JI and GIS:
ERUs vs. Greened AAUs?
A Legal Perspective

Presentation at Project SKPI Workshop

“Opportunities for Programmatic Approach in Joint Implementation and Perspectives for Post-2012 Joint Implementation”

Kiev, Ukraine
11 September 2009

Dr. Bernd Beckmann
Attorney
Hogan & Hartson
Berlin/London
Presentation Overview

- Introduction to project team member Hogan & Hartson
- JI and IET: Background, Facts, Differences
- Green Investment Schemes
- JI ERPA and AAU-PA overview
- Structure of AAU/GIS transactions
- Demand side: Who could buy?
Introduction to Hogan & Hartson

- Hogan & Hartson is a **global law firm** with offices all over the world and over 1,100 lawyers.

- Hogan & Hartson is **part of the implementation team** for the project “Support to Kyoto Protocol Implementation (SKPI)”, funded by the European Union, together with **ICF and TÜV Rheinland**.

- Hogan & Hartson has a preeminent **Clean Energy and Climate Change Practice** with global reach. Experience in field of Kyoto Protocol implementation/CDM/JI includes:
  - Role as **carbon manager** for MCCF, a multilateral carbon credit fund (approx. 165 Mio. € first commitment) for EBRD/EIB, in a consortium with ICF.
  - Advise to the **Russian Federation** in the implementation of Kyoto Protocol, especially on registry and inventory issues (EU TACIS project), in a consortium with ICF.
  - Advise with regard to numerous CDM and JI projects and AAU trades, including the representation of private clients in the **contractual acquisition** and divestiture of CERs, ERUs and AAUs with a fair market value of over $600 million.
JI and IET
Background: Kyoto Protocol Project Mechanisms

- Under the **Kyoto Protocol (KP)** Annex 1 Parties (industrialized countries) are required to reduce their GHG emissions by an average of 5% below their 1990 levels by the end of the Kyoto trading period 2008 to 2012.

- Kyoto Protocol provides **three flexible mechanisms:**
  - **Joint Implementation (JI):** Annex 1 countries or legal entities from such countries implement emission reduction projects in other Annex 1 countries to generate Emission Reduction Units (ERUs)
  - **Clean Development Mechanism (CDM):** Annex 1 countries or legal entities from such countries get involved in emission reduction projects in non-Annex 1 countries to generate Certified Emission Reductions (CERs)
  - **International Emission Trading (IET):** allows sale and purchase of Assigned Amount Units (AAUs), Removal Units (RMUs), CERs and ERUs between Annex 1 countries; AAU transactions are usually accompanied by a Green Investment Scheme (GIS)

- Future of mechanisms depends on post-2012 negotiations, but **CDM does not automatically stop after 2012**, even if negotiations fail.
International Emissions Trading (IET) 
Basic Facts

• **IET** is the only KP flexible mechanism without a required connection to a specific project – **can be less bureaucratic than JI**, attractive for both seller and buyer side

• IET activity has **just recently picked up** (in 2008 only 8 mio. AAUs in GIS transactions!)

• Although Article 17 KP seems to imply that trading takes place only between states, **private entity participation is possible after authorization** (see para. 5 of the Annex to Decision 11/CPM.1)

• If country **allows** private entities to hold AAUs in its national registry account, this qualifies as **authorization**

• AAU trades are conducted through **AAU purchase agreements (AAU-PAs)**

• AAUs can be **delivered immediately** (different from primary ERUS) – can be **interesting alternative to JI** projects!
IET and Green Investment Schemes
Basic Facts

- AAU can be sold **without any obligation** to reduce GHG emissions, as long as seller keeps enough AAUs to meet compliance goals

- **KP** regulations **require no “greening”** for IET – hence no **legal** requirement to do so

- However, **political reasons** (public opinion, credibility etc.) make greening in fact necessary, especially for the buyer side (**no purchase of cheap “hot air”** to meet compliance goals, but meaningful contribution to GHG reductions)

- Greening of AAUs is secured by **Green Investment Schemes (GIS)** which can be **agreed on by the parties** of the AAU transaction

- Countries can regulate GIS by national legislation, but GIS can also be **designed specifically** between AAU transaction parties in AAU-PA
## JI and IET
### Main Differences

<table>
<thead>
<tr>
<th>JI</th>
<th>IET (with GIS component)</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Transfer of carbon credits between Annex 1 countries after conversion of AAUs to ERUs</em></td>
<td><em>Direct transfer of AAUs between Annex 1 countries</em></td>
</tr>
<tr>
<td>Predominately <em>private</em> entities on seller and buyer side (which have been authorized by Annex 1 countries)</td>
<td>Predominately <em>sovereign</em> sellers and buyers, but private entity participation possible</td>
</tr>
<tr>
<td><em>GHG reduction</em> through JI project <em>required by KP regulations</em> and confirmed through verification procedures (Track 1 or Track 2)</td>
<td><em>GHG reductions are not directly part of IET</em></td>
</tr>
<tr>
<td><em>Not at free disposal</em> of JI project participants!</td>
<td><em>GHG reduction requirement</em> can be introduced through <em>voluntary</em> commitment of IET parties through <em>Green Investment Scheme (GIS)</em></td>
</tr>
<tr>
<td>ERUs can only be <em>transferred after</em> they have be “<em>produced</em>” (= conversion has taken place)</td>
<td>AAUs can immediately be <em>transferred at any time</em> (= no need for prepayment, sureties etc.!)</td>
</tr>
</tbody>
</table>
Green Investment Schemes
Important Features

Green Investment Schemes can cover **wide range of features**:

- **Most important feature**: The **payments** for the AAUs **must be used in a certain way** by the (primary) seller according to a **greening plan**

- **Greening plan specifies spending** of funds, e.g. for
  - Projects that lead to **GHG reductions** (e.g. energy efficiency)
  - Education and capacity building
  - Other projects beneficial for environment (pollution reduction etc.)

- **Role of buyer** and seller in greening process must be **defined** (e.g. in project selection, review of tenders, state aid issues etc.)

- **Hard** and **soft** greening

- **Additionality** (additional benefits through GIS compared to business as usual, similar to CDM and JI)

- **Greening ratio** (GHG reductions achieved through GIS in relation to AAU volume – up to 1:1 like for a JI project!)
<table>
<thead>
<tr>
<th>JI ERPA (Primary Purchase)</th>
<th>AAU-PA (with GIS component)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale and purchase of ERUs after they have been “produced” (=converted) through JI project cycle</td>
<td>Sale and purchase of AAUs which can be transferred immediately</td>
</tr>
<tr>
<td>Regulatory requirements for JI projects outside the ERPA (KP regulations)</td>
<td>AAU transfer is not <em>per se</em> connected to a specific project and GHG reductions.</td>
</tr>
<tr>
<td>As ERUs are necessarily connected to specific JI project, ERPA i.a. deals with project risks:</td>
<td>AAU purchase agreement (AAU-PA) will stipulate greening requirements, e.g.</td>
</tr>
<tr>
<td>- Technical risks</td>
<td>- Purposes for which money can be spent</td>
</tr>
<tr>
<td>- Regulatory risks (depending on Track 1 or Track 2)</td>
<td>- Role of parties in greening process</td>
</tr>
<tr>
<td>- Delivery risks etc.</td>
<td>- “Additionality”</td>
</tr>
<tr>
<td>Mostly use of <strong>standard agreements</strong> similar to CDM ERPAs</td>
<td>- Greening ratio</td>
</tr>
<tr>
<td></td>
<td>- Role of <strong>third parties</strong> (escrow agent, custodian, greening agent)</td>
</tr>
<tr>
<td></td>
<td>Almost <strong>no standard agreements</strong> yet (but: EBRD form agreement has just been developed)</td>
</tr>
</tbody>
</table>
AAU Purchase
Basic Structure

- In the most basic AAU transaction structure, **no third parties** are involved
- Seller transfers AAUs to designated account in buyer's national registry
- Transfer of payments and/or AAUs can either be made immediately or be **tied to certain greening targets**
- Problem: **No security** for either side that they will receive full amount of AAUs / full payment
AAU Purchase
Involvement of Escrow Agent

- In the interest of seller and buyer, it can be advisable to involve an escrow agent (usually a commercial bank) to hold the payment amounts.
- Payment amounts can then be disbursed according to greening targets.
- This gives seller security that he will receive payments if greening takes place.
AAU Purchase
Involvement of Escrow Agent and Custodian

• In addition to the escrow agent, a **custodian** can be used to **hold the AAUs** before greening has taken place.

• This provides for security for the seller that **buyer does not receive AAUs before** according **payments** are made.

• **Custodian and escrow agent** are often **identical** (commercial bank).
AAU Purchase
Involvement of Greening Agent

- In order to support effective **spending of funds in accordance with GIS**, parties can agree on appointing a **Greening Agent**

- Greening Agent **administrates distribution of funds** in coordination with buyer and seller (depending on AAU-PA)
Roles of Greening Agent

- Greening Agent can provide **additional security for buyer** that payments are **spent according to the GIS** and are not misused for other (budgetary) purposes

- Serves as a “**supervisor**” to fund allocation

- Greening Agent could be either a **national** entity in seller country (e.g. a certain authority) or an **international** entity

- Can coordinate tenders for projects etc.

- Greening Agent can provide for an “**integrated view**” regarding greening if various national entities are responsible for parts of the greening program
JI and IET
Market Demand for ERU and AAU Purchases

- **ERU demand:**
  - Until recently, most ERUs were purchased for European Union Emission Trading Scheme (EU ETS) compliance: CERs/ERUs can be used for compliance under installation-based EU ETS as an “alternative currency”
  - **Sovereign compliance buyers** (purchases by KP Annex 1 states to meet their KP compliance obligations in 2008-2012) become increasingly important

- **AAU demand:**
  - **No EU ETS buyers**, but other private compliance buyers, e.g. Japanese companies, and other private investors
  - Some potential KP compliance buyers have committed themselves not to use AAUs, but still **currently solid demand** from this buyer group

- **Post-2012 demand** structure for both ERUs and AAUs will depend on **outcome of Copenhagen** negotiations
## Background

### JI Eligibility Requirements – Track 1 and 2

<table>
<thead>
<tr>
<th>Track 1 (full eligibility requirements)</th>
<th>Track 2 (minimum requirements)</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Host Country is a Party to the KP</td>
<td>- Host Country is a Party to the KP</td>
</tr>
<tr>
<td>- Its assigned amount has been calculated and recorded</td>
<td>- Its assigned amount has been calculated and recorded</td>
</tr>
<tr>
<td>- It has a national registry in place</td>
<td>- It has a national registry in place</td>
</tr>
<tr>
<td>- It has in place a national system for the estimation emissions</td>
<td></td>
</tr>
<tr>
<td>- It has submitted annually the most recent required national inventory of emissions</td>
<td></td>
</tr>
<tr>
<td>- It has submitted supplementary information on its assigned amount and has made the accurate additions to, and subtractions from, its assigned amount</td>
<td></td>
</tr>
</tbody>
</table>
Background
JI Project Cycle Track 2

<table>
<thead>
<tr>
<th>Project Idea Note</th>
<th>Project Design Document</th>
<th>Letter of Approval</th>
<th>Validation</th>
</tr>
</thead>
<tbody>
<tr>
<td>By Project Participants</td>
<td>Completed by Project Participants as required by JISC</td>
<td>Issued by the Host and Investor Country</td>
<td>By Accredited Independent Entity (AIE)</td>
</tr>
<tr>
<td>No legal requirement</td>
<td></td>
<td></td>
<td>- AIEs are accredited by JISC</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- Validation is made publicly available</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Issuance ERUs</th>
<th>Review</th>
<th>Verification</th>
<th>Monitoring</th>
<th>Review</th>
</tr>
</thead>
<tbody>
<tr>
<td>by Host Country</td>
<td>by JISC</td>
<td>by AIE</td>
<td>by Project Participants</td>
<td>by JISC</td>
</tr>
<tr>
<td>(ERUs are transformed AAUs or RMUs of the Host Country)</td>
<td>Only if requested within 15 days</td>
<td>Verification is made publicly available (including a justification)</td>
<td>Monitoring Reports are to be submitted to AIE</td>
<td>Only if requested within 45 days of the publication of the Validation</td>
</tr>
</tbody>
</table>
CONTACT:

Dr. Bernd Beckmann
bbeckmann@hhlaw.com