

# Legal Developments in the Carbon Market

Legal Paper  
Workshop of 21 April, 2009 Bogotá

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# Executive Summary

On April 21, 2009, the Inter-American Investment Corporation (IIC), in association with the Departamento de Derecho Económico de la Facultad de Ciencias Jurídicas de la Pontificia Universidad Javeriana and supported by the Swiss State Secretariat for Economic Affairs, convened a legal workshop with Colombian government representatives, academia, and carbon market specialists in Bogotá, Colombia. The aim of the workshop was to discuss the recent developments in the climate change regime and to disseminate specialised legal knowledge to Colombian entities and individuals willing to participate and understand the carbon market.

The first part of the legal workshop included discussions on crucial aspects being currently negotiated by countries under the auspices of the United Nations Framework Convention on Climate Change (UNFCCC), such as the nature and extent of mitigation actions to be adopted by developing countries and the reform of the market-based mechanisms. The progress of the Clean Development Mechanism as a project-based mechanism in Colombia and abroad was also addressed during the workshop. Emphasis was given to possibilities for scaling up the mechanism and increasing the incentives for participation of developing countries in international mitigation efforts, in particular through the adoption of sectoral approaches and crediting of nationally appropriate mitigation actions by non-Annex I countries.

The second part of the workshop centered on the recent developments in the carbon market and the treatment of Certified Emissions Reductions (CERs) under Colombian law. An overview of the taxonomy of the different emission rights and emissions trading markets was given, after which participants discussed the legal nature of CERs and the taxation regime that may be applicable in Colombia. Participants noted that the absence of specific legislation on the subject in Colombia makes the assessment of the legal status of CERs and their tax treatment a complex task, one which requires a detailed analysis of the main features of a CER under international law and of the elements of connection that may exist under national laws dealing with securities, financial instruments, and goods and services.

The second part of the workshop also addressed commercial and legal issues surrounding the structuring of Clean Development Mechanism projects and the sale of CERs. Participants explained and discussed in detail the existing sale strategies for project developers to take their carbon assets to the market and the alternatives (and obstacles) to secure third-party financing for offset projects. The legal workshop concluded with an overview of the key contractual aspects of carbon transactions and of the CERSPA Initiative, highlighting the importance of striving to craft a solid partnership between buyers and sellers and of using a robust agreement that creates incentives for both contracting parties to perform their contractual obligations in good faith.

# 1 Introduction

In 2006 a diverse group of experienced lawyers from developing countries, sponsored by the IIC, came together to develop a carbon contract template, the Certified Emission Reductions Sale and Purchase Agreement (CERSPA), which aims at assisting sellers to participate in the international carbon market with a better understanding of the different terms and conditions under which they can sell their carbon credits.

Since 2006 several workshops have been organised by the CERSPA Secretariat and the IIC with funding kindly provided by the Swiss State Secretariat for Economic Affairs (SECO). The objective of these workshops and seminars is to disseminate carbon legal expertise to project developers in Latin America and help them engage in carbon transactions on an equal footing with foreign buyers.

On 21 April 2009 the IIC, in association with the Departamento de Derecho Económico de la Facultad de Ciencias Jurídicas de la Pontificia Universidad Javeriana, convened a legal panel and workshop in Bogotá, Colombia, to discuss the recent developments in the climate change regime and in the carbon market (hereinafter the “Workshop”). Renowned carbon experts and lawyers working in the field of climate change from Latin America and abroad were invited to participate in the panel and in the legal workshop. The morning session of the Workshop saw a legal discussion panel on climate change regime and recent developments in international negotiations. In the afternoon, speakers from different areas of law presented on particular topics associated with the development of the carbon market in Colombia and abroad.

This paper reports on the discussions held and presentations given during the Workshop. The paper follows the structure of the Workshop by beginning with an overall analysis of the climate change regime and the negotiations leading to a new international climate agreement. The second part identifies key issues and recent developments affecting carbon transactions, with a particular focus on the domestic legal framework in Colombia.

## 2 The climate change regime and the path towards a new climate deal

The acknowledgement of the (past and future) impacts of global warming by the overwhelming majority of the scientific community has put an end to the discussions surrounding the actual occurrence of climate change and prompted the response from the international community to start devising ways to mitigate and adapt to such challenge.

The UNFCCC and the Kyoto Protocol comprise the two main treaty-based regimes currently controlling the emissions of greenhouse gases (GHGs) by countries. With almost universal participation, these two international legal instruments were created to regulate the use of the atmosphere by the parties to these agreements and, ultimately, prevent dangerous anthropogenic interference with our climate system.

The first commitment period of the Kyoto Protocol ends in 2012 and the parties to the climate regime are now in full negotiation mode for a reformed climate agreement. The aim of the morning session of the Workshop was to explain and discuss the international legal regime designed to address the problem of climate change and how this regime is likely to evolve up to and beyond 2012.

### 2.1 The UNFCCC and the Kyoto Protocol

The United Nations Framework Convention on Climate Change (UNFCCC or the Convention) was adopted in 1992 at the United Nations Conference on Environment and Development in Rio. The Convention strives to create a legal regime to stabilize GHG concentration in the atmosphere at a level which can “prevent dangerous anthropogenic interference with the climate system”.<sup>1</sup>

As a framework agreement, the Convention sets forth general goals and obligations to orient the future actions of states as to how they should tackle climate change. The Convention creates supervisory instruments that ensure global participation, assessment of relevant information and provision of technical assistance in order to make the advancement of the commitments made by state-parties achievable. In addition, the Convention lays down guiding principles that inform the protocols, decisions and rules adopted by the Conference of the Parties (COP).<sup>2</sup> Among these principles are (i) inter-generational equity, (ii) the precautionary approach, and (iii) common but differentiated responsibilities.

The notion of equity and its inter-generational aspect is a key principle of the Convention. A broader notion of equity informs most of the obligations and responsibilities of the parties under the climate change regime. It is expected that those who bear the greatest share of responsibility for climate change (according to their historical GHG emissions) should also be the ones taking the lead to fight global warming. An inter-generational perspective of equity also requires parties to the Convention to protect the climate system for future generations. The right of future generations to an adequate climate system is expressed in

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<sup>1</sup> See Article 2 of the UNFCCC, available at <http://unfccc.int/2860.php>

<sup>2</sup> The Conference of the Parties (COP) is the highest decision-making body under the Convention. It is composed of all state-parties to the Convention and meets once every year. The next COP will take place in December 2009, in Copenhagen.

article 3.1 of the Convention where it is observed that “Parties should protect the climate system for the benefit of present and future generations of human kind”.

The precautionary approach, in turn, is reflected in article 3.3 of the Convention, which states that “lack of full scientific certainty should not be used as a reason for postponing [precautionary] measures” required to “anticipate, prevent or minimize the causes of climate change and mitigate its adverse effects”.<sup>3</sup> This principle seeks to avoid that countries adopt a ‘wait-and-see’ approach before putting into place the necessary policies and tools that can mitigate global warming and reduce the impacts of climate change. For several developing countries, in particular, to small island states and others most vulnerable to the climate change effects, not taking any action now may result in serious and irreversible damage in the future.

The principles contained in Article 3 of the Convention have, in practice, shaped and oriented the evolution of the climate legal regime so far. Emission reduction targets and timetables set forth by the Kyoto Protocol only apply to countries listed in Annex I of the Convention (that is, OECD countries and economies in transition). Furthermore, developing countries’ commitments are conditioned on the effective implementation by industrialised countries (listed in Annex II of the Convention) of their obligations related to additional financial resources and transfer of technology.

However, as pointed out by Charlotte Streck, Director of Climate Focus B.V., a new or reformed international climate legal design is needed for the period beyond 2012. This reformed structure should include clear and scientifically informed reduction targets for developed countries and a system that promotes the adoption of GHG abatement policies in developing countries.<sup>4</sup>

The UNFCCC and the Kyoto Protocol have therefore established a legal and political international framework in which developed and developing countries (and the many different groups and diverging interests existing within these two broad categories of countries) restrict the use of the atmosphere sinking capacity. While a first step has been taken to address climate change, a second and more ambitious step is now required from countries if the ultimate objective of the Convention is to be achieved.

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<sup>3</sup> See Article 3.3 of UNFCCC.

<sup>4</sup> Comments from Charlotte Streck during her participation at the Workshop

## 2.2 The flexible mechanisms

The Kyoto Protocol envisages three different market-based mechanisms which aim at helping countries to reduce their GHG emissions in a cost-effective way. Articles 6 and 12 of the Protocol establish the project-based mechanisms known respectively as the Joint Implementation (JI) and the Clean Development Mechanism (CDM). Article 17, in turn, provides for an international emission trading scheme (IET) between parties listed in Annex B of the Protocol.

The JI is a joint undertaking among two Annex I parties to develop a GHG abatement project that generates Emission Reduction Units (ERUs) that can be used for compliance with reduction commitments made under the Protocol. The CDM, in turn, allows for certain carbon abatement projects undertaken in developing countries, unilaterally or with the participation of an Annex I party, to generate CERs that can be sold, transferred to, and used by Annex I project participants.

The underlying rationale behind these mechanisms is that countries face different obstacles and bear different costs in achieving their GHG reduction or limitation targets and, therefore, have an option to seek the most cost-effective way to reduce or curb emissions. This notion is coupled with the geographical neutrality of carbon concentrations in the atmosphere vis-à-vis to their contribution to global warming: Regardless of where the abatement of GHG occurs, it contributes equally to the mitigation of global climate change.

As noted by Charlotte Streck, these mechanisms create economic incentives to leverage market forces in the contribution to global mitigation efforts. The market-mechanisms stimulate investment and capacity building and transfer of environmentally friendly technology to less developed countries, promoting sustainable development. The discussions at the workshop focused particularly on the CDM, which is the only international instrument so far that allows for the participation of developing countries in the Kyoto-based market mechanisms.

Despite the criticism surrounding the governance and environmental integrity of the CDM, it can be said that the CDM has so far been fairly successful in pooling resources and leveraging environment-friendly investments in the developing countries. Under the CDM, public and private entities duly authorised by the parties are allowed as project participants. There are currently more than 1,600 projects registered and almost 300 million CERs have been issued by the Executive Board (each CER is equivalent to one tonne of CO<sub>2</sub>e absorbed or avoided from the atmosphere).<sup>5</sup> It is expected that around 1.5 billion CERs will be issued by the end of the first commitment period, and a potential annual green investment flow of several billion dollars to developing countries is.

As explained by Andrea García Guerrero, Advisor to the Department of the Colombian Ministerio de Ambiente, Vivienda y Desarrollo Territorial, in order to qualify as a CDM project and produce CERs a GHG abatement project must undergo a thorough certification process, which starts with the preparation of a project design document (PDD). The PDD describes the basic features of the project and how it plans to reduce carbon emissions below what would have happened in the absence of the project. The PDD must then be validated by an independent entity (known in the CDM jargon as designated operational entity or DOE) accredited by the COP. The GHG abatement project must also obtain an approval from the

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<sup>5</sup> Figures expressed at the time the Workshop was held.

host country. Such letter of approval confirms that the project is being undertaken voluntarily and that it contributes to the local sustainable development.<sup>6</sup>

The validation of the PDD and the approval by the competent host government entity are prerequisites to register the project with the CDM Executive Board. The act of registration is the formal recognition of the abatement project and defines the moment from which CERs can begin to be generated. Issuance of CERs occurs ex-post, i.e., once emission reductions have been monitored and duly verified and certified by a designated operational entity.

At the time of the Workshop Colombia had a pipeline of 127 projects, 39 of which were approved by the designated national authority of Colombia (the Ministry of Environment) and 14 were CDM projects registered with the Executive Board. According to Andria García Guerrero, the CDM development potential in Colombia is still limited due to the mechanics of the CDM, which favours investment in countries whose energy matrix are largely based on fossil fuels and in which the greatest share of emissions reductions can be achieved with the lowest cost possible. The overall clean energy matrix of Colombia is thus a logical limitation to the country's potential to develop individual CDM projects.<sup>7</sup>

Indeed, there seemed to be general agreement among speakers at the Workshop that the CDM still has a lot of room for improvement, especially in relation to the generation of greater levels of emission reductions and additional social and environmental benefits.

In conclusion, the market-based mechanisms of the Kyoto Protocol, in particular the CDM, has proved to be a rather constructive step toward a comprehensive regime which integrates financial tools, private entities and environmental concerns in order to mitigate climate change and promote sustainable development. There remains, however, a visible need for improvement if these mechanisms are to lead developing economies to a cleaner growth path.

## 2.3 Post-2012 international negotiations

At COP 13, the parties to the Convention adopted the Bali Action Plan and kick-started the negotiation process for a reformed international climate agreement. The Bali Action Plan established a series of milestones and building blocks to guide countries in their negotiations to achieve a comprehensive climate deal at COP 15 in Copenhagen. It also created the Ad Hoc Working Group on Long-Term Cooperative Action under the Convention (AWG-LCA) to serve as a forum for discussions on mitigation, adaptation, transfer of technology and finance.

The AWG-LCA, together with the Ad Hoc Working Group on Further Commitments for Annex I Parties under the Protocol (AWG-KP), created at COP/MOP 1, represent the two main negotiation tracks for a post-2012 agreement. While several issues under negotiation are discussed under both the AWG-LCA and the AWG-KP, the former is focused on achieving agreement on long-term cooperative action for the implementation of the Convention, whereas the latter was primarily designed to define new and bolder reduction commitments for developed countries after 2012.

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<sup>6</sup> Comments from Andrea García Guerrero during her participation at the Workshop

<sup>7</sup> Ibid.

As noted by Charlotte Streck, the following are some of the crucial aspects currently being negotiated by countries: (i) the establishment of new aggregate and individual reduction targets for Annex I countries; (ii) the nature and extent of mitigation actions to be adopted by developing countries; (iii) the generation and distribution of financial resources to assist developing countries in their mitigation and adaptation efforts (and their respective institutional arrangements); (iv) the reform of the market-based mechanisms; and (v) the reduction of emissions from deforestation and forest degradation (REDD).<sup>8</sup>

For enhancing the capability of the CDM to generate emission reductions and increase the level of investment in clean energy in developing countries, parties are considering the creation of a sectoral CDM. Under this approach, activities defined at the sectoral level (e.g. the electricity sector) are registered as a CDM activity and are able to generate offset credits if verified emission reductions within the sector are below a pre-defined baseline. As pointed out by Charlotte Streck, the sectoral CDM may build on the positive aspects of the CDM framework and has the potential to scale up emission reductions in developing countries. On the other hand, she observed, a sectoral CDM faces challenges when it comes to defining individual country-sector baselines. The role that could be played by the private sector under a sectoral CDM approach is also not clear.<sup>9</sup>

Another improvement to project-based mechanisms that is being discussed is the establishment of sectoral no-lose targets by developing countries. The proposal of sectoral no-lose targets is based on the idea of crediting emissions reductions achieved below a voluntary sector emission target. The target would have to be approved by a new or existing body under the auspices of the Kyoto Protocol. There would be no consequences for countries that were not able to meet the proposed target. The same difficulties highlighted above for the sectoral CDM apply however to sectoral no-lose targets.<sup>10</sup>

Registration and crediting of nationally appropriate mitigation actions (NAMAs) proposed by non-Annex I countries is another possibility. While several issues surrounding NAMAs still need to be defined (such as their nature and content, approval process, and provisions related to additionality), the idea of creating a separate registry to record developing country NAMAs and match their national mitigation plans and strategies with financial assistance from industrialised nations is gaining ground and may prove to be an appropriate incentive framework for actions on the part of developing countries.<sup>11</sup>

Overall, it remains to be seen whether countries will be able to achieve consensus on these key issues. In general, participants at the Workshop believe that countries may well reach an agreement on the contours and general framework of a new climate deal, but leaving the details on the actual mitigation, adaptation, and financial mechanisms to be decided and refined at later meetings.

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<sup>8</sup> Comments from Charlotte Streck during her participation at the Workshop

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

## 3 Legal perspectives of the carbon market in Colombia and abroad

The carbon market has seen near-steady growth since 2004. Countless transactions in the regulated and voluntary GHG markets have taken place globally and the degree of sophistication of the contractual arrangements has increased accordingly. As from 2006 the carbon market, and in particular the CDM, have attracted the participation of all sorts of private buyers of offset credits, including energy companies, traders, brokers, and financial players willing to either reduce their emission compliance costs or profit from the differences in the carbon price under different regimes.

Against this background, the importance of disseminating legal intelligence related to the mechanics of the carbon market, especially to those small and medium project owners with little or no access to market information, is unquestionable. An understanding of both the domestic legal framework that may apply to carbon transactions as well as the international legal issues (CDM-related or not) surrounding the sale and purchase of CERs is essential.

### 3.1 Taxonomy of GHG rights and the different legal regimes

The ample universe of GHG rights (and their different names and acronyms) may generate some confusion for those not closely involved in the carbon market. The types of emission reductions rights that can be generated vary in accordance with the regime within which they are created.

Broadly speaking, there are two main types of emission rights: GHG allowances and offset credits. Allowances are emission rights awarded to entities (or countries) so as to regulate and control their GHG emissions throughout a given period of time. In this system, generally known as a cap-and-trade system, allowances are allocated to the entities participating in the scheme before the actual emissions take place. At the end of the defined compliance period, the covered entity must surrender a number of allowances that is at least equal to the amount of GHG emissions it released during the compliance period. Entities may decide to reduce emissions themselves or purchase allowances in the market in order to comply with the scheme.

Examples of cap-and-trade schemes are the IET between parties listed in Annex B of the Kyoto Protocol, which receive and then are able to trade the so-called Assigned Amount Units (AAUs), and the European Emissions Trading Scheme (EU ETS), which distributes European Union tradable allowances (or EUAs) to installations covered under the scheme. As observed by Alejandro Prada, an attorney at the IIC, other cap-and-trade markets exist (such as the New South Wales Greenhouse Gas Reduction Scheme in Australia and the Regional Greenhouse Gas Initiative in the U.S.) or are currently being designed (such as the federal cap-and-trade schemes currently under consideration by congress in Australia, New Zealand, and the U.S.).<sup>12</sup>

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<sup>12</sup> Comments from Alejandro Prada during his participation at the Workshop

Offset credits, in turn, are the result of a project activity that reduces GHG emissions below an established baseline. Known as baseline-and-crediting system, these project activities will normally undergo an independent verification process which aims at certifying that the emission reductions are genuine and are not the result of a common practice or business-as-usual activity of the project developer.

Offset credits are generated once the verification process is complete. Some types of offset credits can be transferred and used for compliance purposes under the Kyoto Protocol and the EU ETS. Examples of baseline-and-crediting systems are the CDM and the JI of the Kyoto Protocol.

As explained by Martha Patricia Castillo, coordinator of the Latin American Programme for Carbon and Renewable Energy of the Corporación Andina de Fomento (CAF), GHG emission rights can also be distinguished in accordance with the regulatory nature of the regime within which they are created.<sup>13</sup> GHG rights created and traded under emissions trading schemes in which compliance by covered entities is mandatory (as in the Kyoto Protocol, the EU ETS, and proposed federal cap-and-trade schemes in the U.S., Australia, and New Zealand) are referred to as the regulated market. CERs, ERUs, AAUs, EUAs are all considered regulated emission rights.

In contrast, offset credits and emission allowances traded in markets where compliance is either optional or absent are referred to as voluntary credits or allowances. Examples of these voluntary GHG reduction instruments are the Gold Standard and the Voluntary Carbon Standard, which provide certification standards for voluntary offset projects and credits in developing countries, and the Chicago Climate Exchange, a voluntary cap-and-trade system in the U.S..

In sum, the type of GHG emission rights a certain entity holds (and consequently the value of such right and the market in which they can be traded) will depend on the characteristics of the emissions trading/regulatory regime in which they are created. GHG rights will be either offset credits or allowances that can be negotiated, according to their eligibility to a certain standard or rules, in regulated and/or voluntary markets.

### 3.2 Legal nature of CERs and taxation regime in Colombia

The legal status of CERs is still undefined in most of the jurisdictions. The peculiar characteristics of a CER coupled with the absence, in most cases, of any domestic legislation addressing the trade of GHG rights make the study of the legal nature of these assets a complex task. The importance of defining the legal nature of CERs lies in the assurance it brings for private entities investing in CDM projects and negotiating these types of rights. A clearly established legal nature can assist entities in determining the exact ownership rights and the taxation and regulatory regime that applies to the CER transaction under domestic law.

From an international law perspective, CERs are essentially accounting units which represent the reduction of one metric tonne of carbon dioxide equivalent and are generated in accordance with the rules and procedures of the CDM. CERs are issued by an electronic

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<sup>13</sup> Comments from Martha Patricia Castillo during her participation at the Workshop

registry administrator (the Secretariat of the Convention) supervised by the CDM Executive Board.

As noted by Juan Pablo González Mejía, attorney at Esguerra Barrera Arriaga S.A., although the Kyoto Protocol does not address the legal nature of CERs, it does set some of their main features, namely: (i) for their creation, an authorization of the local government (through the national designated authority) is required; (ii) they can only be issued after a decision of an international body (the CDM Executive Board); (iii) they are issued with a unique registration number; and (iv) they constitute tradable rights.<sup>14</sup>

For the purposes of trade among private entities, however, the international law perspective must be seen and analysed together with the domestic regulation or the understanding that countries may have regarding the nature and ownership of those rights. In that respect, Juan Pablo González Mejía observed that, while Colombian laws do not regulate the trade of CERs or define their legal status, it is possible to identify similarities (and dissimilarities) between CERs and some existing domestic legal instruments.<sup>15</sup>

Comparing the nature of GHG rights to an administrative permit, Mr. Mejía noted that the generation of CERs requires first that an authorization to participate in a CDM project be given by the Ministry of Environment. Such authorization has the effect of creating some private rights to the project participant which cannot be revoked without its consent.<sup>16</sup>

On the other hand, a CER is not likely to be considered a security in the meaning of Law 964 of 2005 (the public securities law). This is because in the referred law securities are issued for raising resources from the general public, a characteristic that CERs don't share. Neither would CERs qualify as financial instruments or derivatives in accordance to Decree 1769 of 2008, as transactions of CERs are not anchored to the existence of an underlying asset (although the CERs themselves could constitute the actual underlying asset for trading of derivatives).<sup>17</sup>

Finally, Mr. Mejía argued that if CERs are to be negotiated in Colombian electronic bourses it is more likely that they will be treated as commodities and traded in specialized futures and agricultural commodities exchanges.<sup>18</sup>

Along the same lines, Juan Pablo Godoy Fajardo, attorney at Godoy & Hoyos Abogados, noted the absence of any specific rules concerning the tax treatment of CER transactions in Colombia. General taxation rules and principles must then be applied.<sup>19</sup> Mr. Fajardo noted that, for accounting purposes, CERs should be seen as fixed intangible assets. The acquisition of CERs when onerous should be recorded in the company bookings using the cost method of accounting, while, if gratuitous, as deferred receivable.<sup>20</sup>

The sale of CERs, in turn, would be subject to income tax to the extent that the revenues from the sale of the CERs exceed the cost of acquisition. If there is no acquisition cost, Mr. Fajardo

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<sup>14</sup> Comments from Juan Pablo González Mejía during his participation at the Workshop

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> Comments from Juan Pablo Godoy Fajardo during his participation at the Workshop

<sup>20</sup> Ibid.

argued, the rules related to the national estimation of costs are not likely to apply. When such acquisition is gratuitous and no levies are imposed, the taxable event will occur at the moment of sale of the CERs.<sup>21</sup>

With regard to value added taxes (VAT), no levies apply to the transfer of rights or intangible assets since Colombian laws only foresee the applicability of VAT for the sale of moveable tangible assets. Mr. Fajardo noted, however, the existing interpretation that the transaction of CERs could potentially be classified as a service. Still, the international sale of CERs (export) is unlikely to qualify as an export of services and therefore no VAT would apply.<sup>22</sup>

### 3.3 Structuring CER transactions

There are a number of advantages to entering the carbon market. Alejandro Prada noted that it is valuable for potential buyers of GHG credits because they can lower their compliance cost in reducing emissions and improve their corporate image. For sellers it is a way to leverage financing for the project, have greater access to technology, and increase their internal rates of return.<sup>23</sup>

A project owner and future seller of CERs will normally face the question as to whether it should forward sell its GHG assets before the issuance of CERs actually takes place (through a forward carbon contract commonly referred to as Emissions Reduction Purchase Agreement or ERPA) or selling the assets on the spot market after the issuance of CERs has occurred (spot sales are normally via brokers or specialised carbon bourses).

There are number of advantages and disadvantages to both options. Forward contracts are suitable for project owners who seek financial and technical assistance either by using the ERPA as collateral to obtain bank financing or by requesting an advance payment from the buyer (or CDM technical assistance) to develop and implement the CDM project. Normally, forward contracts will be entered into by project owners that require certainty in their project cash flow. It is worth noting that forward carbon contracts vary from project to project and cannot be truly standardized. In the case of forward sales, market price risk (the risk that the price of CERs may go up or down) is normally shared by the contracting parties.

The forward sale of CERs can take place at any moment of the CDM project approval cycle (e.g. at the PPD development, validation, or registration stage). The more advanced the CDM project is in the approval cycle, the higher the price will be that can be obtained for the CERs.

As noted by Alejandro Prada, when searching for finance the project owner will normally have the following options: (i) obtain full equity investment from project sponsors (which may include the buyer of the CERs); (ii) obtain an advance payment from the buyer of the CERs (in the form of a loan); (iii) seek a traditional loan from a bank; or (iv) obtain a loan from a bank using the ERPA as collateral. With the latter option the bank provides credit with interest to the project owner and, in turn, is assigned the right to receive the payments directly from the buyer of the CERs under the ERPA. The buyer, therefore, pays the bank instead of the project owner and the ERPA is used as collateral.<sup>24</sup>

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<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

<sup>23</sup> Comments from Alejandro Prada during his participation at the Workshop

<sup>24</sup> Ibid.

Alejandro Prada further noted, however, that there are a number of obstacles that impede banks from becoming involved in CDM projects. Most significantly, local banks do not often know enough of CDM project structuring and carbon market, which makes it complicated for these institutions to assess transaction risks and the potential future cash flows which can derive from the sale of CERs.<sup>25</sup>

On the other hand, if project owners do not require a predictable cash flow and already possess the financial and technical means to implement the project, they may wish to wait until their CERs are issued and then negotiate them in the spot market. The spot market means that delivery and payment (settlement) is done almost at the same time, through standardized contract templates and delivery and payment guarantees. So far spot CERs have been mostly negotiated in specialized bourses and carbon exchanges based in Europe. Some project owners have also opted to sell their issued CERs through auctions in exchanges based in developing countries, such as the Brazilian Mercantile & Futures Exchange (BM&F).

The disadvantage of this approach however is that the seller will solely bear the market price risk and the amount of revenues it may receive from the sale of CERs will depend on the price of this asset on the market at the moment the transaction is concluded.

### 3.4 Carbon contracts and the CERSPA Initiative

Despite the growth of secondary market transactions (i.e., the sale of CERs by secondary sellers as derivatives –futures and options– through brokers and exchanges), forward contracts (or ERPAs) still remain the most used form of carbon contracts. ERPAs are essentially long-term off-take agreements in which all terms and conditions, including pricing structure, are agreed at present, with delivery of the asset (in this case carbon credits) set to take place at an agreed future date.

As each CDM project development and CER transaction carries its own set of risks, such as whether the project will come into full operation, be validated and be able to generate the emission reductions as estimated in the PDD, each ERPA must be tailor-made for each transaction, taking into account the specific circumstances of the project. The function of the ERPA is, in that sense, to allocate those risks and define clearly the obligations (and rights) of each of the contracting parties.

The CERSPA (Certified Emission Reductions Sale and Purchase Agreement) initiative aims to help project developers negotiate their carbon credits, better understand the terms and conditions for selling CERs, and consequently be able to tap the CDM market potential. Normally, ERPAs are extensive documents, written in English and subject to English Law, and operate under rules that are constantly changing or evolving. Project owners are normally distant from the current discussions on the CDM market and its rules, and, therefore, less well informed to negotiate their ERPAs.

As explained by Thiago Chagas, counsel at Climate Focus, the CERSPA does not intend to be a standard template, but rather a guide for project developers that can serve as a basis for starting negotiations. It is best suited for sellers who are looking for finance or an upfront payment for the project and wish to share the market risk with the buyer of the credits.<sup>26</sup>

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<sup>25</sup> Ibid.

<sup>26</sup> Comments from Thiago Chagas during his participation at the Workshop

There are three main components to the CERSPA: commercial aspects, main obligations, and events of default and remedy. The commercial aspects concern the price and payment. The terms cover the emission reductions that are to be traded: either CERs and/or Post-2012 ERs, the amounts and, specifically, the years in which these emission reductions are to be generated. Provisions on the price must also be agreed upon. The CERSPA provides several options for determining the price: it can be a fixed price structure, a variable one, or a combination of the two.

Payment provisions are also important. The CERSPA specifies that payment is upon delivery and provides options for advanced payments in case the project developer requires assistance to finance the project.

Obligations are reasonably allocated between the buyer and seller. For the seller, these include mainly: (i) obtaining the right approvals and permits in order to generate and sell the CERs; (ii) implementing the project in line with Kyoto Protocol and the PDD; (iii) informing the buyer if there are any material changes in the project such as in its implementation and operation; and (iv) delivering the CERs on the agreed delivery dates. In turn, the buyer is under the obligation to: (i) take receipt of the contracted CERs, and not undertake any willful conduct so as to prevent delivery; (ii) ensure it has an electronic registry in place able to receive the CERs; and (iii) make timely payments on the agreed dates.

By clearly dividing the obligations the CERSPA seeks to manage the risks involved with CDM projects. However, should problems arise in the fulfilment of obligations of the parties, it is important that the ERPA indicates how to approach such a situation. The CERSPA provides clauses for events of default and their respective remedies. The main principle applied by the CERSPA is to minimise the liability of both parties, unless a breach by one of the parties is considered an intentional breach.

In conclusion, as observed by Thiago Chagas, the CERSPA is more than simply a contract template. It should be a document that promotes and constructs a relationship of partnership between two parties that will span over a number of years and requires close cooperation. It is valuable if the buyer is involved in the project so that he/she is aware of the possible risks, difficulties, and delays. In this way there will hopefully be a solid partnership based on a robust legal document that creates incentive for sellers and buyers to act in good faith and comply with their contractual obligations.<sup>27</sup>

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<sup>27</sup> Ibid.

# Annex – List of Participants

## **Alejandro M. Prada**

Dr. Alejandro M. Prada is a Colombian attorney, with postdoctoral studies in Spain and Germany. He has fifteen years of work experience in international business and negotiations. Mr. Prada is Project Attorney at the Inter-American Investment Corporation and is responsible for corporate projects in the Andean and Caribbean countries. He has experience in financing carbon emissions reduction projects in several Latin American jurisdictions.

## **Andrea García Guerrero**

Andrea García Guerrero is a climate change advisor to the Minister of Environment, Housing and Territorial Development of Colombia. She directs the Ministry's climate change office since 2008 and is part of the Colombian delegation to the United Nations Framework Convention on Climate Change negotiations since 2006.

Ms. García Guerrero holds a masters degree in Biological Sciences from Florida International University, where she worked mainly in ecophysiology and climate change, especially in tropical forests. She also holds a bachelor's degree in forest science from the University of Florida in Gainesville.

## **Charlotte Streck**

Charlotte Streck is a founding partner and Director of Climate Focus and an international lawyer, expert in climate change and carbon finance law and policy. She advises on the regulatory framework of the United Nations Framework Convention on Climate Change, the Kyoto Protocol, and the European Union Emissions Trading Scheme. Before she founded Climate Focus in February 2005, Ms. Streck was counsel at the World Bank in Washington, D.C. for five years where she gained extensive experience in drafting and negotiating complex carbon finance agreements.

She has a background in both law and sciences and holds a PhD in environmental law from Humboldt University in Berlin. She authored and edited five books and numerous articles on environmental law and policy, serves on several editorial boards, is a board member of the Global Public Policy Institute, an adjunct lecturer at the University of Potsdam, Germany, and lead counsel for climate change of the Center of International Sustainable Development Law at McGill University, Montreal, Canada.

## **Martha Patricia Castillo**

Martha Patricia Castillo has been working in the climate change field for the past eight years. From 2002 to February 2006, she was in charge of the implementation of the CDM by Colombia's Ministry of Environment, Housing, and Territorial Development, as well as other topics related to economic instruments for environmental management, and provided support to the Colombian delegation in the international negotiations on climate change. Since 2006 she has worked with the Andean Development Corporation (CAF) in the Latin American Carbon Program (PLAC +e) as coordinator of origination of new projects eligible for the international carbon market. Ms. Castillo is an economist with an MSc in Environmental Economics and Natural Resources from the University of Maryland.

**Juan Andrés López-Silva**

Juan Andres López-Silva worked for over ten years with the World Bank in Washington D.C. as Senior Environmental Specialist. As such, he managed global environment operations and policy making initiatives in the Latin American and Caribbean region, including private-public partnership arrangements to help industries adopt cleaner environmentally friendly technologies.

Before joining the World Bank, Mr. López-Silva worked as Head of the International Negotiations Office at the Colombian Ministry of Environment, Housing, and Territorial Development, where he led the negotiating teams at international conventions, including the UNFCCC, the Convention on Biological Diversity, and the Montreal Protocol on Ozone Depleting Substances. Late in 2006, Mr. López-Silva returned to Colombia where he founded a company he currently leads, engages in developing carbon financing operations in Colombia and other Latin American countries in sectors such as forestry, hydropower, oil production, and transport. Mr. López-Silva has an MA in International Economics and Relations from Johns Hopkins University at SAIS.

**Juan Pablo Godoy Fajardo**

Juan Pablo Godoy Fajardo obtained his Juris Doctor (J.D.) from Pontificia Universidad Javeriana, Bogotá, 1988. He is admitted to practice in Colombia and is fluent in Spanish and English. His areas of expertise include tax planning & advice (corporate and international); power and natural resources law; tax controversies (corporate and international); estate and personal tax planning; and trade regulations and customs law.

Mr. Godoy Fajardo is currently the chairman of the Colombian Institute of Tax Law, member of the Colombian Association of Petroleum and Mining Lawyers and the board of directors of the LA Institute of Tax Law. He was the former chairman and current member of the International Fiscal Association (IFA). Tax professor at Universidad del Rosario, Universidad de los Andes, and Pontificia Universidad Javeriana since 1991 and frequent speaker at CITE and ATLAS seminars on tax planning for operations in Latin America. Listed as top tax advisor in Colombia by Who's Who Legal and Latin Lawyer.

**Juan Pablo González Mejía**

Juan Pablo González Mejía graduated with honors at Pontificia Universidad Javeriana and received a Master of Laws (LL.M) degree from Cornell University in the United States. He worked as an attorney for the firm of Gamba, Barrera, Arriaga & Asociados from 1991 to 1996. Starting in 1997 he served as Legal Vice President for the Bogotá Stock Exchange, where he later held the position of Executive Vice President. As such, he led the integration of the Colombian stock exchanges. Later, as Executive Vice President of the Colombian Stock Exchange, he was responsible for the management of the startup of the Colombian Electronic Market.

Since 2002 Mr. González Mejía has advised numerous domestic and international institutions on matters related to financial, securities and corporate law. He was a member of the commission to draft the Securities Market Law under the leadership of the Ministry of Finance.

Juan Pablo González Mejía is currently a professor of Securities Law in the School of Law at Pontificia Universidad Javeriana.

**Julia Miranda Londoño**

Julia Miranda Londoño is a lawyer with a degree from the Pontificia Universidad Javeriana. She studied environmental law at Colombia's Universidad Externado and has extensive experience in environmental issues in Colombia. Ms. Londoño is general director at the Special Administrative Unit for the National Natural Parks System, which is part of Colombia's Ministry of the Environment, Housing, and Territorial Development. She is responsible for the administration and management of Colombia's national natural parks system.

**Thiago Chagas**

Thiago Chagas is a lawyer specialised in the legal and regulatory aspects of the carbon market. Mr. Chagas has been advising on domestic, regional, and international emissions trading and has extensive experience with legal structuring of carbon offset projects in developing countries. He is also an expert in carbon contracts and has participated in drafting and negotiating carbon sale and purchase agreements all over South America, Asia, and Africa.

Prior to joining Climate Focus, he was a lawyer advising on carbon brokerage and climate consulting in Latin America and holds a degree in law from the Pontificia Universidade Catolica de São Paulo and a Master of Laws in International Law from Edinburgh University, Scotland.