CARBON EMISSIONS TRADING UNDER THE KYOTO PROTOCOL AND BEYOND CAN MEAN OPPORTUNITY BUT IMPORTANT DUE DILIGENCE AND LEGAL CONSIDERATIONS SHOULD NOT BE OVERLOOKED

The Kyoto Protocol is an international treaty that requires ratifying nations to reduce greenhouse gas emissions in accordance with its terms in an effort to combat global climate change. The United States has not ratified the Kyoto Protocol but many other industrialized nations have and as a result they must meet certain target reductions within certain specified time periods. Importantly, the Kyoto Protocol contains mechanisms that allow industrialized nations to meet their emissions reduction targets, at least in part, by purchasing emission reductions achieved in less industrialized countries. This client alert focuses on the Kyoto Protocol's "Clean Development Mechanism" or "CDM," which encourages investments in carbon emission reduction projects by enabling participants to have the emission reductions that result from the projects approved on a per ton basis as certified emission reductions ("CERs"). CERs are analogous to stock certificates and can be sold, although at this juncture their liquidity and pricing are uncertain.

The CDM mechanism is relatively new, having been made formally available only after the Kyoto Protocol entered into force in 2005, and is growing in its application since thousands of companies are subject to mandatory emission reductions. Moreover, with growing demand for climate change legislation in the United States, many companies are planning ahead for projects that may reduce emissions of carbon dioxide and other greenhouse gases and can learn from the lessons of CDM and other trading mechanisms provided under the Kyoto Protocol.

The CDM entails completing a project in an eligible host country that results in carbon emissions reductions which, but for the project, would not otherwise have occurred. Projects can be initiated by any of a number of entities including, for example, governmental and nongovernmental entities, financial institutions, and private sector companies. The projects can involve a myriad of undertakings, including measures to increase energy efficiency, methane recovery (particularly applicable to landfills, coal mines, pipelines, sewage treatment, and agriculture), industrial process changes, energy cogeneration, and land use dedicated to enhancing greenhouse gas reductions.

To create CERs, certain steps set out in the Kyoto Protocol must be followed. Once the emissions reductions have been approved by a United Nations body, known as the CDM Executive Board, the CERs can be traded and used to offset carbon emissions in various other countries.

There are two phases to the process leading up to CER approval: (1) the project design or validation phase; and (2) the operational or verification phase. Validation requires an assessment of whether the project, if implemented, will fulfill the CDM criteria and generate tradable CERs, as well as obtaining approval from the host country. Upon successful validation, the

CDM Executive Board registers the project. Verification is a periodic review to determine the actual emission reductions of the CDM project. Validation and verification must be performed in accordance with certain specified procedures and by a third-party designated operational entity ("DOE") that has been accredited by the CDM Executive Board. Under most circumstances, two different DOEs are required, one for each phase. Public comment periods are required during each phase. After successful verification, the DOE determines and certifies the emission reduction and forwards the information to the CDM Executive Board for issuance of the CER documentation.

CDM projects are attractive because they enable potentially worthwhile capital-intensive projects to be financed based in part on a newly created future income stream. The relative newness of the CDM mechanism, the scale and complexity of some of the projects, and regulatory, political, and market uncertainties make CDM projects riskier than more traditional project finance projects. As such, from the perspective of the entity that will be responsible for the project, appropriate attention to due diligence and risk mitigation techniques is warranted throughout the process.

Due diligence efforts would include assessments of the legal and practical feasibility of the project as conceptualized. Due diligence begins with an assessment of whether: (a) the host country is a party to the Kyoto Protocol; (b) the host country has designated a domestic national authority for approving CDM projects; (c) the CERs would be subject to taxes and/or financial products regulations; (d) the project would be required by, or subject to, regulation; (e) changes in law are reasonably anticipated; and (f) contractual provisions with the various participants in the project would be enforceable. Due diligence would also include a preliminary assessment of whether: (a) the project would meet CDM criteria; (b) the project is feasible; (c) the advantages of the project (in terms of time, cost, safety and other factors) outweigh the disadvantages; and (d) the project would meet the criteria, if any, of the potential CER purchasers.

Risk mitigation would include ensuring that the contracts with various participants contain adequate protection against identified risks and/or obtaining insurance where feasible against these risks. Potential risks associated with CDM projects include: (a) inadequate validation; (b) delays or cost overruns; (c) failure to obtain host country approval; (d) changes in law; (e) force majeure; (f) errors or omissions in the verification; (g) shortfall in the CERs generated; (h) taxes and administrative expenses; (i) title to the project; (j) title to the CERs; (k) point of title transfer; (l) price of CERs; and (m) liquidity of the market for CERs. Some of these risks can be addressed in the project contracts, for example, by including certain conditions precedent to a party's obligations, indemnities, and recourse in the event of default. Importantly, insurance products are emerging into the CDM marketplace that can help mitigate some of the risks as well as add value to the CERs where the risks have been mitigated by insurance. Coverage can be aimed specifically at Kyoto-type risks, e.g., failure or delay in CER approval or shortfalls in CERs resulting from the CDM project, as well as non-Kyoto-risks such as business interruption and political risks. Availability of insurance can depend on the size of the project and other factors. Where insurance is available, there can be opportunities to customize coverage to suit the particular project and appurtenant risks.

CDM projects can be a point of controversy where the emissions reductions at issue are not believed by environmental groups to be a fair offset for emissions deemed to be more egregious. At the same time, CDM projects can be a win-win situation for the participants and for the environment. One of the keys to a successful CDM project in any event will be careful and thoughtful due diligence and risk allocation.

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