

# CERSPA: A new template agreement for the sale and purchase of Certified Emission Reductions (CERs)

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*In order to make the most of the opportunity created by the Clean Development Mechanism project developers in developing countries need to have a thorough understanding of the contracts they use to sell their Certified Emission Reductions. The Inter-American Investment Corporation supported an initiative to produce a new Certified Emission Reduction Sale and Purchase Agreement template agreement known as CERSPA and an accompanying explanatory document. These documents will assist small and medium sized project developers understand Certified Emission Reduction sales contracts and participate in the global carbon market on an equal footing with more experienced buyers.*

## 1. Introduction

Developing country participation in the Clean Development Mechanism (CDM) is premised on the CDM promoting sustainable development in host countries. The CDM promotes this objective by creating an opportunity to benefit from reducing emissions that is de-linked from any obligation to do so.<sup>2</sup> However, this no-liability opportunity is entrenched in the international rules at the sovereign level only and the rules do not extend down to project level transactions. Public and private sector entities voluntarily participate in the CDM and are free to enter into whatever contractual arrangements they desire to buy and sell Certified Emission Reductions (CERs).<sup>3</sup> Nonetheless, to help CDM projects contribute to sustainable development over the long term the sale of

CERs should represent an opportunity to generate hard currency income through access to the international carbon market. Unfortunately, if a CDM project developer does not fully understand the contract terms under which it can sell its CERs or the range of options that are open to it, it runs the risk that the sale of CERs inadvertently becomes a potential liability that may undermine the project itself rather than an opportunity.

The first contracts to buy and sell emission reductions under the CDM were developed by the World Bank for the Prototype Carbon Fund (PCF) and the Dutch Government under the Certified Emission Reduction Unit Purchase Tender.<sup>4</sup> These first contracts were created before the Marrakesh Accords had been decided and before the Kyoto Protocol<sup>5</sup> entered into force.<sup>6</sup> The terms of these contracts evolved as the rules for the CDM were developed through the Marrakesh Accords and subsequent decisions of the COP/MOP<sup>7</sup> and CDM Executive Board.

The World Bank drafted its first contracts – known as emission reductions purchase agreements (ERPAs) as forward contracts that were individually negotiated and tailored to each project.<sup>8</sup> The ERPAs were drafted to help achieve the PCF's objective of catalyzing the carbon market before the Kyoto Protocol entered into force. As a result,

1 Correspondence should be sent to r.osullivan@climatefocus.com. Some of the text of this article is taken from the CERSPA Guidance Document, an open-source document available at <http://www.cerspa.org>.

2 Article 12 para 2 of the Kyoto Protocol states: 'The purpose of the clean development mechanism shall be to assist Parties not included in Annex I in achieving sustainable development and in contributing to the ultimate objective of the Convention', and Article 12 para 5(a) states that developing country participation in the CDM must be voluntary. This voluntary participation to promote sustainable development without additional emission reduction obligations is very different to the quantified emission limitation and reduction commitments assumed by industrialized countries under Article 3 of the Kyoto Protocol.

3 This freedom is obviously subject to domestic laws.

4 The Dutch Government's first tender rounds targeted JI projects (ERUPT). CERUPT followed later and was modelled after the successful experience of earlier rounds of ERUPT.

5 FCCC/CP/1997/L.7/Add.1 Decision 1/CP.3 'Adoption of the Kyoto Protocol to the United Nations Framework Convention on Climate Change', Annex, reprinted (1998) 37 ILM 22 (Kyoto Protocol).

6 Article 12 of the Kyoto Protocol was the sole source of international law on the CDM at the time. Article 12 contained references to certifying real, measurable and additional emission reductions, but was largely silent on how transactions would occur. The only reference to transactions was a reference to the CDM benefiting non-Annex I countries and that the CDM shall assist in arranging for funding for projects. See arts 12(3)(a), 12(5) and 12(6) of the Kyoto Protocol.

7 Conference of the Parties to the United Nations Framework Convention on Climate Change serving as Meeting of the Parties to the Kyoto Protocol.

8 See C Streck 'World Bank Carbon Finance Business: Contracts and Emission Reductions Purchase Transactions' in D Freestone and C Streck (eds) *Legal Aspects of Implementing the Kyoto Protocol Mechanisms* (Oxford University Press Oxford 2005).

the contracts did not contain strict remedies for under-delivery and contained a number of terms dealing with defining, monitoring and verifying emission reductions.<sup>9</sup> The early World Bank ERPA's also formed the basis for the first two ERPA templates produced by the International Emissions Trading Association (IETA), which modified the contracts better to reflect the needs and interests of its members. In 2005–2006 both the World Bank and IETA redrafted their ERPA templates to include a section of standard terms to be accompanied by a section of project specific terms such as price and volume.<sup>10</sup>

Today, project developers can choose from a wide range of carbon buyers and between several contractual structures under which they can market their CERs. Some project developers are moving away from selling their CERs under forward contracts, and aim to sell their CERs on the spot market once they are issued. However, selling CERs under a forward contract is still the most common way for a project developer to enter the international carbon market and sell its CERs. The pioneering work of the World Bank and IETA has produced sophisticated legal documents that summarize much of the existing intelligence in this emerging legal discipline. However, both models have been developed by institutions that represent mostly buyers (IETA) or act as buyers themselves (the World Bank).

In many instances project developers sell their CERs under contracts that include delivery guarantees, penalties and strict enforcement clauses. Such clauses may be appropriate in some larger projects supported by companies with deep pockets, but these clauses can turn a CER sale agreement from an asset into a liability and undermine the usefulness of a CER sale contract to secure debt financing. For many small and medium sized projects such clauses can also put the entire project at risk, as well as the company behind it. Many carbon contracts are also missing elements common to other long-term purchase agreements, such as price adjustment clauses or limitations on liabilities. The latest IETA Code even attempts to extend liability to force majeure events – an area where neither party is traditionally held liable precisely because force majeure events are beyond the control of either party.<sup>11</sup>

<sup>9</sup> *ibid.*

<sup>10</sup> See the other articles in this Special Issue on the World Bank and IETA contracts.

<sup>11</sup> The IETA Code contains an optional clause that can be used to extend liability for force majeure events to the party unable to perform owing to the force majeure event. While this may seem

In order better to enable CDM project developers to participate in the global carbon market on an equal footing with more experienced buyers there is a need to assist project developers to draft and negotiate CER sale and purchase contracts. Many CDM projects are being developed by small and medium sized entities that do not have the resources to obtain advice from expert law firms. Few sellers have the capacity to follow the developments of the CDM in detail and most either negotiate the sale of their CERs without any legal representation or rely on legal advisors without previous exposure to CDM projects.

## 2. Background to the CERSPA

In response to the need to provide legal assistance to CDM project developers the Inter-American Investment Corporation (IIC) sponsored<sup>12</sup> an initiative to develop a new CER sale and purchase agreement (CERSPA) and an accompanying Guidance Document. The objective of the initiative was to produce an easily accessible and balanced agreement that reflects and protects the interests of the project developers and financial institutions supporting CDM projects.

The CERSPA is intended to be a simple, balanced agreement that reflects the interests of buyers, sellers and the financial institutions that support CDM projects. The Guidance Document follows each clause in the CERSPA, explaining the key elements of each clause and offering alternate drafting options when necessary. The documents identify key issues for sellers and financial institutions and provide a tool box of legal ideas and drafted language that will help project developers realize the value of their CERs without putting their project at risk. Educating sellers before they enter negotiations will also help reduce transaction costs as buyers often spend considerable time having to explain the CDM specific clauses before negotiations even start.

The CERSA and Guidance Document were drafted with the input of over 20 CDM lawyers and experts, the majority

balanced on the face of it, in practice the seller will be exposed to significantly more force majeure risk when generating and delivering CERs than a buyer will be in paying for them. See Clean Development Mechanism Certified Emission Reductions Purchase Agreement, Section 6.4 'Force Majeure', available online at: <http://www.ieta.org/www/pages/getfile.php?docID=1794>.

<sup>12</sup> Funding for the initiative was kindly provided by the Government of the Republic of Korea, through the Korea-IIC SME Development Trust Fund, and by the Swiss Government, through the State Secretariat for Economic Affairs (SECO).

of whom are from developing countries.<sup>13</sup> The drafting process involved a workshop held at the IIC's headquarters in Washington DC and the circulation of a number of versions of the documents for the group's comments and input. The CERSPA and Guidance Document will be open-source legal documents and are expected to continue to evolve over time as more lawyers, project developers and other stakeholders have the opportunity to use the documents and provide their input and expertise. The documents were drafted in English but will be translated into a number of languages to help facilitate dissemination and use in developing countries.

While it is hoped the CERSPA may form the basis of subsequent agreements with medium and smaller buyers, it is unlikely that many larger institutions will abandon their preferred precedents. The CERSPA will none the less also prove to be a valuable resource to sellers in these instances, as it can be used to understand key issues and identify available alternatives.

### 3. Key clauses of the CERSPA

The following section discusses some of the clauses and explanations in the CERSPA and Guidance Document. The full documentation is available in a number of languages at <http://www.cerspa.org>.

#### 3.1 Sale and purchase of CERs

CERs are the result of the emission reductions generated by a registered CDM project and defined in the decision of the COP/MOP of the Kyoto Protocol. Legal experts are still discussing whether CERs legally constitute a commodity, a security, a permit or another type of intangible right. Few national laws contain clear definitions of CERs or other carbon rights. In some jurisdictions the legal nature of a CER depends on the context in which it is being considered as the same CER can be characterized differently for tax, accounting, financial regulation and contractual purposes. However, there is no doubt that CERs can be traded.<sup>14</sup>

One of the main purposes of all CER contracts is to establish the price and volume of CERs sold. The CERSPA sets out two different methods for calculating volume; fixed volumes and percentages<sup>15</sup> and four different methods for

establishing the unit price for each CER: fixed price, simple indexed price, a combination of an indexed price and a fixed price, and an indexed price with a floor and ceiling.<sup>16</sup> These methods are explained in turn in the Guidance Document:

- *Fixed price.* The simplest approach included in the CERSPA is a fixed unit price for each CER, which will remain in effect for the term of the agreement. This approach provides certainty to both parties. The default language does not explicitly take inflation or market fluctuations into account. However, these could be taken into account when the parties negotiate the fixed price, or inflation can also be taken into account by stipulating that the unit price will automatically increase by a certain percentage each year.
- *Indexed price.* An indexed price refers to a spot market price to calculate the unit price. The spot market price can either refer to CERs or, more likely, to other publicly traded emission rights, such as the spot allowance price in the EU. As a result of this approach the unit price will fluctuate and change with each annual payment. Such a calculation method entails opportunity and risk for both the seller and buyer, depending on how the reference spot market price changes over the term of the agreement. However, using a simple indexed price means that neither the seller nor its banks will be able to calculate the carbon revenue and thus the value of the agreement.
- *Combination of indexed and fixed price.* Combining a mixture of a fixed unit price for each CER and an indexed price guarantees a minimum price and reduces the impact that spot price fluctuations have on the unit price. A combination of an indexed price and a fixed price can also incorporate a ceiling and a floor on the unit price as described below.
- *Indexed price with a floor and ceiling.* Including a floor (ie minimum) and a ceiling (ie maximum) on the unit price protects both the seller and the buyer from larger movements in the spot price and should assist in long-term planning.

An alternative mechanism for determining an indexed unit price is provided in the Guidance Document, which allows for pre-agreed adjustments based on larger movements in the market while still providing a floor and a ceiling price.

The CERSPA sets out two different methods for calculating the spot price; using the spot price immediately

<sup>13</sup> A complete list of participants is included in the CERSPA and Guidance Document, available at <http://www.cerspa.org>.

<sup>14</sup> Article 17 of the Kyoto Protocol creates the possibility of emissions trading and the rules and modalities for the CDM refer to the 'transfer' of CERs between CDM participants.

<sup>15</sup> See Certified Emission Reductions Sale and Purchase Agreement version 1.0, clause 3.01 'Sale and Purchase', available at <http://www.cerspa.org>.

<sup>16</sup> *ibid* clause 3.02 'Price and Payment'.

prior to delivery or by taking an average spot price over a longer time period.<sup>17</sup> Using the spot price two business days prior to delivery as a reference price will ensure up to date prices are used but can expose the parties to short-term market fluctuations. Using the spot price for CERs over the last 12 months prior to delivery will reduce the risk of being exposed to temporary or short-term market fluctuations prior to delivery, but as a result may not accurately reflect the latest market position.

The spot price can be calculated with reference to the spot price for CERs, or perhaps another (fungible) unit such as an EU allowance. The CERSPA refers to the price for comparable CERs, but it is also possible to link the spot price of a CER to the spot price of an EU allowance. The CERSPA refers to the 'spot price' as opposed to 'market price'. This is because 'market price' could be read to mean market price for comparable CERs sold under a forward contract, whereas 'spot price' clearly refers to the price of a CER after it has been issued.

### 3.2 Delivery

Delivery of CERs contains two elements: when and where delivery occurs. The CERSPA leaves open when delivery is to occur. Most contracts contain annual delivery obligations but shorter or longer time periods are also possible under the CDM rules. Compliance with the EU Emissions Trading Scheme commitments are currently assessed on 30 April each year, so most EU buyers request delivery early in the year. However, if the date is set too early (for example January), it may not leave enough time to get the CERs generated in December verified, issued and then delivered to the buyer. This is particularly relevant if the seller commits to deliver all CERs generated each calendar year or all the CERs generated before 1 January 2013.

Determining where delivery is to occur is principally influenced by how 'delivery' is defined. Whether or not the buyer is listed as a project participant who has communication rights with the Executive Board can also affect where and how CERs are delivered. In the CERSPA, delivery is defined as the receipt of CERs into a registry account nominated by the buyer. However, this is qualified in that it deems delivery to have occurred if the buyer does not have a registry account that can accept the CERs or fails to nominate an account.

The Guidance Document discusses additional ways of mitigating delivery and payment risk through using an

escrow agent. Two different methods of using an escrow agent are drafted and discussed.

### 3.3 Communication with the Executive Board

Entities listed as project participants in the project design document have the right to communicate with the Executive Board on a number of project related issues, including where to distribute the CERs once issued. To realize this right they need to be listed as the focal point for communication with the Executive Board. Issues such as whether the buyer has provided any financing for the project or whether the seller is selling 100 per cent of its CERs to the buyer should be considered when negotiating the communication rights. As default language the CERSPA template language states that the seller has sole communication rights with the Executive Board.<sup>18</sup>

The Guidance Document discusses the other ways in which the parties can communicate with the Executive Board: one party can have sole communication rights for all aspects of the project; the parties can have joint communication for all aspects of the project; one party can have sole communication rights over some aspects of the project with the parties having joint communication rights with respect to others, such as distribution of CERs.

If the parties agree on joint communication, then both the buyer and the seller will need to sign any communication sent to the Executive Board before delivery of CERs can take place. Similarly, if the seller intends to sell some of the CERs to third parties, the seller's ability to deliver CERs to the third party will also depend on the buyer's joint signature of the communications with the Executive Board. The parties should agree to amend the communication rights to remove any rights of the buyer once all of the buyer's CERs have been delivered. Unless the buyer has provided a significant amount of financing for the project or is buying most or all of the CERs generated by the project, it may not be appropriate to grant communication rights to the buyer.

### 3.4 Force majeure

Force majeure events excuse an affected party from performing obligations affected by the force majeure event. The CERSPA definition of force majeure includes two important CDM risks that are beyond the control of either party but may not typically appear in other ERPA: unforeseen CDM Executive Board events and a failure or malfunction of the project which prevents generation of CERs. The first is included because the Executive Board

<sup>17</sup> *ibid* clause 3.02(b).

<sup>18</sup> *ibid* clause 8.01 'Communication with Respect to CERs'.

has at times made unexpected decisions that can have significant adverse impacts on projects and neither party has control or influence over the Executive Board.<sup>19</sup> Failure or malfunction of the project is most important for projects that rely on unpredictable biological processes to generate CERs (such as methane recovery and combustion projects) and renewable energy projects that rely on wind or water to generate CERs.

### 3.5 Events of default and remedies

The defaults and remedies are a key aspect of the agreement, which affect whether or not the agreement becomes an asset to the project developer that can be used to attract debt financing or a liability that has the potential to bankrupt the project developer. The CERSPA aims at minimizing liability for both parties unless there has been an intentional breach or gross negligence.

The agreement lists a number of standard events of default which are applicable to both parties. These events include:

- material breach of the agreement
- misrepresentation
- insolvency and bankruptcy.

'Payment failure' is an additional event of default by the buyer, and 'delivery failure' is an additional event of default on the part of the seller.

The buyer's and seller's remedies are split into two types: remedies for regular events of default, and stricter remedies for defaults caused by intentional breach or gross negligence. The main remedy in case of a regular event of default is the right to terminate the agreement. In case of an intentional breach or gross negligence, the affected party can claim damages.

Stricter remedies for delivery failures and payment failures are often considered by parties even if the delivery shortfall is not caused by intentional breach or gross negligence. These tend to include obligations to deliver replacement CERs or pay damages if there is a delivery failure. The risks and potential benefit of these remedies to each party need to be considered as they increase the risks for the seller which should be reflected in a higher unit

price. Lower delivery default amounts (minimum annual CERs to be delivered) and cumulative delivery defaults can also be considered. In return it is not unreasonable for the seller to expect stricter remedies for payment failures. These could include payment of damages pegged against the market price. However, if the unit price is also calculated in reference to a market price, the value of this type of remedy for the seller is limited to when a floor price is also used. Both parties need to assess the potential benefits gained by having stricter remedies in light of time and costs of enforcement.

## 4. Conclusion

The first few years of the carbon market were dominated by government and institutional CER buyers. However, the last two years have seen the carbon market boom with a significant increase in private entities participating in the market. Point Carbon's 2007 report on the carbon market<sup>20</sup> reports that the total carbon market in 2006 was valued at €22.5 billion, €3.9 billion of which came from the CDM. This increase has been driven by new funds and purchase programs that have appeared within Europe, Japan and, to a lesser extent, in North America.

The increased demand for emission reductions within industrialized countries creates a significant opportunity to support climate friendly projects in developing countries through the CDM. However, the CDM is a complex process and many of these new project developers are new to the carbon market with limited access to expert legal advice. As a result CER sale and purchase negotiations often tend to be an extremely difficult process for sellers during which the opportunity offered by the CDM can unexpectedly become a liability. The CERSPA initiative drew on the experience of an international group of legal experts working in the field of climate change to develop and explain a new CER sale and purchase agreement template. The CERSPA and Guidance Document aim to reflect the interests of buyers, sellers and financial institutions. It is hoped that the CERSPA and Guidance Document will support project developers during CER negotiations and help them better to understand the risks and opportunities offered by the CDM.

<sup>19</sup> If either party is a government it may have some influence within the Executive Board. However, in these instances there is a clear conflict of interest and a government should not attempt to use its influence for its own benefit. Unfortunately observations of the Executive Board have shown it is not immune to political influence – both self-interested and otherwise.

<sup>20</sup> Point Carbon (2007) 'Carbon 2007 – A new climate for carbon trading' K Roine and H Hasselknippe (eds).