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# Specific Risks Associated with Contracting for Carbon

## Those who trade in carbon emission reduction "credits" face a complex matrix of risks, which vary according to matters such as the type, subject matter and motivation for the trade, stage of development, location, counterparty and international and local regulatory regimes.

The risk profile of a primary transaction for CERs with a developer of a renewable energy project under the Clean Development Mechanism in China will clearly be very different to that of a secondary market trade for EUAs under the EU Emissions Trading Scheme in the UK. An understanding of these risks, the ways in which they can be addressed and the impact they have on pricing is a key component in contracting for emission reduction credits.

Several international market organisations have prepared standard forms of contract, including the International Emissions Trading Association (**IETA**), the European Federation of Energy Traders (**EFET**) and the International Swaps and Derivatives Association (**ISDA**), for trading or primary emission reduction purchases.

These and other forms of contracts provide a useful framework, but they are only part of the picture. The specific technical, environmental, legal, financial, political and commercial risks associated with an individual transaction need to be assessed in the context of the regulation and processes under which the emissions reductions arise and are transferred.

This paper aims to highlight some (but by no means all) of those risks, primarily in the context of a purchase of CERs under an emissions reduction purchase agreement, although many of the observations are also relevant to the purchase of other forms of emissions reductions.  Some specific comments on JI are included.

## Who?

### Counterparties

This is not simply a question of assessing the credit-worthiness of the counterparty, but also its legal and commercial ability to perform its obligations. This consideration will influence the structure of the transaction. For example, structuring a transaction that requires a counterparty to deliver substitute credits or to pay liquidated damages for non-delivery of project credits may be a viable option in the case of a large corporate, but is questionable practice in the case of a small farmer.

The regulatory regime of the Host Country needs to be considered in order to verify that the counterparty has the legal right to the emissions reductions to be sold and is entitled to transact. There may also be restrictions on foreign investment or foreign ownership in the Host Country.

For example, the Measures for Operation and Maintenance of Clean Development Mechanism Projects in China (**Measures**) provide that the project owner must be a Chinese funded or Chinese holding enterprise and unless a contract with a foreign buyer stating the proposed price for CERs has been submitted as part of the request of a Letter of Approval, the CERs generated by the project must be transferred into China's national account in the CDM registry and can only be transferred out with the authorisation of the Chinese Designated National Authority (**DNA**).

Apart from the contracting parties, there are a number of governmental, international treaty and private sector organisations involved in creating and transferring emission reduction credits. Understanding the characteristics, roles, procedures and capabilities of each of these entities is vital.

### Host Country

Host Country risk manifests itself in many different forms. As well as the political risks associated with doing business in a specific country, the actions of the Host Country are an essential factor in determining whether and when emission reductions credits can be generated or transferred.

In order to utilise the flexibility mechanisms of the Kyoto Protocol the Parties must have complied with the requirements of the Protocol relating to the calculation, registration and reporting of their emissions reductions.

In the case of JI projects, the Host Country has a significant role in instructing the conversion of AAUs to ERUs and the transfer of those ERUs. The ability of the Host Country to transfer ERUs is also dependent on the Host Country having performed its treaty obligations, notably in relation to commitment period reserve obligations under Article 17 of the Kyoto Protocol.

Approval of the country DNA is a prerequisite for the creation of CERs under the CDM and approval of the country Designated Focal Point (**DFP**) is a prerequisite for the transfer of ERUs under JI. Whether or not the approval processes of the Host Country DNA or DFP are transparent and set out clear criteria for project approval has a significant bearing on the risk profile of a primary transaction.

### Other Country

As with a Host Country, the actions of the country into which emissions reductions are intended to be transferred are essential in determining whether and when emissions reductions can be generated or transferred. Several issues need to be considered including:

- the requirement to obtain DNA approval and restrictions imposed by certain DNAs on issuing Letters of Approval to persons incorporated or resident outside their country; and
- caps on the use of CERs or ERUs for compliance purposes under the EU ETS, which vary greatly between Member States.

### Designated Operational Entities (DOEs) and Accredited Independent Entities (AIEs)

Given the essential role of these entities in the validation or verification of emissions reductions, the number of DOEs / AIEs and their capacity to undertake these functions have a direct effect on the timing of authorisation and creation of emission reduction credits.

### CDM Executive Board (EB)

The risks that the EB will reject a project or new methodology and the possibility of significant delays in getting approval as a result of reviews need to be considered, given the significant impact on the economics (and in some cases viability) of the project, as a result of projects not being approved. The project participants should also elect a focal point for communication with the EB, in order to avoid the need to obtain the involvement of all participants in dealings with the EB.

## What?

The type and vintage of emissions reduction credits to be purchased need to be specified in any agreement. Purchasers may wish to exclude certain types of project from which the emission reductions are derived from the scope of the contract due to their own business and environmental policies.

Purchasers of VERs in the voluntary market need to ensure that the credits they purchase will stand up to scrutiny from stakeholders and therefore are likely to require that the credits comply with one of the market standards and take measures (to the extent possible) to ensure that the emission reductions are additional, measurable and sustainable and have not been double-counted (please see Taylor Wessing's article "*Voluntary Offsetting*"). Especially in the case of VERs, the nature of the rights that are contracted for, and how this is or is not recognised under the laws of the contracting parties and project activity, need to be considered.

## When?

The risks associated with contracting for emission reduction units in an early stage project are clearly greater than those later in the project cycle. These risks include:

- development risks associated with any project such as permitting, construction delays and costs overruns, and
- Kyoto compliance risks associated with the acceptance of the PDD, methodology and approval of the project.

Contracts entered into at an early stage

of development therefore need to provide for these eventualities. These may include conditions precedent, avoiding material upfront payments and scaling back purchase obligations where the project fails to meet milestones or meet minimum commitments.

The terms of the contract and pricing may also be subject to review and approval by the Host Country DNA as part of its requirement to issue a Letter of Approval.

Later in the project cycle typical operational risks such as technology performance, operation and maintenance, force majeure and catastrophe continue, but there are also specific Kyoto compliance risks, such as inadequate monitoring and verification (see below) that need to be considered.

## How?

### Methodology

The methodology to be used to determine the emissions reductions is critical. If a new methodology is to be developed, this represents a significant investment of time and money, with no certainty that it will be accepted. Even if there is an approved methodology in place, there is a risk that it will be amended, suspended or even withdrawn by the EB.

### Monitoring

The PDD is required to set out a monitoring plan. Emissions reductions must actually be monitored and recorded in accordance with this plan if the reductions are to be verified so that CERs can be issued. Errors such as calibration of equipment, transposition of data and loss of records can be costly. Purchasers should satisfy themselves that robust systems are in place for the capture and storage of accurate monitoring data.

### Local regulations

The permitting and environmental laws imposed by the Host Country will have to be complied with. Understanding these requirements is vital.

### International Rules and processes

Participants are dependant on the establishment and operation of the international processes to transfer emission reductions from the CDM registry accounts to national accounts. The risks associated with the necessary infrastructure to effect these transfers (such as the linking of the Community Independent Transaction Log to the CDM International Transaction Log) need to be addressed in the contract. Similarly, contracts need to anticipate changes in laws or International Rules that affect the ability of the parties to perform or the purpose of the contract.

## Why?

### Pricing and payment

The price and way in which it is determined should reflect the risks inherent in the transaction and the allocation of those risks between the parties. A firm commitment to deliver CERs or to pay liquidated damages will command a higher price than a non-firm commitment. Market price volatility can be avoided by fixing the contract price but the parties may have very different ideas of pricing or understanding of the reflection of risk in the price. Some contracts attempt to share this risk by providing for a revision to a fixed price by reference to market prices where there has been a significant movement in prices. Where a market price is incorporated into the contract (either for pricing or calculation of damages), thought should be given as to which is the appropriate reference price in the absence of a relatively deep and liquid market in the type of emission reduction that is the subject matter of the contract.

The pricing should also take into account who is to be responsible for the share of proceeds charges levied by the EB to cover the administration costs and to be added to the Adaptation Fund managed by the World Bank. Certain Host Countries also impose charges on the transfer of emissions credits. For example, in China the revenue earned from CERs is owned jointly by the government and the project owner. The Government's share is as follows:

- 65% from HFC and PFC projects;
- 30% from $N_2O$ projects; and
- 2% from CDM projects in priority areas (i.e. energy efficiency improvement, development and utilization of new and renewable energy, and methane recovery and utilization) and forestation projects.

### Taxation

Issues such as VAT/indirect taxes and stamping taxes need to be borne in mind. Advice, both in the jurisdiction in which the emissions reductions arise and the jurisdiction to which they are transferred, should be sought and the agreement should provide for such matters.

### Non-delivery

The motivation of a purchaser for buying emission reduction credits (i.e. for compliance or voluntary offsetting) will inform the nature of the remedies that it requires to be included for non-delivery. For a compliance buyer, the ability to obtain delivery of emission reductions that can be used for its specific compliance obligation will be the goal. It will therefore seek a remedy enabling it to source and pay for CERs or EUAs from other sources, and the project activity generating those credits may be a subsidiary consideration. Non- compliance buyers investing for a financial return may be satisfied with compensation based on the difference between the market price and contract price for the volume of credits contracted for. For providers of voluntary offsetting schemes the ability to obtain appropriate substitute credits will be the objective and the type of project activity and credit are material.

Risks of non-delivery may also be mitigated by contracting for only a portion of the anticipated emission reductions and/or from a portfolio of project activities.

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