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Carbon Contracts Cornerstones

Drafting Contracts for the Sale of Project Based Emission Reductions

Foreword

The International Emissions Trading Association (IETA) is a non profit organization created in June 1999 to establish a functional international framework for trading greenhouse gas emissions reductions. Our 47 international members include leading multinational companies from across the carbon trading cycle: emitters, solution providers, brokers, insurers, verifiers and legal compliance.

IETA works for the development of an active, global green-house gas market, consistent across national boundaries. In doing so IETA focuses on the creation of systems and instruments that will ensure effective business participation.

In 2001 IETA Members established a working group on “project contracts” with the aim to create a multi-stakeholder dialogue on possibilities for the standardization of carbon contracts. This working group is chaired by Baker & McKenzie. It's members include representatives from businesses in OECD and Non-OECD Countries as well as environmental NGOs, Carbon Funds and Governmental Organizations.

This discussion paper has been produced by IETA Member Baker & McKenzie as a common starting point for the preparation of Carbon Contracts in the carbon trading market. The objective is to begin the process of standardizing the Carbon Contract process to help facilitate trades and emissions projects by streamlining the contractual process so helping to reduce transaction cost. It is envisaged that this Paper will mark the beginnings of a process to develop standardized carbon contracts for different types of transactions. This process will it is hoped develop and mature alongside the carbon market.



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1. Introduction

The Kyoto Protocol is not yet in force, the exact nature of domestic legal regimes governing reductions in emissions of Greenhouse Gases (GHGs) is (in most countries) still not known, there is no regulated scheme for transactions involving project based emission reductions and the market for such emission reductions (ERs) is not yet liquid. As such, the proper drafting of contracts for the transfer of ERs from one party to another party is vitally important.

2. Objectives

The aim of this document is to provide a foundation for further discussion on the basic terms and conditions to be used in drafting contracts for the purchase and sale of a variety of ER related products.

In the absence of a clearly defined and internationally accepted set of product types, articulating a standard set of terms and conditions for their purchase and sale is inappropriate. This paper outlines the major issues which will need to be covered in contracts for the transaction of ERs (however they are defined) and discusses some of the interrelationships between matters of definition, delivery, validity, verification and certification. Each of the issues discussed below should be considered when drafting any contract for the purchase and/or sale of emission reduction rights.

As the Kyoto Protocol rules and domestic regulatory frameworks are established, thereby creating standard instruments, the ability to develop standardised contracts will become possible. For example, there is already the trading of renewable energy certificates in some jurisdictions through standard documents and confirmations, as well as trading through the use of existing procedures such as under ISDA arrangements. Nonetheless, where forward sales of ERs are to take place, contracts will still need to be tailored to the specific project. In addition, where such rights carry a contingent liability (such as CERs under the Kyoto Protocol, which may be invalidated at a later date) contractual arrangements specific to the project will be required.

3. Checklist

3.1 Project

- (a) compliance with relevant domestic and international legal and other requirements;
- (b) allocation of rights to the project ERs (existing and future)
- (c) allocation of project risks

3.2 ERs

- (a) status under the relevant laws?
- (b) ownership by the seller
- (c) mechanisms to enable effective delivery



Contracts which carefully consider such issues will be more likely to result in the successful generation of ERs or other such benefits from a specific project activity, and may also increase the marketability of a buyer's interests in that project to buyers in any secondary market. This cornerstones document considers the clauses that would be required in such contracts to ensure that key issues are dealt with.

4. Clauses

4.1 Parties

- (a) Should be project participants, those with a potential claim to any ERs and possibly others who have key obligations or responsibilities in relation to the project. eg host government. Note that any contract including a state as a party requires special attention to be paid to enforceability.
- (b) Give full corporate names and details for the parties.
- (c) Consider seeking parent company guarantees or other forms of security for Sellers who are small, illiquid or new subsidiaries.

4.2 Recitals

The recitals should comprise a summary of the purpose and subject matter of the contract, namely for the Buyer to buy and for the Seller to sell the rights to the ERs generated by a particular project activity.

4.3 Definitions

- (a) In view of the considerable regulatory uncertainty in this area, it is vital for the definitions clause to contain a clear and concise definition of what exactly is being bought or sold. It should specify:
 - (i) whether it is a legislative right (for example, an Allowance under the United Kingdom Emissions Trading Scheme or a Certified Emissions Reduction (CER) under the Clean Development Mechanism of the Kyoto Protocol); or
 - (ii) whether it is a contractual right (to the benefits arising from an ER activity).
- (b) Where the contract relates to an existing right under domestic law or a domestic regime (such as UK Allowances or Australian sequestration rights) the process of defining the right will generally be more straightforward than where the rights are purely contractual.
- (c) Attempts to define what is being bought or sold are complicated by the lack of internationally recognised fungible legal rights, and the existence of widely varied domestic regimes governing emissions and renewable energy derived rights. From a buyer's perspective, this means that broad definitions of what is being purchased reduce risk of non delivery and are therefore preferable. A seller may want a narrower definition to reduce the risk of open-ended onerous obligations.



- (d) Given the possibility for dispute, the definition of the "product" will therefore need to clearly identify the nature and scope of the rights as they have been agreed between the parties. This will, by necessity, vary between contracts.
- (e) The rights, which arise from an emission-reducing activity, may be separable or even give rise to different rights which may or may not be interchangeable, for example UK Allowances and UK Renewable Obligations Certificates or Australian Renewable Energy Certificates (RECs) and state based sequestration rights. The contract should address how such rights are to be dealt with.
- (f) Where the ER to be traded is not a current right based on existing law, the definition will need to address the issue of the fungibility of rights under possible future regulatory regimes (*see table below*).
- (g) Clearly defining the nature of the right(s) being bought and sold is of prime importance in the definitions clause. Definitions will also need to cover:
 - (i) Baseline: namely, the level of GHG emissions from which the GHG ERs resulting from the project activity are to be measured;
 - (ii) Greenhouse Gas: this may be defined by reference to the definitions contained in the Kyoto Protocol;
 - (iii) The Unit of Measurement: the definition needs to specify the measurement in which the emissions are to be acquired. This will usually be tonnes of CO₂e equivalent. If however the measurement is to be in tonnes of other greenhouse gas emissions (eg. Methane) then account needs to be made for shifts in the global warming potential factor. In this regard, if a buyer wishes to acquire tonnes of CO₂e equivalent from a methane project then the contract should specify it in such measurement and not in tonnes of methane.
 - (iv) Kyoto Protocol: the definition of the Protocol should include any amendments made to it and decisions taken under its auspices.

Box 1 - Emissions Trading Systems - What's Planned?

There are currently several national emissions trading systems being planned or beginning to be implemented. These can be split up into those that are:

- (a) based upon a 'cap and trade' model or
- (b) those operating as a 'baseline and credit' system.

In a cap and trade system, such as international emissions trading under the Kyoto Protocol or the US SO₂ emissions trading system, an overall limit or 'cap' is established for emission by participants, and allowances equal to the overall cap are distributed. Participants may trade any allowances above the amount they must hold for their particular emissions level.

In baseline and credit trading systems such as Joint Implementation (JI) and Clean Development Mechanism (CDM) under the Kyoto Protocol, a baseline of future



emissions in the absence of mitigation action is defined. An entity then implements mitigation actions and documents the reductions from baseline emissions achieved. Once a regulator has approved the baseline and the reductions achieved, the entity receives credits for the reductions. Credits can be traded and used for compliance with specified regulatory obligations.

These two systems take various forms. An historical level of emissions or an emissions trend could be used, a cap could be set at a constant level for each period, or it could increase or decrease over time. A cap can also be defined in terms of emissions per capita or per unit of output, where these rates may remain constant or change over time. As a result total emissions may not be known in advance.

4.4 Sale and Purchase

- (a) This clause should outline the number and the vintage (i.e., year of generation) of the ERs arising from the project activity to be sold to the Buyer.
- (b) The contract should make clear what rights the parties have to future ERs or to other environmental benefits or values resulting from the project.

4.5 Delivery

Capacity to deliver and imposition of delivery obligations, including identifying mechanisms for delivery will depend on the identity of the product being transacted. For example, most legislative rights will have their own requirements for transfer of legal ownership independent of any which may be imposed by the contract.

(a) Delivery Date or Trigger Event?

- (i) It is necessary to determine when the defined rights will accrue to the Buyer. The question of timing both of accrual and delivery is highly important to the potential value of ERs, and the Buyer's capacity to on sell either the base product or a derivative.
- (ii) Some contracts set out a delivery date, while others rely upon a trigger event (for example, the ratification of the Kyoto Protocol) for the rights to accrue.

(b) Delivery Mechanism and Transfer of Title

- (i) The legal mechanism used to transfer the ERs will depend on the type of right(s) being transferred. If the right(s) arise under a governmental regime (such as the UK Emissions Trading Scheme), regard will have to be had to the requirements of that regime. It is likely that there will be defined methods for ensuring delivery and transfer of title which will need to be complied with.
- (ii) If the right does not exist under a statutory or governmental regime, the contract must specify the delivery mechanism, taking into account the delivery risks associated with the chosen form of delivery. In emissions contracts, however, depending on circumstances and the definition of



the product, it is possible to share part of this risk, or minimise it by utilising some form of clearing house or registry.

- (iii) The contract must specify the point at which title is transferred. Possibilities include upon execution of the contract, payment being made, or upon change of ownership being entered on a register.
- (iv) Whether the right is an existing or a future right will also be of significance. If the contract provides for future delivery of the ERs, mechanisms will be needed to ensure that delivery occurs. While certain changes can be accommodated, others may result in a force majeure event.
- (v) Delivery mechanisms for future rights need to take into account possible legislative changes (both domestic and international) which may impact upon both the creation of the rights, and the process for their transfer.

(c) Shortfall or Failure to Deliver

- (i) In order to secure and then transact the ERs, the Seller will need to put in place appropriate arrangements to ensure that, where contracted, the specified quantity of ERs is indeed delivered. This is particularly important in renewable energy projects which may have no variable generation or with technologies that require regular maintenance and go off-line.
- (ii) There should be an option to manage shortfalls under the contract through mechanisms such as:

- (A) physical replacement of the volume of the shortfall of ERs from other projects or from future years.
- (B) payment to the Buyer the greater value of:
 - repayment of any up-front payment monies; or
 - the cost to the Buyer of purchasing replacement ERs.

This is particularly important if the Seller cannot source ERs from elsewhere.

However, it is important that some form of disincentive exists to prevent the Seller later selling the ERs at a higher price to another party and then simply repaying the sale monies.

- (C) project step-in rights so that the Buyer has the ability to run the project and generate the ERs (this is less appropriate in projects where ERs are simply a by-product of a much larger business).
- (D) lien on other assets, particularly in cases of potential insolvency.



- (iii) Consideration should also be given to frustration of the contract if the ER rights never materialise.
- (iv) Appropriate indemnities should also be incorporated, particularly if the ERs are relied upon for compliance purposes and a shortfall results in the Buyer receiving a penalty for non-compliance.



4.6 Evidencing The Validity Of The ERs Being Contracted

(a) Documentation

- (i) The core obligation in any contract involving the transaction of ERs is the delivery of the underlying product, however that is defined. One of the most significant issues to be agreed between the parties is how the delivery will be evidenced. The risk that either the product will not be delivered (or not be capable of being delivered) or that there will be no evidence of that delivery is one of the most significant risks associated with this type of contract.
- (ii) Regardless of the specific definition of the "product", it is likely that one of the parties is going to have to show that the emission reductions, the subject of the contract, actually occurred. At present, the evidentiary burden is usually discharged via a demonstration that, when measured against an appropriate baseline, the particular project activity has delivered real and measurable reductions of GHG emissions.
- (iii) The contract must make clear who is to be responsible for carrying out initial and ongoing validation of the project, and for the associated costs. It should also specify whether third party verification is required, and if so, outline the criteria for this.

(b) Baseline Measurement, Verification and Certification

- (i) Clauses requiring or allowing appropriate baseline measurement and quantification to occur are essential. Any contract for the sale of ERs should attempt to ensure that there is:
 - (A) appropriate baseline measurement; and
 - (B) there is a procedure for independent verification of the practical emission reduction process (which will ensure the emission reductions promised will actually have occurred - as opposed to credit for projected emissions).
- (ii) All terms associated with validating the ERs should be clearly defined (see "*Definitions*").
- (iii) It may be advisable to set out in appendices to the contract the terms and conditions that are to be used in the contract with the third party verifier and the wording of the opinions that are to be issued by the validator and verifier (where these matters are not expressly provided for in the legislation/regime - if any- for the emissions reductions being transacted). This includes dealing with liability and insurance issues.

(c) Changes to the Scientific Processes for Quantifying and Verifying ERs

- (i) The scientific processes employed to quantify and verify ERs may not always produce the result desired by the contracting parties. Any project may produce more or less tonnes of ERs than expected. In addition, the amount of ERs produced may differ if the measurement



science changes or if the relevant authorities adopt different verification requirements or discount formulae.

- (ii) To take account of such scientific uncertainties, the contract could include a "reopener" clause permitting the recalculation of tonnes if different numbers are adopted by the relevant authorities.
- (iii) It may be advisable to refer specifically in the contract to the measurement and assurance standards that are to be used.

4.7 Risk

Box 2 - Regulatory and Sovereign Risks

Uncertainty remains as to:

- o whether the Kyoto Protocol will be ratified;
- o which Parties will ratify the Kyoto Protocol;
- o what the requirements will be to validate rights;
- o how sovereign state allowances and rights will be utilised by private parties;
- o when credits will start and what form domestic legal regimes will take; and
- o fungibility between domestic and international regimes.

As such, any contract must be drafted in such a way that the terms are broad enough to capture whatever is ultimately defined under the relevant legal regime(s) that emerge. Terms must be clear enough to avoid conflict among parties.

- (a) Where ERs are sold under established domestic or international legal systems, issues of **sovereign and policy risk** are reduced because the product has been legislatively defined and rules and procedures already set up for their trading.
- (b) However, where the Seller sells ERs outside such frameworks on a purely speculative basis, there is no certainty that they will be recognised or have any value under future legal systems. This means that there is a risk not only that they may have no value, but that if they do have value, those property rights may be expropriated by host country governments.
- (c) Acceptance of the resultant risk is a commercial issue to be determined between the parties. Since risk allocation is usually reflected in price, it will be important for buyers and sellers to identify all risks, and to carefully and clearly allocate them between the parties involved to ensure that there is no dispute at a later date.
- (d) While regulatory and sovereign risks are likely to be the main risk-related concerns in relation to a contract for the purchase of ERs, the parties should also address the allocation between them of other possible risks. As with all contracts, risk is best allocated to the party most able to bear it. Some risks which will need to be considered and managed within an ER contract include:
 - (i) Where the Buyer assumes the risk of devaluation or other loss to due to a change in the law, court action or similar, the contract may set out that at what point the Buyer assumes the risk.
 - (ii) While future legislation may allow for the creation of ERs, it is possible that in some cases restrictions will be placed on dealing in them, for



example by limiting international transfers, particularly where national targets under the Kyoto Protocol are not being met. This could restrict the Buyer's access to the rights it has been allocated under a contract and innovative solutions will need to be investigated, such as the use of trust structures.

- (iii) There is also a possibility that the host government might decide to impose additional taxes on the project, increasing the transaction cost. Clauses should therefore be drafted allocating responsibility for the payment of such taxes.
- (e) Where a project is to generate a number of emissions credits and where the credits are to be divided among a number of parties, it is important to identify which credits are to be acquired by each of the parties (e.g., the first 50,000, or half of an expected amount of 100,000). The accounting treatment of this and other issues will be covered in a future IETA publication.
- (f) However it is allocated, the contract will need to provide risk mitigation strategies such as insurance. In addition, obtaining Host Country approval at the outset is critical.

4.8 Price and Terms of Payment

- (a) The contract should set out the price to be paid for the ERs. The price may vary for different vintages of ER rights or different types of ERs, for example absolute sector UK Allowances versus relative sector UK Allowances, or Australian wind farm RECs versus wood waste RECs.
- (b) The price for any ERs covered by an option should be set out, as applicable.
- (c) The terms of payment need to be clearly stipulated in the contract. They may take several forms, for example:
 - (i) full upfront payment; or
 - (ii) option; or
 - (iii) payment on the occurrence of a future event, eg the ratification of the protocol.
- (d) The issue of taxation should be dealt with, for example is the price inclusive or exclusive of goods and services tax, and what of other charges? This issue may be dealt with in the payment clause or in a separate and more extensive clause (see *"Taxes, Levies and Charges"*)
- (e) Credit risk should be addressed, particularly if payment does not occur on execution of the contract.
- (f) Issues such as penalties for late payments, increases for inflation and other charge related items will also need to be included in the calculation of payment quantities. In particular, it should be made clear who is responsible for the payment of any fees, charges and costs connected with the transfer of the ERs to the Buyer.



- (g) The method of payment should also be specified.

4.9 Warranties and Representations

- (a) The ER contract should include a number of warranties relating to:
 - (i) title to the ER, potentially also including a warranty that no security has been granted over the rights;
 - (ii) creation of the ERs (particularly important where they do not exist at the time of contracting);
 - (iii) rights being free of any encumbrance or other dealings;
 - (iv) certainty that the activity has not been used to generate any other form of ER;
 - (v) validity of the rights;
 - (vi) that the reduction is permanent; and
 - (vii) the undertaking of the emission reduction activity.
- (b) The parties should also include the usual commercial warranties of corporate power and creation (i.e., that they have the power and authority to enter into and perform the contract), and may also decide to include a mutual disclaimer of all other warranties.
- (c) The Seller may wish to expressly exclude any warranties as to the merchantability or fitness for a particular purpose of the ERs.
- (d) Timing of representations will also be an issue for the parties to address. They may decide:
 - (i) that each representation is made both upon entering into a master agreement and upon each individual transaction; or
 - (ii) that each party will cause each representation to be true through the entire term of a master agreement.

4.10 Liability and Indemnities

- (a) The parties will have to determine to what extent if any the liability of either or both of them should be limited.
- (b) The contract may include a waiver of "special" damages, whereby neither party is entitled to consequential, incidental, punitive, exemplary, indirect damages, lost profits or business interruption damages.
- (c) The parties will also have to decide whether any indemnities are required. The Buyer may for example indemnify the Seller in respect of any legal proceedings brought by third parties in relation to the Buyer's use of the ERs.



- (d) Indemnities should also cover specific issues such as those relating to carbon debits and potential losses relating to leakage. Where ERs are purchased from activities that have occurred, this should not be an issue. However, where processes to create ERs may result in future leakage then protection will be required against any impact this may have on the contracted ERs.

4.11 Default, Termination and Remedies

- (a) Events of default should be specified in the contract, for example:
- (i) where the Seller fails to deliver the ER rights;
 - (ii) where the Buyer fails to make a payment when due;
 - (iii) where the Seller breaches a warranty or a representation or a warranty proves to have been materially false when made;
 - (iv) where the Seller fails to comply with his validation / verification obligations;
 - (v) failure to secure host country government approval; and
 - (vi) failure to satisfy requirements in Kyoto Protocol for CDM or JI projects.
- (b) The consequences of an event of default should be set out. For example, the party not in default may be given the right to terminate immediately, and/or the right to a reduction in the purchase price or the repayment of any monies paid with interest (Buyer) or to charge interest on the purchase price (Seller). Provision may also be made for the payment of liquidated damages.
- (c) In relation to a failure to make a payment when due or to perform a covenant under the Agreement, the parties may decide that the failure must be cured within a certain number of business days of written notice being received, with failure to do so conferring a right of termination upon the non-defaulting party.
- (d) In the case of remedies, various options may be included. A non-defaulting party may:
- (i) withhold all payments owing;
 - (ii) designate an early termination date upon which all outstanding transactions are terminated; and or
 - (iii) exercise all other remedies under an agreement.
- (e) The issue of **exclusivity** must also be considered, namely:
- (i) are the contract remedies exclusive remedies for events of default?; or
 - (ii) are the contract remedies in addition to any other remedy available at law or equity?



4.12 Progress Reports and Audit Rights

Given the long term nature of some contracts, and the period of time before a first delivery may be required, regular progress reports and/or audit rights may be the only reasonable way for the Buyer to be able to assess whether the Seller will be able to perform. Otherwise, the Buyer may be locked into a long term contract with no way to terminate, even if it appears that the Seller will not be able to perform. The Buyer should be given the right to terminate the contract in the event that reports prove unsatisfactory. The Seller could also benefit from interim reports as these could reveal a higher level of reductions than anticipated.

4.13 Confidentiality

- (a) The parties will have to determine what constitutes confidential information in respect of the agreement, and define this clearly. The existence and terms of the contract itself may be deemed to be confidential.
- (b) A decision will need to be taken as to whether the confidentiality obligations should be made mutual or should fall only on one party.
- (c) The parties must decide what obligations to impose in respect of information deemed to be confidential.
- (d) The confidentiality clause should include a carve-out in respect of information in the public domain, or already known to the other party at the time of disclosure, or required to be disclosed by a public authority.
- (e) The confidentiality obligation should be expressed to survive the expiry or termination of the agreement, and provision should be made for the return of confidential information to the disclosing party upon such event.

4.14 Arbitration and Dispute Resolution

- (a) In light of the ongoing uncertainties surrounding this form of transaction, it is important that procedures for dispute resolution are set out in the contract.
- (b) The parties may wish to develop their own dispute resolution or adjudication procedures. At least for the time being it is not clear that the judicial system in most countries will be sufficiently familiar with the technicalities of ER projects to provide cost effective resolution of disputes.
- (c) If the parties do nevertheless choose to resolve disputes via official arbitration proceedings binding upon them, the place of the arbitration and the arbitration system to be used should be set out in the contract, particularly where the country of the two contracting parties differs.

The Permanent Court of International Arbitration has issued a set of Optional Rules for Arbitration of Disputes Relating to Natural Resources and /or the Environment and is promoting their use for settlement of disputes relating to emissions trading (see: www.pca-cpa.org).



4.15 Taxes, Levies and Charges

- (a) It is common for legislation which creates rights and provides for their registration and transfer to set out taxes, levies and charges. The contract should therefore contain provisions relating to the payment of fees for the creation and registration of ERs, and should also make clear who bears the cost of any transfer fees.
- (b) The issue of payment and allocation of these costs will be particularly important in countries which have onerous taxation regimes.
- (c) An issue arises as to whether or not stamp duty or other local taxes are payable on any transaction. This will depend on the jurisdiction in which the transaction occurs. Legal advice should be sought to determine whether any such charge will arise.
- (d) The parties should be aware that future legislation may at any time impose various taxes or charges on ER transactions. This possibility should be addressed in the contract and risk apportioned so far as possible.
- (e) Finally, it is important to note that CDM projects under the Kyoto Protocol will have to direct a particular 'share of proceeds' to specified funds. Therefore any contract involving a CDM project should include a clause which takes account of this obligation.

4.16 Force Majeure

The parties will have to decide what should constitute a "force majeure" event for the purposes of the contract. It may simply be defined as anything beyond the reasonable control of the party affected by it. The parties will have to decide what the consequences of such an event are to be.

4.17 Third Parties

- (a) The parties should take a view as to whether any third parties should have the right to enforce or to take the benefit of the terms of the contract. In particular, they should decide whether they wish any of their affiliates (subsidiaries, holding companies, sister companies) to have such rights. If it is decided that third parties are not to have any rights under the contract, the third parties clause should state this clearly to avoid confusion.
- (b) Further to the above, there are several ways in which third parties might become involved in contracts for the sale of ERs. These include:
 - (i) as a facility owner;
 - (ii) as a reducer;
 - (iii) as a verifier;
 - (iv) by way of financing;
 - (v) in a regulatory position as a local government; or
 - (vi) in an overseer / guardian capacity as an NGO.



- (c) In light of the fact that the contracting parties are unlikely to have a contractual relationship with third parties, in certain situations it will be necessary to consider competing claims, access rights and permanence issues. Any risks imposed could be dealt with by way of due diligence and through attaining assurances from the third party.

4.18 Boiler Plate

- (a) The boiler plate clause should deal with the following outstanding issues:
- (i) Entire Agreement: A clause stating that the contract supersedes all prior agreements, representations, understandings, negotiations and communications between the parties.
 - (ii) Governing Law: A provision to establish the law and jurisdiction by which the contract is to be governed.
 - (iii) Variation: A statement that the contract can only be amended by written agreement between the parties.
 - (iv) Severability: A statement to the effect that if a court should find any provision of the contract invalid or unenforceable, this shall be without prejudice to the validity and enforceability of the contract's other provisions.
 - (v) Waiver: A statement that the failure of either party to enforce strictly its rights under the contract does not amount to an acceptance of any variation to the contract's terms or relinquishment of any right under it.
 - (vi) Survival: A statement that any obligations which are stated to survive the expiry or termination of the contract, or which from their nature or context it is obvious that they are intended to do so, shall survive the expiry or termination.
 - (vii) Notice: The clause should set out how notices required to be served under the contract between the parties are to be sent.
 - (viii) Assignment: Generally, the other party's written consent will be required for any assignment of rights to a third party under a contract for the transfer of ERs. The issue of exceptions to such a requirement should also be considered. It may be that:
 - (A) there are no express exceptions included in the contract; or
 - (B) the contract states that consent is not required for assignment to an affiliate or pursuant to a merger or acquisition.

The contract may also stipulate that consent shall not be unreasonably withheld.

Alternatively, it is possible that the investors in the project may not want the contractual obligations to perform the activities giving rise to the ERs to be assignable at all, as they will have carried out due diligence on these parties before investing in the project.



5. Domestic Laws

Finally, it is critical that any ER contracts comply with all local laws. In particular this includes taxation and corporate securities law. For example, the trading of future renewable energy rights under standard form contracts is regulated in Australia by the Corporations Act.



Box 3 - Specific Project Issues: CDM and JI Projects

All of the issues raised in this document apply equally to JI and CDM projects undertaken under the Kyoto Protocol. However, such projects also raise the following issues:

(a) CDM Projects

CDM projects allow for the generation of Certified Emission Reductions (CERs) which, unlike JI projects, can be generated from projects from 1 January 2000 and are therefore bankable. The project criteria need to be met. While Article 12 of the Protocol is relatively brief, the current CDM negotiating texts are well developed with prescriptive "project cycle" guidelines. These draft texts set out clear requirements and approval processes that are likely to be required. In particular it is worth noting that:

- (i) the "Project Entity" may be able to earn CERs by introducing an ER technology into a developing country; and
- (ii) the intention is to provide fast track procedures for renewable energy and small scale energy efficiency projects.

As with all projects, adequate contractual arrangements will need to be entered into. These include:

- (i) recognition of the need to make "Share of Proceeds" payments. Article 12 of the Kyoto Protocol makes it clear that some share of CER revenue will be taken as a tax;
- (ii) recognition that there is a real sovereign risk issue because of the need to obtain Host Country Approval. While many CDM projects are already under way or have even forward-sold ERs, official host country approval has not generally been issued. Many developing countries, while prepared unofficially to endorse projects, are still establishing CDM offices and approval mechanisms. Most buyers of ERs will therefore wish to ensure that such approval is a condition precedent of any sale and that Host Countries legally recognise that the CER rights rest with the Project Entity; and
- (iii) the appropriate allocation of delivery obligations.

It will also be crucial that project developers understand how long projects will be permitted to generate CERs for. And in relation to baselines, it will be important to ensure which aspects of the baseline will be treated as constant and which will be subject to change over the lifetime of the project.

(b) CDM Projects Ensuring the Support of the Project-site Government

Local government support for a project is vital in order to satisfy the Article 12 criteria for CDM projects. The contract should guarantee, as far as possible, the cooperation of the government in whose territory the project is located. The investing company should enter into a prior agreement with the project-site government. This contract should include a government promise to take all steps necessary to ensure that the financial



participant obtains rights to CERs or comparable benefits from the project and to refrain from actions that hinder this result.

Key project documents (project plan, baseline determination, monitoring and verification protocols) should be incorporated in the contract with the government to ensure their consent to the project is informed. In order to meet the sustainable development and consideration requirement, a statement by the government warranting the ways in which the project will contribute to sustainable development should be included. The contracting party should also secure a statement by the government that the project will go beyond the requirements of its domestic laws regarding ERs in order to satisfy additionality. Finally, in relation to future credits, there needs to be a statement by the government that the financial participant holds clear title to the rights to the ERs and CERs or comparable benefits resulting from the project. Alternatively, the contract can apportion some of the rights to future CERs or benefits to the project-site government.

(c) Joint Implementation

JI projects can generate specific Emission Reduction Units (ERUs). In addition to ensuring that all project rules are complied with the contracts will need to ensure:

- (i) only emissions between 2008-2012 are transacted; and
- (ii) that participating country approval is obtained.

Assigned Amounts may be transacted at any time following ratification of Kyoto and so potentially in advance of 2008. It is possible to construct a contract to provide for transfer of both Assigned Amounts, and ERUs under JI.