

# Stay Current.

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## Entry into Force of Kyoto Protocol Provides New Incentives for Cross-border Investment

by Charles A. Patrizia and Darin Bifani

Following official ratification by Russia on November 18, 2004, the Kyoto Protocol to the United Nations Framework on Climate Change (the Protocol; the United Nations Framework on Climate Change, the Convention) entered into force on February 16, 2005. The Protocol requires the countries listed on Annex I to the Convention to reduce their respective emission levels of specified greenhouse gases to the levels set forth on Annex B to the Protocol by 2012.<sup>1</sup> To assist Annex I countries in complying with their emission reduction obligations, the Protocol establishes various “flexible mechanisms.”

One of the most potentially significant flexible mechanisms is the clean development mechanism (CDM). Under the CDM, if an Annex I country invests in a qualifying project in a non-Annex I country which achieves certified greenhouse gas (GHG) emission reductions, the Annex I country, depending on the terms and conditions of the investment, may receive all or a portion of the resulting “certified emission reduction units” (CERs) and use those CERs to satisfy its GHG emission reduction obligations.

In addition to the firm’s non-US clients that may either consider investing in or seek investment for CDM projects, the entry of the Protocol into force is also likely to be of interest to the firm’s US clients. Even though the United States is not a signatory to the Protocol, and accordingly is not required by that instrument to reduce its GHG emissions, US companies have foreign direct investment in sectors in non-Annex I countries that fall into the ambit of CDM, such as the mining sector, and will likely be actively considering the potential for utilizing the CDM to either reduce project financing or operating costs or capture CER sale revenue streams to boost overall project financial performance. The entry of the Protocol into force will also likely be of strong interest to the firm’s financial clients that are looking to play a role in what is expected, over time, to become a multi-billion dollar market in the structuring, issuance and trade of instruments

representing emission reductions that can be used to satisfy Annex I country emissions reduction obligations.

### The Protocol and Flexible Mechanisms

Under the Protocol, Annex I countries must reduce their emissions of six GHGs<sup>2</sup> to a specified percentage of their respective GHG emission levels in 1990 during the commitment period from 2008-2012.<sup>3</sup> In order to assist Annex I countries to meet their GHG emissions reductions obligations, the Protocol establishes four flexible mechanisms: (i) CDM; (ii) joint implementation; (iii) emissions trading and (iv) joint action.

The following is a brief summary of each of these mechanisms:

- (i) **CDM.** The purpose of CDM is to assist Annex I countries to meet their reduction targets and also promote “sustainable development” in non-Annex I countries.<sup>4</sup> By investing in qualifying projects in non-Annex I countries, Annex I country investors are eligible to receive CERs which they may apply to meet their emissions reduction obligations. The number of CERs which are issued to an investing Annex I country in connection with a specific investment is determined by the number of CERs generated by the project and the agreement between the Annex I investor and the project participants.
- (ii) **Joint Implementation.** Joint implementation, like CDM, also ties Annex I country investment to emission reduction units. However, joint implementation permits Annex I countries to meet their emission reduction obligations by investing in and receiving emission reduction units generated from projects in other Annex I countries.<sup>5</sup> Unlike CDM projects, there is no requirement in a joint implementation project that the project promote “sustainable development.”

- (iii) **Emissions Trading.** Emissions trading is only vaguely defined in the Protocol. Article 17 of the Protocol provides that the “Parties included in Annex B may participate in emissions trading for the purposes of fulfilling their commitments under Article 3.” The rules governing emissions trading are to be defined by the Conference of the Parties. Article 17 also provides that emissions trading “shall be supplemental to domestic actions for the purpose of meeting quantified emissions limitation and reduction commitments under [Article 3].”
- (iv) **Joint Action.** Under Article 4 (1) of the Protocol, two Annex I countries may agree to achieve their reduction targets jointly, provided that their aggregate emission levels do not exceed the combined amount of their respective permitted emission levels set forth in Annex B to the Protocol.

## Practical Overview of the CDM

While each of the flexible mechanisms has the potential to play a significant role in the emissions reductions efforts of Annex I countries, given the tremendous amount of investment by Annex I countries in projects in non-Annex I countries that potentially impact GHG emissions, the CDM may have the greatest potential to affect cross-border investment structuring and financing. The following is a brief overview of how the CDM works.

### (a) Project Design

In order for a project to generate CERs, the project developer must first prepare a Project Development Document (the “PDD”). The PDD contains various information about the project, including: (i) a general description of project activity; (ii) application of a baseline methodology; (iii) duration of the project activity/crediting period; (iv) application of a monitoring methodology and plan; (v) estimation of GHG emissions by sources; (vi) environmental impacts and (vii) stakeholder comments. The PDD must also contain various annexes, including: (i) contact information for participants in the project; (ii) information regarding public funding; (iii) baseline information and (iv) monitoring plan.

One of the most critical elements of the PDD is the definition and application of the baseline methodology. Article 12 (5) (c) of the Protocol provides that emissions reductions may only be certified if they “are additional to any that would occur in the absence of the certified project activity.” In order to establish “additionality,” the project sponsor must either use a previously approved “baseline methodology” or must propose a new one and have that methodology be approved by the CDM Executive Board. Once the baseline is established, GHG reductions below the baseline may, subject to meeting all other requirements in the CDM approval process, generate certified CERs.

As noted above, in order to receive CERs a project must contribute to “sustainable development” in the project’s

host country. The PDD must include a written affirmation to this effect by the government of the country hosting the project.

### (b) Validation and Registration

The Project Design Document must be approved by an entity known as a designated operational entity, or DOE. The list of eligible DOEs is maintained by the CDM Executive Board.

The DOE confirms that stakeholder comments were received and taken into consideration and ensures that emissions reductions will occur because of the project, that the baseline and monitoring methodologies set forth in the PDD comply with CDM Executive Board guidelines and that there is written confirmation by the host country that the project will contribute to sustainable development.

After making the PDD available for further comment for an additional 30-day period and taking any comments into consideration, the DOE determines whether or not the project will be validated.

If validated, the PDD is submitted to the CDM Executive Board for approval. If the CDM Executive Board approves the project, the project is formally registered.

### (c) Monitoring

Once implemented, the project must be monitored to track actual GHG emission levels. Monitoring must be done in accordance with the monitoring methodology set forth in the PDD and submitted to the DOE.

### (d) Verification/Certification

If monitoring has been done in accordance with the monitoring methodology set forth in the PDD and there have been GHG reductions for the measured period, the DOE issues a written confirmation of verification and submits a certificate report to the CDM Executive Board.

### (e) Issuance

The certification report of the DOE serves as an official request for the issuance of CERs by the CDM Executive Board. Unless a review is required, the CDM Executive Board issues the CERs.

## Opportunities for United States Investors and Financial Entities

Even though the United States is not a signatory, the entry into force of the Protocol should provide significant opportunities for investment by United States entities. While the Protocol does not specifically address the terms and conditions under which investors from countries that have not signed the Protocol and are not nationals of the non-Annex I country where the investment will occur may participate in CDM projects, the indirect or direct involvement of a US investor in an otherwise qualifying

project and the subsequent sale of CERs to an Annex I country would not violate, and would rather directly further, the two stated requirements of CDM: (i) it would allow the Annex I country to meet its Protocol compliance obligations and (ii) it would contribute to the non-Annex I country's "sustainable development."

It is most likely that, at least in the near term, the terms and conditions of a US investor's participation in a CDM project will be determined, not by the CDM Executive Board, but rather by the country where the investment is to take place, as that country, as noted above, is required to issue a written affirmation that the project will contribute to the country's "sustainable development." While this is an issue that must be addressed on a country-by-country and project-by-project basis, it would not be surprising to find that countries condition approval for projects where non-nationals are participating upon the existence of investment structures that place varying degrees of incentives or disincentives on the non-national to continue to provide administrative, technical or financial support to the project over time.

In addition to project-based investment, United States financial institutions should be able to take advantage of the growing market for CERs and other instruments representing GHG emission reductions in a number of different ways. Given both the expertise and global reach of United States financial institutions, they should have significant opportunities to assist both project developers and CER and other carbon instrument purchasers in a number of activities, including structuring the issuance, pricing and placement of carbon bonds, the design of

derivative instruments and the development of new trading markets.

## Conclusion

Despite technical, legal and financial uncertainties, the entry into force of the Protocol will undoubtedly add new momentum to the nascent carbon credit trading markets and push companies and financiers alike to consider trying to capture CERs to both lessen financing costs and increase project returns. Even at this early stage, the Protocol and the CDM appear to provide significant investment opportunities for both United States and non-United States entities in a number of cross-border contexts.

*For further information on this issues discussed in this alert, please contact any of the following Paul Hastings attorneys:*

### In Washington, DC

Charles A. Patrizia (202) 551-1710  
charlespatrizia@paulhastings.com

### In Tokyo

Darin Bifani (81-3) 6229-6015  
darinbifani@paulhastings.com

### In Los Angeles

Dino E. Barajas (213) 683-6130  
dinobarajas@paulhastings.com

## Notes

1. Article 3 (1) of the Protocol provides: "The Parties included in Annex I shall, individually or jointly, ensure that their aggregate anthropogenic carbon dioxide equivalent emissions of the greenhouse gases listed in Annex A do not exceed their assigned amounts, calculated pursuant to their quantified emission limitation and reduction commitments inscribed in Annex B and in accordance with the provisions of this Article, with a view to reducing their overall emissions of such gases by at least 5 per cent below 1990 levels in the commitment period 2008 to 2012."
2. The GHGs are carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride.
3. The emissions limitations for each Annex B country are set forth on Annex B to the Protocol.
4. Article 12 of the Protocol provides: "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 to assist Parties included in Annex I in achieving compliance with their quantified emission limitation and reduction commitments under Article 3."
5. Article 6 of the Protocol provides: "For the purpose of meeting its commitments under Article 3, any Party included in Annex I may transfer to, or acquire from, any other such Party emission reduction units resulting from projects aimed at reducing anthropogenic emissions by sources or enhancing anthropogenic removals by sinks of greenhouse gases in any sector of the economy, provided that: (a) Any such project has the approval of the Parties involved; (b) Any such project provides a reduction in emissions by sources, or an enhancement of removals by sinks, that is additional to any that would otherwise occur; (c) It does not acquire any emission reduction units if it is not in compliance with its obligations under Articles 5 and 7; and (d) The acquisition of emission reduction units shall be supplemental to domestic actions for the purposes of meeting commitments under Article 3."

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