Carbon Contracting – risk allocation, structuring, pricing and POAs

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Summary

- Key Risk Allocation
- Transaction Structure and Pricing
- Programme of Activities – Unique Risks to POA
Risk Allocation

- Emission Reductions Purchase Agreement (ERPAs) – market standard agreement between primary Sellers (project owners) and Buyers.

- Three Key Risks: (1) Project Performance
  - (2) CDM Process Risk
  - (3) Regulatory/Demand Risk

- Who bears what risks (Buyer or Seller) in the ERPA will determine the transaction structure and CER pricing (i.e., generally, the more risk that the Seller bears, the higher the price paid per CER and flexibility of payment terms).

Project Performance and CDM Process Risk

- Project Performance: Important to remember that a CDM Project is simply an additional layer of an underlying project (i.e., a wind farm, landfill gas project, etc). Without a successfully performing underlying project, emission reductions will not be generated. In general, Buyers will have no control over such underlying project and so Sellers will bear the risk of project performance. There are many associated project risks (i.e., lack of wind, under-delivery of waste or lack of financing) that the Seller must consider. Buyers will want to gain comfort that the underlying project is functioning properly and contingencies are in place.

- CDM Process Risk: Preparation of PDDs, Registration, Monitoring, Verification and Issuance. Who controls these processes? Different for different transactions. Generally, primary Sellers will bear this risk and contract out to CDM Consultants.

- Also known as “Risk of Under-Delivery”: Generally, ERPAs will include a CER delivery schedule. If the Seller fails to meet the CER schedule for any reason then the project under-delivers. Guaranteed or non-Guaranteed delivery? What are the consequences for under-Delivery? Different for different transactions.
Regulatory Risk

– General “Kyoto risk” (i.e., beak-down of the UNFCCC framework)

– **Compliance/Eligibility Risk**: Key risk: The risk that the project CERs will not be able to be used by in a particular jurisdiction for compliance under a particular scheme (i.e., EU ETS).

– This is really the **demand risk**: i.e., as an Intermediary/Buyer – how to cover off the risk that the jurisdiction I want to sell the credits into changes the rules.

– Emergence of market-standard “Escape Clauses” – largely to protect Buyers.

Regulatory Risk (A) Examples

– General “Kyoto risk”: Clause Examples:

  – “**CDM ceases to operate as contemplated under the International Rules**.”

  – “**The Host Country withdraws from the UNFCCC, Kyoto Protocol or refuses to sign, ratify or adopt a successor or supplementary international agreement**.”
Regulatory Risk (B) Examples

- **(B) Compliance/Eligibility Risk**: Key risk: The risk that the project CERs will not be able to be used by liable entities in a particular jurisdiction for compliance under a particular scheme (i.e., EU, Australia, NZ and Korea ETS).
- This is really the **demand risk**: i.e., as an Intermediary/Buyer – how to cover off the risk that the jurisdiction I want to sell the credits into changes the rules. Very relevant for Australia which is subject to a range of qualitative and quantitative criteria (and political uncertainty)!
- “**Project must be Registered by 31 December 2012**” (CP for participants in the EU ETS)
- “**The CERs generated by the Project are no longer eligible for compliance use in the EU ETS on a 1:1 basis with an EUA**” (escape clause for participants in the EU ETS)
- “**The issued CERs may not be surrendered to the Regulator to meet compliance obligations under the Australian Clean Energy Act**” (escape clause for participants in Australia’s future ETS)
- Similar clauses can be adapted to cover off particular risks relevant for the particular domestic ETS
- Australia (50% International Credits from 2015 – Qualitative restrictions and Floor price)

Regulatory Risk (C) Examples

- **(C) Discretionary Options**: Aside from “traditional” escape clauses, starting to see the emergence of discretionary Call Options and/or unilateral termination rights for any reason
  
  “**Buyer has the right, but not the obligation, to terminate its purchasing obligations in respect of future issuances**” (or blend of small guaranteed volumes coupled with a Call Option over remaining CERs). Much depends on timing of payment.

- **(D) Alternative Standard Options**: Also seeing the emergence of “alternative standard options” – also designed to maximize Buyer revenue.
  
  “**Buyer has the right to require the Seller to register the project under an alternative GHG offset scheme and to purchase the relevant offset credits issued under that scheme**” (such as the VCS)
  
  “**If the Host Country implements a domestic ETS to which the project is allocated allowances, the Seller is obliged to procure the delivery of such allowance to the Buyer**…”
Transaction Structuring

- Timing of payment (i.e., advance payment or following delivery: *who bears what key risks (as described above) will impact on the unit price paid per CER*).

- **Pay-in-Advance** or **Pay-on-Delivery**: In developing a CDM Project, Sellers should consider how the Project will be financed. If CER sale revenue is required to implement the Project (i.e., Seller requires a PIA structure) then Sellers must be prepared to bear Project Performance and CER Process Risk. Must make their Project “bankable”.

- Role of the **Focal Point**

CER Pricing (1)

- Typically - CER prices may be *fixed or floating* – affects price risk exposure
- Fixed prices:
  - protects buyer from price spikes and seller from price drops;
  - precludes capture of favourable market movements
- Floating prices:
  - mitigates exposure to market volatility
  - enable partial capturing of favourable market movements
  - may be pegged to market price
- *Price formula may also provide for sharing of “upside”*
- *Actual implementation costs (i.e., CFL projects), plus a margin.*
CER Pricing (2) – Key issues in floating price

- Key issues in using floating pricing:
  - Exchange selection (ECX or Bluenext)
  - Floor/ceiling? (Eg minimum and maximum)
  - Rolling average (mean of closing prices over the 5 BDs following Delivery)
  - **No liquidity - Fall back where no operational market** (3 independent brokers, reasonable estimate)

What makes programmatic CDM different?

- An overarching (voluntary or mandatory) GHG Reduction policy, measure or stated goal (the POA) – i.e., small-scale renewable, CFL distribution.
- POA is Registered once – together with one Validated CDM Programme of Activities (the CPA).
- Structure – usually a portfolio of unique and separate CPA project activities rather than one. Each “Validated” by a DOE and then included in the POA.
- Enhanced scaleability and flexibility:
  - can add any number of new activities after registration
  - lower transaction costs; faster development
  - part of EB's Registration role in essence outsourced to DOEs
  - Reduced CDM process/Registration risk
  - Can be developed across multiple countries
- Coordinating/Managing Entity – develops/runs project
- Design Documents – not one PDD but 3+x "Design Documents"
- But otherwise, same general CDM principles apply – additionality, processes of Validation and Verification
Programmatic CDM – Key risks

- In addition to usual CDM process and Project performance and Delivery Risk (Guaranteed or non-Guaranteed Volumes): Unique POA risks, include:

- **Control of CERs**: Buyer cannot be sole Focal Point unless it is the Coordinating/Managing Entity

- **Title to CERs**:  
  - CPA-PEs, consultants or other involved entities could all seek to claim title – extra layer of title risk

- **CPA-PEs**:  
  - particularly their compliance with CDM-POA-DD and CDM-POA-CPAs

- **Project roll-out risk**:  
  - financing; CPA PEs may require financing to roll out  
  - deployment and monitoring systems important

Thank you