

5.0 contracting carbon



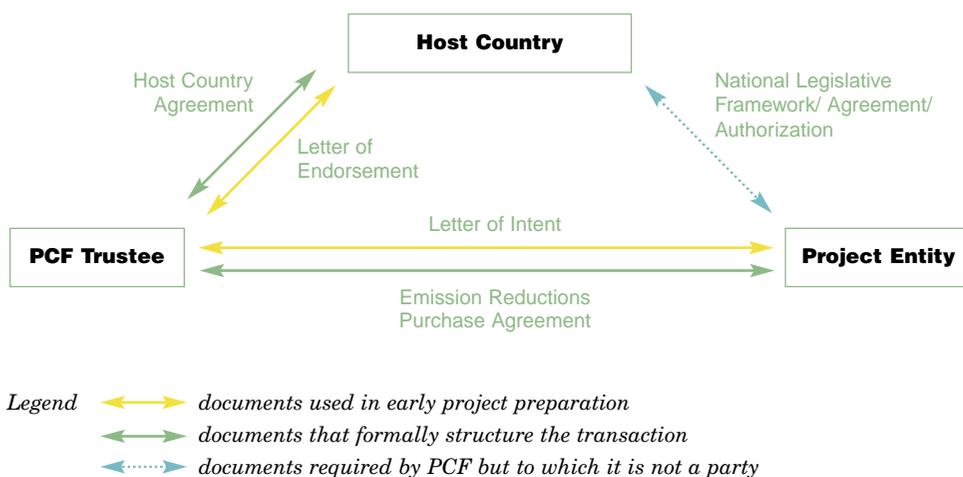
The PCF is negotiating emission reduction purchase transactions before the procedures of the Kyoto mechanisms are finalized. While this provides an opportunity for negotiators and market players to understand how these transactions can work, it also places the PCF in an uncertain legal environment. To accommodate this uncertainty, PCF has developed a set of legal documents for ER purchase transactions. These documents are intended to be sufficiently flexible to adapt to the Kyoto Protocol's future requirements.

EARLY PROJECT PREPARATION

In the early stages of project preparation, parties to the transaction proceed through a series of formal steps (see *Figure 5.1*), including the following:

Letter of Endorsement. In the early stages of PCF's project review, PCF requests a Letter of Endorsement from the host country. With this letter the host country confirms that it endorses further development of the project for the purposes of the Kyoto Protocol and it is willing to provide all necessary assistance in this regard.

Figure 5.1. Legal Documents for PCF Projects



Letter of Intent. After a project is approved by the PCF's Participants Committee, PCF may sign a Letter of Intent with the project sponsor. In this document, the PCF declares its intention to purchase ERs (under terms to be agreed), while the project entity grants PCF an exclusive mandate and agrees to repay project preparation costs if it unilaterally decides not to proceed with the transaction.

STRUCTURING THE TRANSACTION

Several legal documents engage the parties to the transaction (*see Figure 5.1*).

Emission Reductions Purchase Agreement. An ERPA will be signed either by the project entity or the host country, depending on national policies and regulations relating to the ownership and the transfer of emission reductions, and the (IBRD as trustee of the) PCF. The ERPA ensures that the project entity or the host country sells to the PCF all rights, title and interest in all or a part of the emission reductions generated by the project.

The PCF commits to pay the purchase price in exchange for the exclusive right to have an independent third party certify all or a certain amount of emission reductions generated by the project. In this respect, the ERPA resembles a forward contract. The ERPA also includes structural provisions that assign risks to the parties most capable of absorbing them (*see Chapter 3*). Furthermore, the ERPA contains provisions on satisfactory project implementation and requests the maintenance of insurance by the project entity.

The PCF recognizes that the regulatory framework of the UNFCCC and/or the Kyoto Protocol relating to the ownership, holding and transfer of emission reductions is still under development. The PCF therefore seeks to ensure that the ERPA will be structured flexibly enough so as to enable the parties to the agreement to conform with the guidelines, modalities and procedures of the forthcoming regulatory framework.

Host Country Agreement. In addition to the formal project approval, the PCF will seek a commitment from the host country to transfer rights, title and interest in the emission reductions generated by PCF projects to the PCF participants¹, either directly or through a private sector project entity. Such agreement may also contain provisions to make sure that the project entity is able to carry out the project with due diligence and efficiency. To this end, the host country is required to take all necessary action, including the provision of permits and licenses. The host country also undertakes that it will remain in compliance with its relevant obligations under the UNFCCC and the Kyoto Protocol.

In the case of the Latvia Liepaja Solid Waste Management Project, the project entity was a public entity and the ERPA which was signed by the host country included these provisions (*see Web version for details*).

¹ Literally "to or to the order of, the IBRD as trustee of the PCF".



Due to significant interest, the PCF is approaching its limit for transactions involving wind technology. In accordance with the PCF Instrument, no more than approximately 25 percent of the Fund's assets should be put into projects using the same technology.



RISKS MITIGATED THROUGH LEGAL DOCUMENTS

In addition to normal project risks, PCF legal documents try to address specific risks posed by the purchase of emission reductions under the legislative framework of UNFCCC and/or Kyoto Protocol. PCF experience has shown that the lack of expertise in carbon transactions may be a limiting factor in a carbon market. Carbon transactions are a new business and the knowledge and capacity to deal with these transactions may be limited. Carbon transactions cause new interactions between different sectors such as energy, finance, development, and environment. For many legal and administrative experts, PCF emission reductions purchases are their first exposure to this kind of transaction. Further, most countries have yet to put legislative and administrative frameworks in place to regulate the ownership, holding, and transfer of emission reductions. As long as such legislation is not in place, the PCF has to address the issues of regulatory risk and uncertainty in its agreements.

LOOKING AHEAD

PCF is developing new types of legal documents to accommodate new types of transactions, including umbrella host-country agreements covering multiple projects, and agreements with intermediaries who bundle smaller transactions.