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ENVIRONMENTAL NEWS

POTENTIAL ISSUES IN GREENHOUSE GAS EMISSIONS TRADING

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Delegates from most of the world's nations meeting in Marrakech, Morocco, recently reached agreements that will greatly facilitate greenhouse gas emissions trading and increase the likelihood that the Kyoto Protocol will enter into force. Europe is moving ahead: the European Union has already introduced legislation establishing a greenhouse gas emissions trading program; and Great Britain has enacted a greenhouse gas emission trading scheme. Agreements reached at this meeting could change the cost structure of projects, especially energy projects, that emit or store greenhouse gasses in the future.

While many companies are waiting for the Kyoto Protocol to enter into force before engaging in emissions trading, others are trading now, hoping to improve their competitive position in the event that costly emissions reductions are required. Regardless of the specific pace of the ratification process, companies engaged in energy projects should at least understand how those projects could relate to potential greenhouse gas emission reduction and trading schemes and take precautions now to effectively position themselves with regard to future programs.

Below is a brief discussion of the background of the Kyoto Protocol, the Marrakech Accords, and the potential issues associated with greenhouse gas emission trades.

BACKGROUND

In 1997, under the auspices of the United Nations, parties to the Framework Convention on Climate Change adopted the Kyoto Protocol. The Kyoto Protocol established specific greenhouse gas emission reduction targets for 38 developed and developing countries, primarily in the northern hemisphere ("Annex I countries"). Those parties agreed to achieve these reductions between 2008 and 2012 and to demonstrate progress toward achieving these targets by 2005. While these commitments were made by countries, it is widely assumed that they will devolve into specific emission reduction requirements by greenhouse gas emission sources, such as the energy industry.

The Kyoto Protocol envisioned trading of greenhouse gas emission reduction credits to reduce the cost of compliance. It provided for the trading of emissions within Annex I countries, between Annex I countries and between Annex I and non-Annex I countries. The Kyoto Protocol adopted a Joint Implementation program ("JI") to facilitate trading between Annex I countries and a Clean Development Mechanism ("CDM") to facilitate trading between Annex I and non-Annex I countries. Both JI and CDM are project-based and allow certified emission reductions

accruing from project activities to be used to contribute toward compliance with emission reduction requirements in Annex I countries. To qualify for credits, emission reductions must be (i) voluntarily undertaken by the parties, (ii) real, measurable and long term, and (iii) in addition to what would have occurred in the absence of the project activity.

MARRAKECH ACCORDS

The delegates at Marrakech reached the following agreements that could greatly facilitate trading:

- > Operational rules for trading mechanisms, including JI and CDM;
- > Fungibility provisions that allow credits created under the various programs to be treated as equal units;
- > A trading unit for emission reductions associated with carbon sinks in Annex I countries (the life of this unit is limited to one year and cannot be banked for future years);
- > Rules allowing non-Annex I countries to create CDM emissions credits without an Annex I partner;
- > Establishment of a CDM Executive Board that will be authorized to approve methodologies for various emissions credit validation procedures, such as establishing emissions baselines and measuring emissions reductions, and to establish a Registry of CDM emission reductions.

THE PROSPECTS FOR LEGALLY BINDING EMISSIONS REDUCTIONS REQUIREMENTS

The Kyoto Protocol has not entered into force and its emission reduction requirements are non-binding. To enter into force, the Protocol must be ratified by 55 countries, including industrialized countries representing at least 55% of total 1990 greenhouse gas emissions from this group. Thus far, 40 countries, including one industrial country, Romania, have ratified the Kyoto Protocol.

Because the United States accounts for approximately 37% of 1990 emissions, its failure to ratify the Kyoto Protocol would be a major impediment to the Kyoto Protocol's entry into force. However, with the agreements reached at Marrakech, European countries are expected ratify the Kyoto Protocol. If they are joined by Russia and Japan, the possibility that the Kyoto Protocol could enter into force is greatly increased regardless of the position taken by the United States.

COUNTRIES AND COMPANIES ARE ALREADY TRADING

Despite the absence of regulatory programs, greenhouse gas emissions reduction credits are being traded. In 2001, the Dutch government purchased credits from Eastern Europe for the reduction of 4.18 million tons of greenhouse gas emissions between 2008 and 2012 at a cost of E35.8 million (US\$31.8 million) or an average of E8.60 (US\$7.60) per ton. This price is surprisingly high, given that there are reports of trades that have occurred at average clearing prices below US\$1.00 per ton. Some brokerage firms are attempting to create electronic, web-

based carbon trading markets. At this time, however, most trades, especially between Annex I and non-Annex I countries, will be project-related and will likely be structured as private party transactions, although the electronic marketplaces also offer an array of hedging instruments, such as forward settlement, streams and options.

In addition to trades between companies, “trades” are occurring within companies. As companies develop carbon management schemes to hedge against the potentially substantial costs of greenhouse gas emission reductions in the future, firms are evaluating internal opportunities for reducing greenhouse gas emissions or increasing their ability to sequester greenhouse gases in plant life. Acting now to reduce a firm’s overall greenhouse gas emissions budget presents both risks and potential rewards. The primary risk is that current reductions will not be recognized by any future mandatory emission reduction program and firms will be forced to reduce below their now lowered baselines, having already exhausted their low cost emission reduction options. However, the agreements reached at Marrakech should reduce this risk.

Regardless of whether a firm plans to trade greenhouse gas emission credits now, projects should be evaluated for potential greenhouse gas emissions implications. Firms should also evaluate whether the project could offer opportunities for trading emission credits and the financial implications of trading. Firms should ensure that even if they do not choose to trade now, they have not inadvertently given up the ability to create credits and trade in the future.

If firms do choose to trade, they will need to prepare to participate in the market place. Below is a brief list of some of the legal issues that firms will encounter.

ISSUES

Issues associated with greenhouse gas emission trading projects fall into three primary categories: (i) project development and execution; (ii) emission reduction trading; and (iii) emission reduction verification.

(i) Project Development and Execution

Since emission reduction credits are likely to be project based, these projects face the same issues as any other project:

- > Project design.
- > Project financing and security agreements.
- > Project operations and maintenance.
- > Project ownership.

(ii) Emission Reduction Sales Issues

The trading of emission reduction credits adds additional issues:

- > Emission reduction credit ownership criteria
 - in the emissions reductions credit sales agreement, and
 - in the case of sequestration agreements, in the land title or lease documents themselves. This may require the creation of new property rights in the host country.
- > Allocation of liability if the actual emissions reductions are less than expected; allocation of benefits if the actual emissions reductions are greater than expected.
- > Impact of emission reduction credit price variability on project security and financing agreements.

- > Allocation of the risk of and indemnification for selling the emission reduction credit more than once.

(iii) Emission Reduction Verification Issues

Closely related to emission reduction credit transfer issues are issues associated with emission reduction credit verification:

- > The ability to move emissions reductions between subsidiaries and parents or other affiliates.
- > The ability to demonstrate that the emissions reductions are additional to what would have happened without the project, and, closely related, that they are comparable to the host countries baseline.
- > Whether a verification program has been adopted in the host country or is under consideration.
- > Allocation of responsibility for meeting future verification requirements.
- > Allocation of the risk of false verification or validation.

1990. Mr. Otis also served the Enterprise for the Environment multi-stakeholder project chaired by former EPA Administrator William Ruckelshaus.

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If you have any questions regarding any of the material contained in this newsletter, please feel free to call Mr. Otis or Mr. O'Donoghue at Curtis' New York principal office at 212.696.6000.

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