risk in a Host Country before becoming involved in a CDM Project.
- Many Host Country decisions or events can impact adversely upon a CDM Project (for example, change in law, currency fluctuations, excessive administrative burdens) which may be out of the control of all parties to a CDM Project
- The Host Country Government (e.g. the DNA) could assist potential investors to understand the nature and extent of Host Country political and sovereign risks by explaining issues such as the Host Country policy in relation to the CDM and relevant Host Country legal frameworks which will impact the project.
- Investors are likely to prefer Host Countries with an established legal and political system which clearly recognise and support CDM investment.

General Project Risks

- These risks include the risk of force majeure events, the risk of project underperformance (e.g. due to human error or delayed construction) and the risk of cost overrun in developing and commissioning the CDM Project.
- These risks are common to projects other than CDM Projects and Host Country project developers may have experience in managing and mitigating them.
- Cost risk is particularly important to consider in the context of a CDM Project, which requires input from a number of consultants (e.g. DOEs) and the development of highly technical documents such as baseline methodologies.
- Early purchasers have sometimes paid costs to develop and register a CDM Project upfront (with such costs deducted from later payments for CERs) but this practice may not continue as the CDM market develops

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

Contingencies in the CDM Project Cycle

- Whilst some risks (e.g. political risk) can arise at any stage of a CDM Project, every project will have to address certain contingencies (“what ifs”) at each stage of the project cycle. As the project makes its way through the project cycle, the participants’ level of exposure to wasted time and money is increased.
- For example:
 - Stage One: Developing the Concept of a CDM Project: how should the project be structured? What if the baseline methodology is rejected?
 - Stage Two: Registering and Commissioning a CDM Project: what if the project construction costs are significantly more than expected? What if the construction contractor fails to fulfil its obligations?
 - Stage Three: Operating a CDM Project – Monitoring and Verification: what if the emission reductions are not accurately monitored/ What if the underlying project is disbanded as it is not generating a profit?
 - Stage Four: Entering into a Contract to Sell CERs: What if the market price for CERs changes significantly? What if the Kyoto Protocol does not enter into force?
- Project participants must have an understanding of the contingencies at each stage of project development so as to properly assess the risks that the CDM Project presents for them.

Local Issues:

- South America
- Brazil

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