

# Legal & Contracting Issues in the CDM

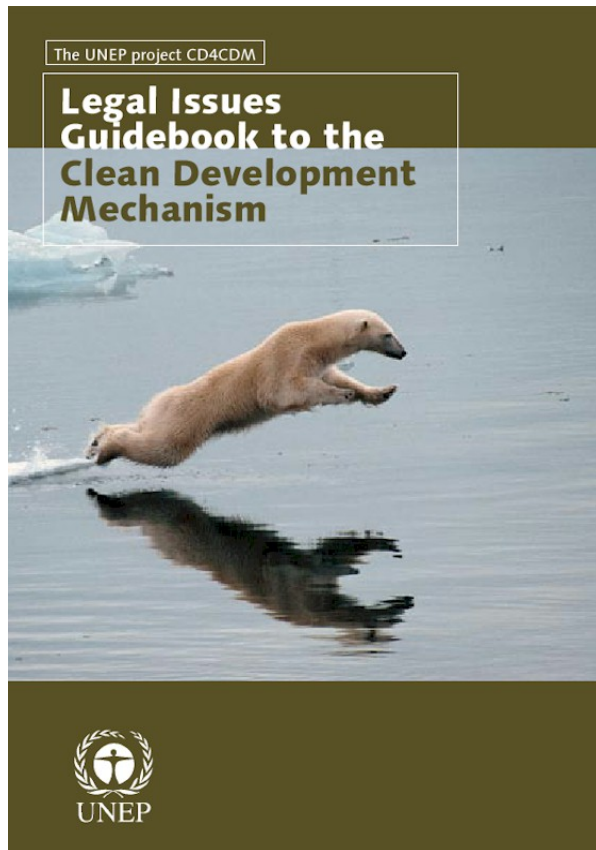


**Glenn S. Hodes**  
**UNEP Risø Center**  
**glenn.hodes@risoe.dk**



## 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

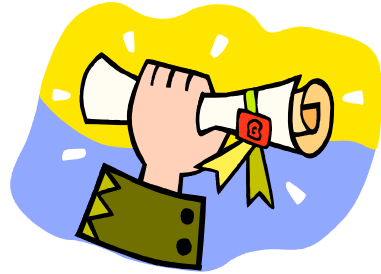
|  | <b>Forward contract</b>   | <b>Spot market contracts</b>   |
|--|---|--|
| <b>Financing</b>                               | Allows for advance payments<br>Future CERs can serve as collateral for bridge financiers                        | Some financier may take the prospect of future CER spot sales into account   |
| <b>Market and price risk</b>                   | Price risk normally shared<br>An advance payment adds risk for the buyer  | Seller takes price risk<br>Premium CER prices  |
| <b>Cash flow</b>                               | Forward contracts guarantee stable cash flow  | No predictable cash flow<br>Seller should not be dependent on the CER revenue to meet debt repayments or operational costs |
| <b>Production and delivery risk management</b> | To be negotiated<br>The seller should be careful in accepting CER delivery guarantees                           | The CERs are production “risk-free”<br>The seller assumes the risk the production risk                                     |
| <b>Contractual arrangement with the buyer</b>  | 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)    |
| <b>Pricing</b>                                 | 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