



14th Asia Pacific Seminar on Climate Change: Legal Issues in the CDM

Manly Pacific Hotel

Wednesday 22 September 2004

Martijn Wilder, Partner
Baker & McKenzie, Sydney

Summary

- The Legal context
- The CDM as a Legal Mechanism and the “Prompt Start”
- The Window of Opportunity
- Broader Legal Issues
- Selling CERs- Key contractual Issues

The Legal Context

- Global (Kyoto), regional (EU) and domestic (UK, NZ, US, Australia) legal frameworks have now been established or are being developed that:
 - place restrictions on the ability to emit greenhouse gas emissions;
 - create new classes of carbon or emission reduction assets and in doing so encourage the pursuit of projects- CDM included- that are greenhouse emissions reducing; and
 - Establish markets within which to trade emission reduction assets.
- New area of law and regulation combining finance, projects, environment, trading and contractual law in a public law framework.
- Present a range of potential markets for although not all are accessible.

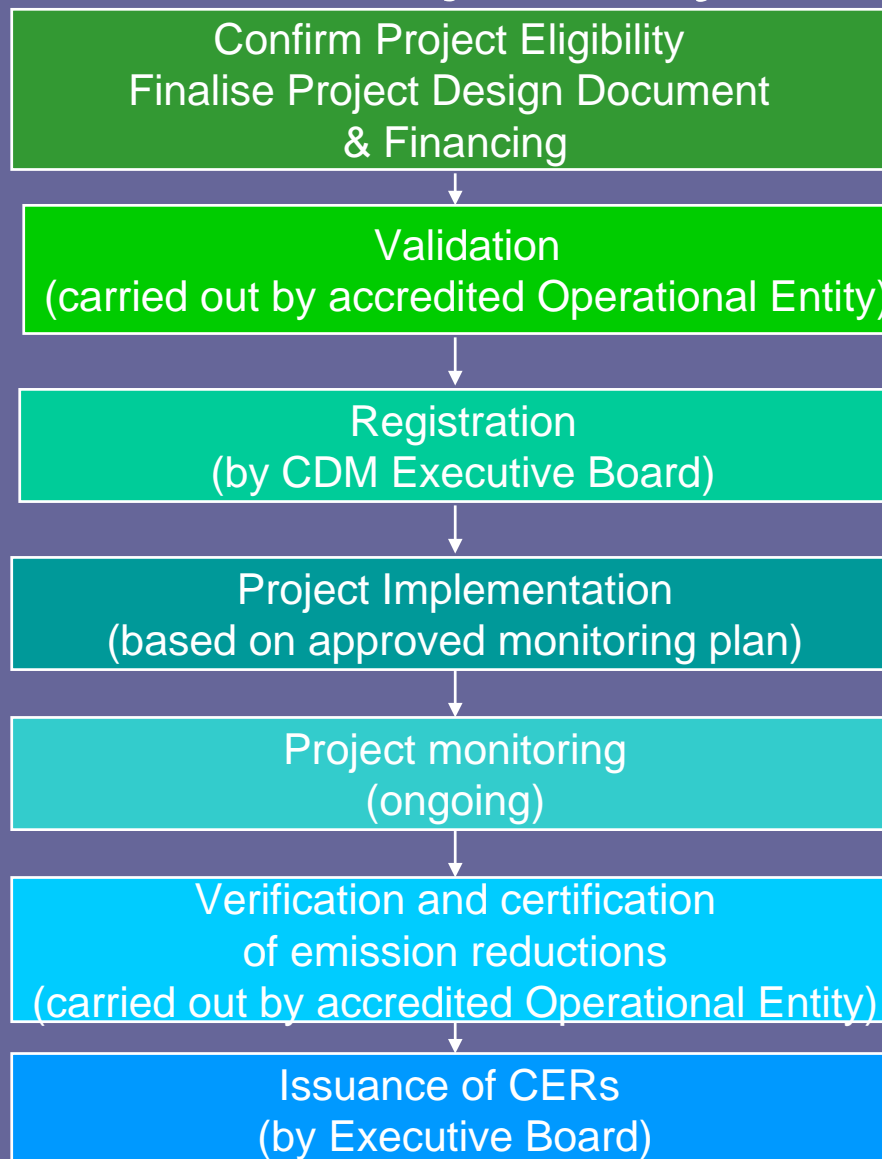
Clean Development Mechanism: Article 12

- Article 12 of the Kyoto Protocol establishes the CDM with projects meeting following criteria:
 - project activity must be undertaken by an Annex B country in a non-Annex B (developing) country
 - the participation of both countries (and investors) must be voluntary and approved by both countries
 - the project activity must produce real, measurable and long-term benefits related to the mitigation of climate change and assist in achieving sustainable development
 - emission reductions (CERs) must be additional to any emission reductions that would occur in the absence of the project activity (“environmental additionality”)

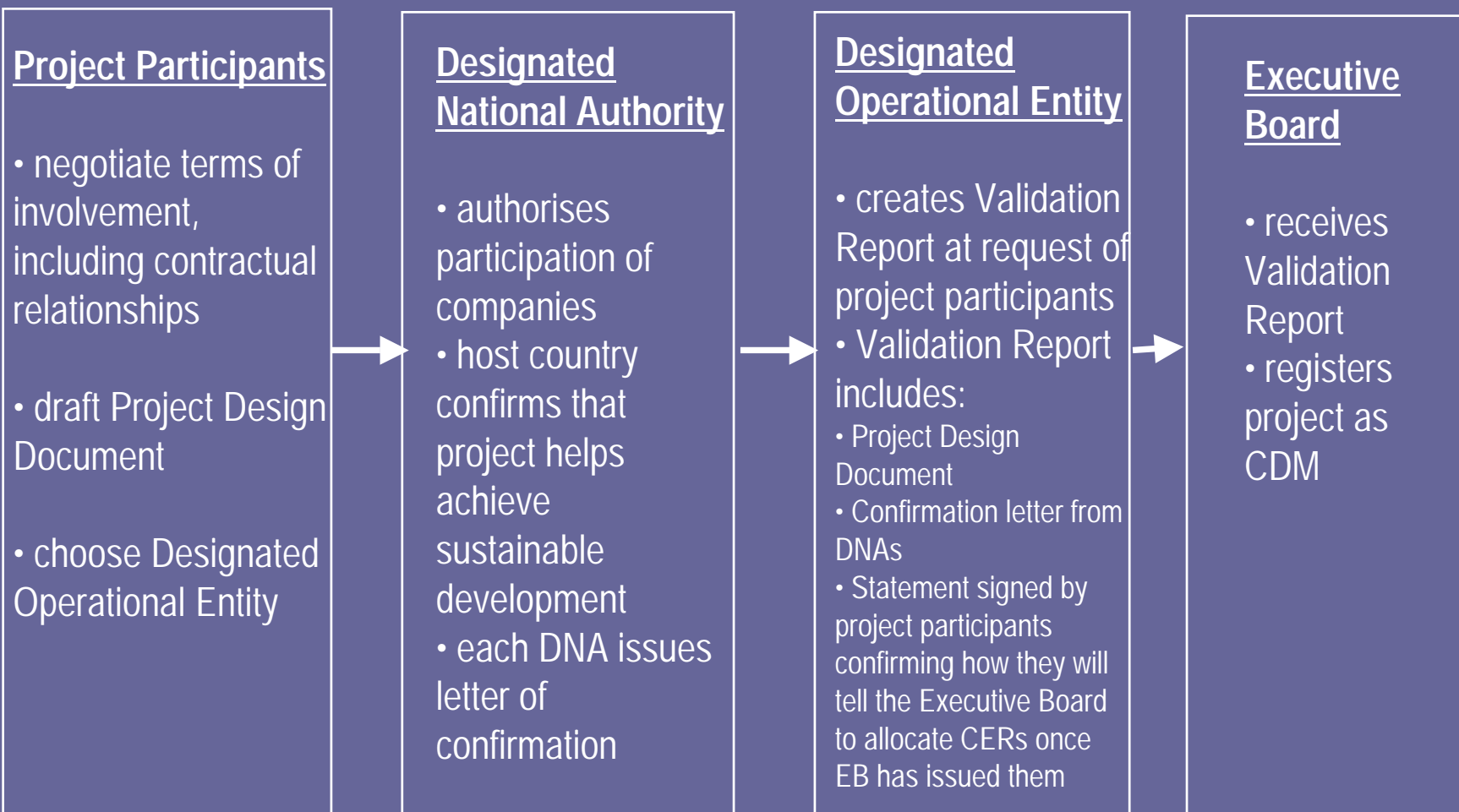
Clean Development Mechanism: Article 12

- Creation of additional abatement units CERs which CERs must be created in accordance with Kyoto Protocol rules and must have project registered and DOE functioning to obtain CERs
- A CER is a legally defined asset under the Marrakesh Accords:
 - “A CER is a unit issued pursuant to Article 12 and requirements thereunder, as well as the relevant provisions in these modalities and procedures, and is equal to one metric tonne of carbon dioxide equivalent, calculated using global warming potentials defined by decision 2/CP.3 or as subsequently revised in accordance with Article 5.”
- Significant development of rules and concepts by CDM Executive Board
- Authorisation of the Prompt start
- The Linking Directive
- Domestic law overlay

CDM Project Cycle



Before Project Registration



After Project Registration

Project Participants

- project creates GHG reductions
- submit monitoring report to Designated Operational Entity

Designated Operational Entity

- generally different DOE for validation, verification and certification, but can seek EB approval to do all
- Creates Verification Report and Certification Report
- Sends Certification Report to EB containing request for CERs to be issued

Executive Board

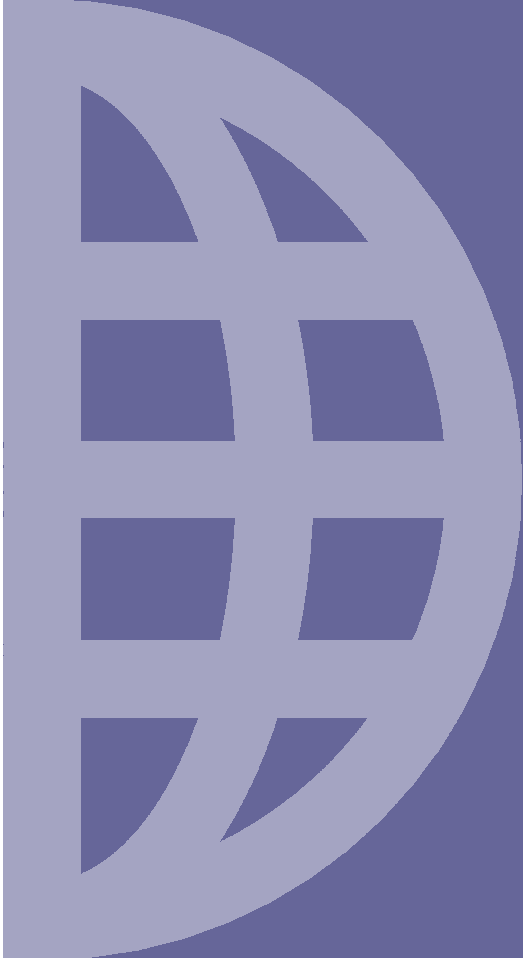
- receives Certification Report
- issues CERs automatically if no objection by Party to the project or 3 members of EB
- EB orders registry to issue CERs into "pending account"
- from pending account, registry will transfer CERs to host country for "share of proceeds" and to participants accounts

What if CERs are Incorrectly Measured?

- The measurement of CERs for a project is certified by a Designated Operational Entity
- The Executive Board will automatically issue CERs from a Certification Report unless a Party to the project or 3 members of the Executive Report request a review for fraud, malfeasance or incompetence of the DOE
- The Executive Board can withdraw or suspend the accreditation of a DOE
- If the accreditation of a DOE is withdrawn or suspended, registered CDM projects will not be affected unless "significant deficiencies" are identified in the relevant validation, verification or certification report for which the DOE was responsible.

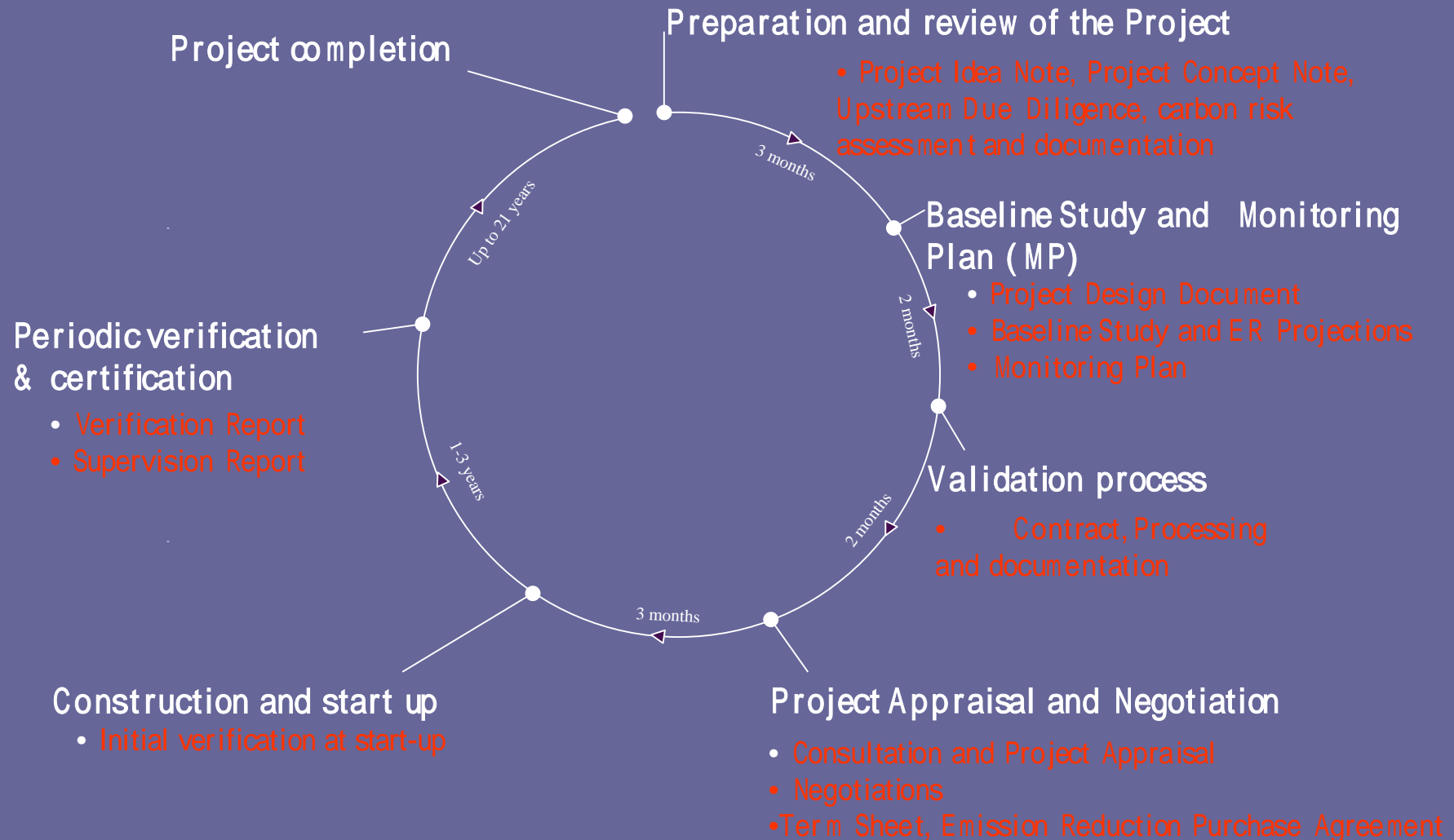
What if CERs are Incorrectly Measured

- If the Executive Board assigns another DOE to review a Certification Report and it is found that excess CERs were issued, the deficient DOE must supply to the Executive Board (within 30 days of the end of review) an equivalent number of Kyoto Protocol rights (ERUs, CERs etc) equal to the excess CERs
- These rights are transferred to a cancellation account in the CDM registry.
- Therefore, the existing extra CERs that were issued for the project remain valid
- If the suspension or withdrawal of the DOE accreditation will adversely affect a project, project participants can request a hearing before the Executive Board.



Window of Opportunity

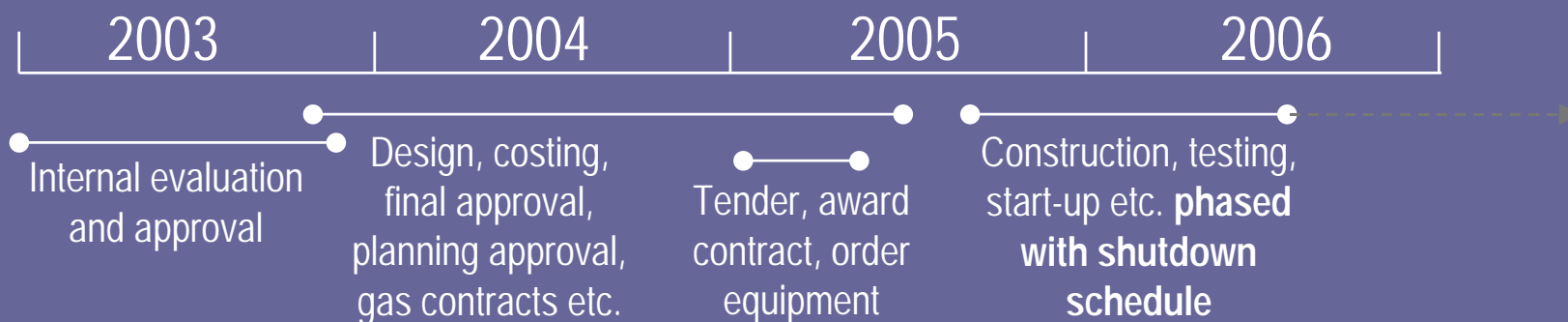
Carbon Asset Creation and Maintenance Manufacturing Pro



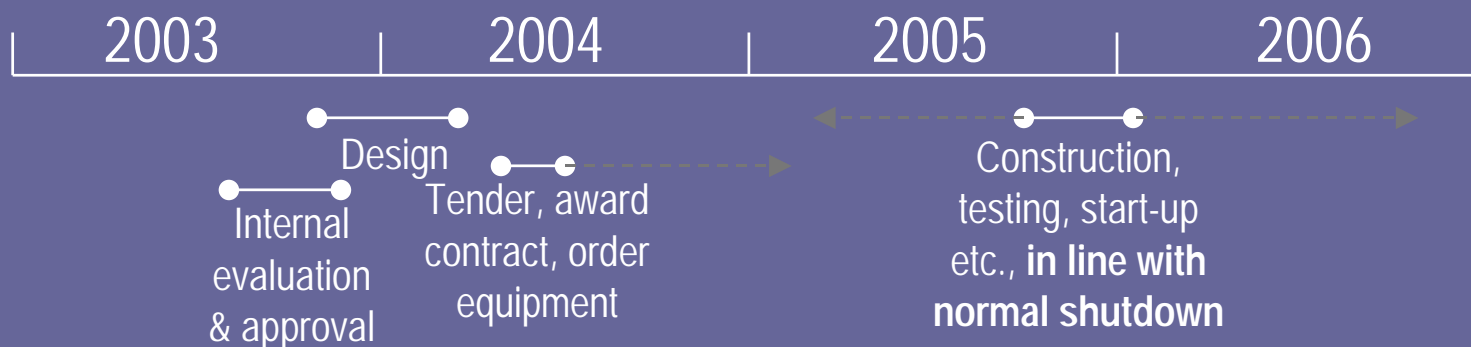
Original World Bank Project Cycle on which others are modeled

Project Timelines

Major Project: Oil to Gas Switch in an EU refinery 10 % emissions saving at the site

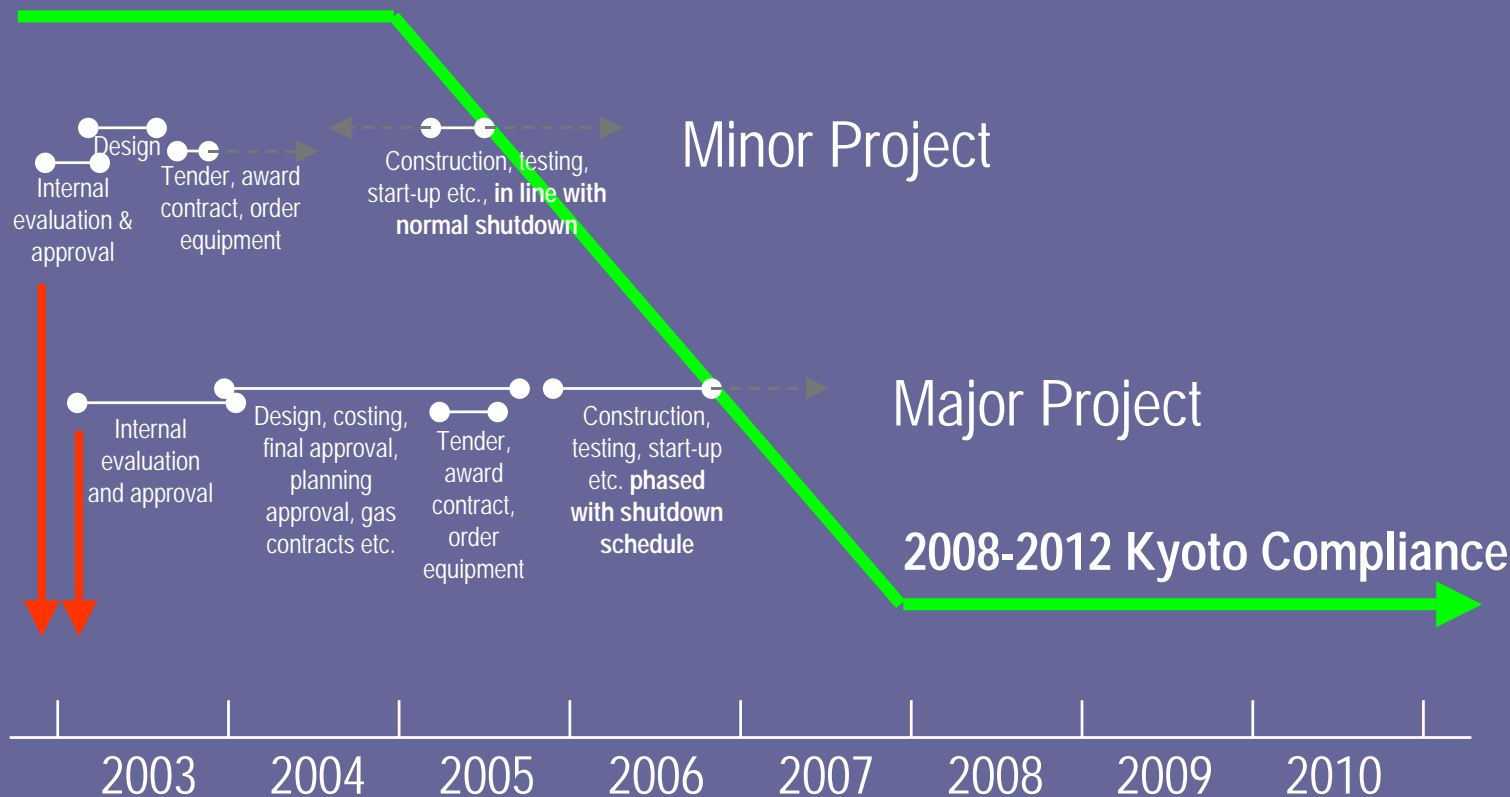


Minor Project: Furnace air-preheater 1-2 % emissions saving at the site



Combining the Timelines

Needed reduction path



Emission reduction projects take time to implement and current transactions rarely going beyond 2012.

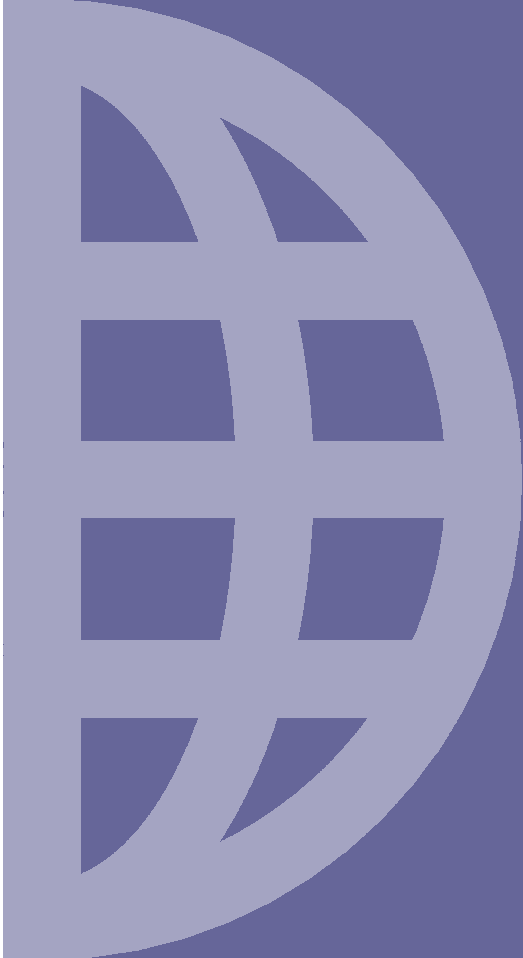
Major projects can take 3-4+ years due to;

- Capital allocation and approval process.
- Planning approval, stakeholder engagement etc.
- Construction lead times.
- Alignment with facility shutdown schedule*

Even **minor projects** can take up to 4 years due to;

- Alignment with the facility shutdown schedule*

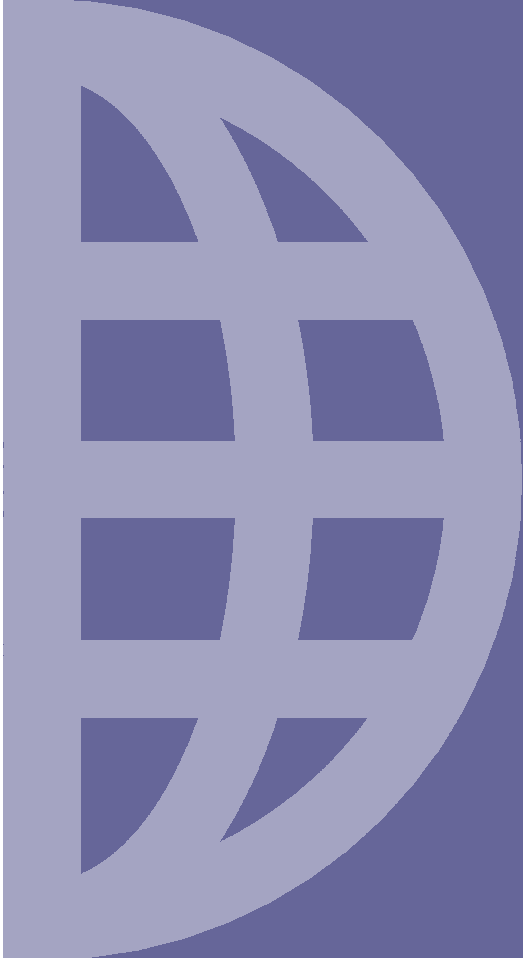
* A refinery will have a major shutdown every 3-4 years. On average, expect a lead-time of 2+ years for a minor project.



Broader Legal Issues

Broader Legal Issues

- Whether the Kyoto Protocol will enter into force and the Status of the “prompt start” of the CDM
- Unilateral CDM Projects
- Ability of Host Country private participants to hold registry accounts and Ability of Host Countries to trade CERs- now clarified
- Establishment of DNAs
- Development of concept of “additionality” and the Draft Consolidated rules for measuring additonality
- Interaction with Host Country laws- Foreign Direct Investment, Property Laws, Currency Controls, ownership and transfer of property rights eg China.
- Legal Ownership of CERs- presumption of project ownership but issues of local law, concession agreements and nationalisation of assets
- The Linking Directive



Selling CERs

Key Contractual issues

- Parties- private contracts public participation?
- Nature of the Asset
 - Contractual right or defines statutory right
 - ability to substitute- pre 2008, post 1st CP and in event of shortfall
- Legal Ownership & transferring clear legal title (and losing the notion of delivery)
- Role of the project design documents and the distribution agreement in case of CDM projects.

Key Contractual Issues

- Non-performance of obligations (ERUs not created/transferred)
 - May occur for a range of commercial, operational, sovereign or Kyoto regime reasons
- Remedies for non-performance
 - Who is liable?
 - Remedies range from good faith co-operation, to replacement rights, penalties, step-in rights, indemnities and force majeure
- Kyoto and sovereign risk
 - What if Host country has not met requirements re CP reserve and rights cannot be transacted? What if project found to be non-additional? What if carbon assets are nationalised ?

Key Contractual Issues

- Dispute resolution- appropriate forums
- Governing law & enforceability
 - Local law conflicts and public policy dangers eg Netherlands, Japan, Brazil, China.
- Warranties and Indemnities
- Local law requirements
 - Legal ownership
 - FDI laws
 - Tax
 - Trading licences
 - Unintended consequences
- Transaction costs

A stylized globe icon on the left side of the slide, rendered in a light blue color. It features a grid of latitude and longitude lines, with the grid cells being semi-transparent. The globe is positioned on the left side of the slide, partially overlapping the dark blue background.

14th Asia Pacific Seminar on Climate Change: Legal Issues in the CDM

Manly Pacific Hotel

Wednesday 22 September 2004

Martijn Wilder, Partner
Baker & McKenzie, Sydney