

Strategies for Carbon Contracting and ERPA Negotiation

Facilitated by
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IMBEWU Enviro-Legal Specialists (Pty) Ltd

- Environmental legal consultancy operating in conjunction with an Attorneys firm (Warburton Attorneys)
- Based in Johannesburg
- Providers of wide range of environmental, sustainability, and climate change legal advice, electronic legal registers, due diligence investigations, audits & environmental and climate change legal training.
- Particular specialty: advice on issues pertaining to implementation of climate change mitigation projects, e.g.,
 - relevance of the international context,
 - project initiation,
 - authorisations and consents,
 - contractual matters (management contracts, agreements for purchase and sale of emissions reductions),
 - development of carbon strategies and policies.

Outline of Session

- Introductory.
- Carbon deals and complexity in the carbon market.
- Possible hurdles to "smooth" carbon contracting.
- Recommendations.
- Emissions Reduction Purchase Agreement.

- Some general legal issues to consider:
 - ownership of CERs;
 - taxation of income from CERs;
 - contractual terms.

"Strategy"

- Suggests a planned, informed and coordinated approach.
- Does this mean that approaches have been unplanned, uninformed and uncoordinated?
- Basic understanding of:
 - what commodity is being generated by a project activity;
 - when it will be generated;
 - whether it will be generated;
 - what will its generation cost;
 - does the generator actually own the commodity;
 - is there a potential purchaser;
 - what price-level is reasonable;
 - what is the composition of the optimum commercial deal for the purchase and sale of the commodity?

Kyoto Protocol

- Seeks to achieve an environmental end through a commercial means.
- Origin of the international carbon market in all its increasingly complex manifestations.
- Location of the CDM.

The CDM: redux

- A "market-based" mechanism intended to encourage a change in the behaviour of greenhouse gas emitters.
- Permits an entity in a developing country to:
 - implement a project that achieves *inter alia*:
 - greenhouse gas emissions reductions;
 - sustainable development; and,
 - transfer of environmentally safe and sound technology and know-how; and,
 - generate a so-called "carbon credit" and trade the carbon credit on the international carbon market.
- A carbon credit:
 - represents the *absence* of one tonne of CO₂ equivalent that would, in a business as usual scenario, have been admitted to the atmosphere;
 - is the saleable/fungible commodity generated by a CDM project; and,
 - trades across both compliance and voluntary markets.

Project implementation: to consider

- Conventional and carbon aspects of project implementation.
- Considerations associated with the *conventional* aspects of the project will be applicable, e.g.:
 - Technical, e.g., is the plant commissioned and operational;
 - Financial, e.g., has the project been capitalised; and,
 - Legal, e.g., does the project activity require environmental authorisation to be undertaken?
- Considerations associated with the CDM *carbon* aspects of the project will also be applicable, e.g.:
 - Technical, e.g., is there an approved CDM Methodology?
 - Financial, e.g., is the project financially additional?
 - Legal, e.g., has the host country's approval been obtained?

Project implementation: applicable law(s)

- CDM project implementation is no different from the implementation of any other project *but for* the veneer of the international climate change regime.
- Law associated with CDM project implementation:
 - "Although climate change is an environmental issue the scope of climate change law is much broader than the traditional "environmental law" areas of contamination, planning and development." (Wilder, M., *International Climate Law: Recent Developments and Key Issues*, IETA, Greenhouse Gas Market 2004).
 - Therefore "Climate Change Law" might include:
 - (various aspects of) International Law
 - Foreign Investment Law
 - Public Procurement Regulations
 - Securities and Financial Regulation
 - Tax Regulation
 - Environmental Law
 - Property Law
 - Administrative Law

Carbon deals and complexity in the carbon market

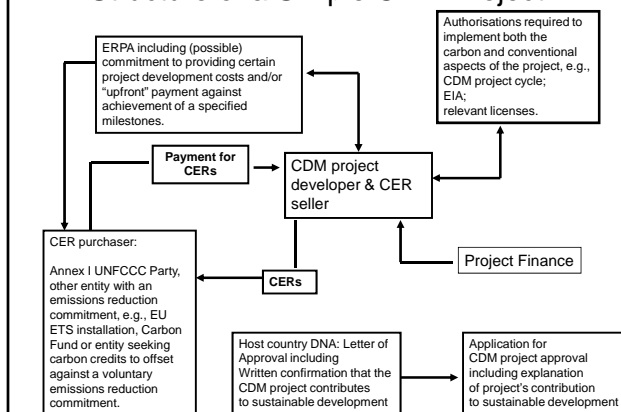
Carbon Deals

- ❖ CDM initially designed as a bi-lateral mechanism, i.e., a developed country investor + developing country project owner.
- ❖ Developments in the carbon market include:
 - Carbon funds;
 - Secondary market;
 - Voluntary market;
 - Unilateral CDM;
 - Commercial companies seeking both to develop CDM projects, e.g., providing consultancy services, and (possibly) to own (a portion of) the CERs generated.
- ❖ Has led to great complexity in the carbon market.

Complexity in the carbon market

- ❖ Species of carbon credits that may be traded (CER, ERU, VER, AAU?).
- ❖ The fact that these each of these carbon credits represents a different type of commodity, with its unique characteristics.
- ❖ The post-2012 market?
- ❖ The rise of greenhouse gas emissions trading schemes in different parts of the world.
- ❖ Compliance vs Voluntary markets: motivations and appetites of roleplayers.

Structure of a Simple CDM Project



Possible hurdles to “smooth” carbon contracting

Internal

- Non-core business.
- New “trick”.
- Understanding of the market: “there be dragons”.
- Carbon often considered to be a natural component of other sustainability-related issues.
- Urgency of carbon timeframe vs. funding cycles within organisations.

External

- Market uncertainty and complexity.
- Factors effecting generation and sale of the carbon asset.
- Truly understanding:
 - the nature of the deal that may have been offered;
 - opportunities that may exist and how to capitalise on such opportunities.

Recommendations

- Achieve support of the “decision-making” level.
- Assess the feasibility of entry into the carbon market – use a specialist.
- Prepare a strategy for entry into the carbon market - tailored to the demands of the particular entity, e.g.:
 - an IPP in the renewable energy sector;
 - a producer of biomass that may be applied to renewable energy generation.
- Appoint a person whose job it is to drive the carbon business, i.e., a “champion”, to implement the strategy – specialist knowledge and flexibility of mandate.
- “Know the beast” – stay informed on developments in the market.

Emissions Reduction Purchase Agreement

ERPA: Definition (CDM context)

- May be defined as:
 - a commercial contract of a particular species;
 - entered into by a seller and a purchaser;
 - for the purchase and sale of:
 - a specified number of CERs;
 - a particular percentage of CERs, generated by a (usually specified) CDM project (the "Contract Volume");
 - at a specified price per CER; or
 - at a price per CER that is determinable according to a specified formula.

ERPA: Utility

- ERPA used in many contexts:
 - for the purchase and sale, on a forward basis, of CERs yet to be generated (typical);
 - on a "spot" basis for Over The Counter (OTC) trades;
 - as part of the financial documentation underpinning project development in a debt finance contract; or
 - as security cession the provision of debt finance for project development.

ERPA: Character

- Provides clarity with regard to:
 - the parties to the contract: seller and purchaser;
 - the commodity to be sold, e.g., CERs;
 - the volume of CERs expected to be generated during each verification period;
 - the volume of CERs to be purchased and sold;
 - the price at which the CERs are to be sold (usually described per CER);
 - which entity possesses legal title to the CERs that may be generated.

ERPA: Character (continued)

- Conditions precedent.
- Ensuring that legal title will be passed.
- Prescribing:
 - how delivery of the CERs will occur;
 - the terms of payment (when, how; where, which currency); identifying risks associated with the particular project;
- Apportioning responsibility for such risks to the party best able to assume the risk;
- Providing for:
 - possible optional rights to purchase CERs that may be generated by the CDM project in excess of the Contract Volume;
 - the price, or a mechanism to determine the price, to be paid for such excess CERs;
 - relevant warranties;
 - allocation of transaction costs;
 - management of non- short-delivery;
 - dispute resolution mechanisms.

ERPA Terms – shifting targets *State and Trends of the Carbon Market*

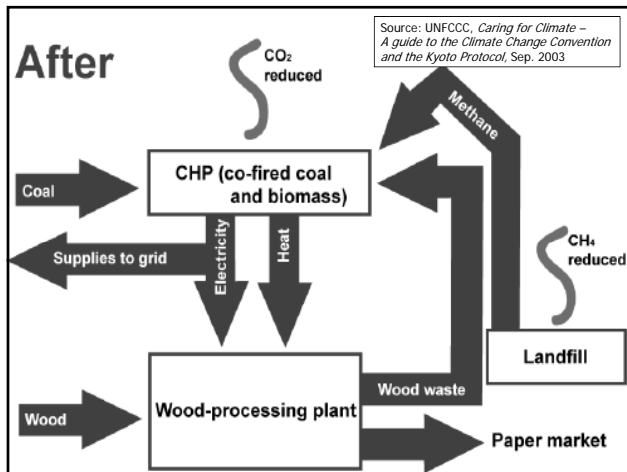
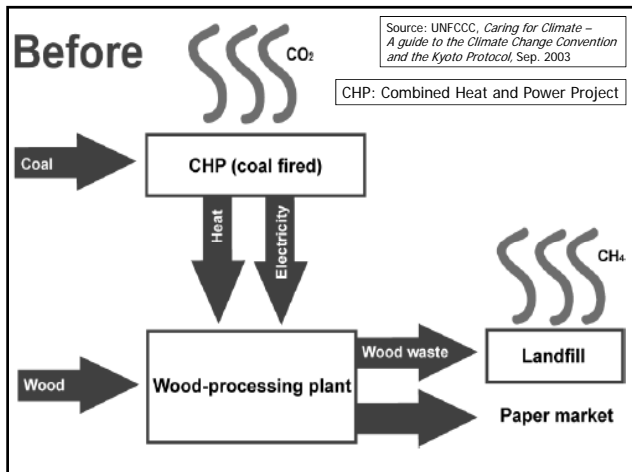
- Indexed transactions were a lot less prevalent in the second half of 2006 and the first quarter of 2007.
- Fixed forward prices were the norm, with buyers and sellers reporting that these were less complex to negotiate and agree before moving on to the next transaction.
- Those projects that had a floating component, usually incorporated a combination of fixed (around US\$6.50-7.80 or €5-6) and indexed pricing.
- In these transactions, a floor price (at a level lower than fixed price transactions) was agreed, and the buyer and seller shared any potential price upside.
- The potential higher price was based on a percentage of an EUA index price, e.g. 75% of Dec-'08 delivery.
- Many buyers prefer to negotiate a lower price and hedge any expected delivery shortfalls through contracting only a fraction of expected deliveries from the project design document.

State and Trends (2)

- Several contracts contained conditions precedent that require that the project be validated and registered with the CDM Executive Board within a specified time-period, typically 12 months from the date of the contract.
- Some contracts have provisions for either party to claim damages for losses suffered for willful default or gross negligence by either party in addition to making the other party whole under the contract.
- A small percentage of buyers and sellers reported that advance payments were made in the case of CDM projects.
- When advance payments were used, payments for up to 50% of the ERPA value were not uncommon.
- The schedule of payment typically associated with technical, operational or regulatory milestones.

ERPA: Specific Issues (CER ownership)

- CER ownership needs to be properly passed from seller to buyer:
 - not a foregone conclusion that the entity which implements a CDM project will have unfettered title to CERs.
- Currently CER ownership has not been tested before the courts
- A suggested test for ownership: "in the absence of any law or contract to the contrary, the project owner who undertakes the specific CDM Project activity is the legal owner of any CERs produced and entitled to deal with them exclusively" (*Legal Issues in the CDM, UNEP, at 64, www.cd4cdm.org*).
- Warranties
- Perspective from Carbon Expo 2007.



ERPA: Specific Issues (Risk)

- CDM project is subject to the usual risks associated with project developments of that type.
- In addition there are other, CDM specific, project risks:
 - risks associated with the carbon market;
 - risks associated with the host country.
- The ERPA should seek to mitigate risks to the greatest degree possible and to allocate responsibility for particular risks to the party best able to assume such responsibility.

ERPA: Standard Forms

- Reasons for the development of standard forms:
 - uniformity of provisions in contracts that are likely to have a number of common provisions;
 - no need to negotiate such provisions *ab initio* for each project;
 - reduced legal costs.
- Limitations:
 - Standard forms may fail to take into account specific issues related to the particular project.
- Available standard forms.

IETA: Developments in a Standard Form ERPA

- International Emissions Trading Association
- IETA standard ERPA version 2.0 (previous)
- IETA standard ERPA version 3.0 (latest)

Some issues to consider when contracting for the sale of CERs

- Project developer's requirement for early financial flows.
- Insurance:
 - of project assets;
 - of CERs.
- Sustainable development.:
 - (potential) purchaser's requirement;
 - difficulties of measuring such a requirement;
 - the Gold Standard.

