Negotiating Emission Reduction Purchase Agreements

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Presentation Structure

– Delivery Obligations
– Prices and Payment
– Default and Remedies
– Dispute Resolution

Delivery Obligations

Delivery Obligations

- ERPAs can provide for CERs to be sold either:
  - in fixed volumes with the seller guaranteeing delivery of a certain number of CERs
  - in non-guaranteed volumes, with the buyer buying all or a certain % of CERs from a project such that the volume sold depends on project performance.
- Non-guaranteed delivery is market standard in primary market transactions.
- Also common in secondary market - secondary sales often pass through CERs received in primary purchases.
- Each approach has different risks and benefits for buyers and sellers.

Breach of Delivery Guarantees

– Default for breach of delivery guarantee may be subject to:
  – remedy within a certain period, or make-up at following delivery date;
  – cumulative threshold over multiple delivery dates such that default only arises if threshold breached during term of ERPA;
  – requirement of negligence or intentional breach to be default.

Mitigation of Delivery Risk

- Risk of breach of guaranteed delivery obligations can be mitigated by:
  - guaranteeing only a proportion of CERs to be generated:

    <u>e.g. calculate guaranteed volume as % of PDD volume;</u>
  - using conditions precedent to manage project risks:

    <u>e.g. no delivery obligation unless project commissioned in accordance with specific standards and registered;</u>
  - where possible, pooling CERs from multiple projects to spread risk (e.g. where local developer owns multiple projects):

    <u>e.g. ERPA covers multiple projects with guaranteed volume calculated as % of total CERs expected from all projects</u>

Non-Guaranteed Delivery

- CER volumes sold under primary forward ERPAs often determined by project performance i.e. volume of CERs generated.
- Examples of non-guaranteed delivery provisions:
  - Buyer purchases all CERs from the project:

    <u>The seller shall sell and deliver to the buyer all CERs issued with respect to greenhouse gas reductions achieved by the Project prior to 1 January 2013.</u>

Non-Guaranteed Delivery

- Buyer purchases all CERs from the project, subject to maximum volume:

  The seller shall sell and deliver to the buyer all CERs generated by the Project up to a maximum of 500,000 CERs.

- Buyer purchases % of CERs from the project (remaining % may be sold to other buyer or subject to call option):

  The seller shall sell and deliver to the buyer 60% of the CERs issued with respect to greenhouse gas reductions achieved by the Project prior to 1 January 2013.

Prices and Payment

CER Prices

- CER prices may be fixed or floating – will affect price risk exposure.
- Fixed prices:
  - protects buyer from price spikes and seller from price drops;
  - precludes realisation of benefits from favourable market movements

    e.g. if market price rises above fixed price, seller must sell below market price and cannot capture price increase.
- Fixed prices common in early carbon markets.
- Fixed prices have become less common as markets and players have become more sophisticated.
- Pricing mechanisms often similarly sophisticated.

CER Prices – Floating Prices

- Floating prices:
  - mitigates exposure to market volatility;
  - enable partial capturing of favourable market movements.
- Floating price may be pegged to market price.
- Development of liquid exchange platforms has meant "Market Price" commonly defined by exchange prices:

Default and Remedies

Events of Default

– Parties may include specific events of default in ERPAs.
– Events of defaults most commonly included in ERPAs are:
  – breach of material obligations (e.g. delivery failure by seller, payment failure by buyer);
  – breaches of representations and warranties; and
  – insolvency.
– Parties may allow a "cure period" under an ERPA (limited period in which to rectify the default)
  e.g. where a buyer fails to make payment due to administrative error.
– Intentional breach may be addressed separately.

Damages

- ERPAs often provide for payment of damages following:
  - delivery shortfall where delivery guaranteed;
  - termination due to intentional breach;
  - termination due to event of default regardless of whether intentional (less common).
- Damages may be:
  - liquidated;
  - unliquidated (only in case of termination).

Liquidated Damages

- Liquidated damages:
  - parties agree formula for calculation of damages in ERPA
  - more transparent but potentially limited in scope, as formula may exclude certain heads of loss.
- Liquidated damages often calculated as cost for non-defaulting party to enter into replacement transaction:
  - Seller's Replacement Costs = (ERPA Price – Market Price) x unsold volume due to termination
    <u>Results in positive damages amount where ERPA price above market price</u>

Liquidated Damages

– Buyer’s Replacement Costs = (Market Price – ERPA Price) x unsold volume due to termination
  <u>Results in positive damages amount where ERPA price below market price</u>

Dispute Resolution

Governing Law

- It is more common for ERPAs to be governed by the law of the buyer's jurisdiction
  - Typically driven by buyer's jurisdiction
- Although we do see ERPAs governed by the Host Country law
- Most important to choose governing law seller is comfortable with:
  - in Africa, could be English law or French law
  - many jurisdictions in Africa will be familiar given the inheritance of English common law or French civil law

Dispute Resolution

- ERPA disputes generally resolved through negotiation and arbitration.
- Quicker, simpler and cheaper than litigation.
- ERPA arbitration provisions need to specify:
  - rules governing arbitration e.g. ICC Rules, LCIA Rules, UNCITRAL Rules;
  - location of arbitration (should be a neutral location);
  - language of the arbitration (often English, but should be reasonable for both parties);
  - number of arbitrators (typically one or three arbitrators); and
  - means by which the arbitrator(s) are appointed.

Group Exercise – Role Play

Negotiating a Buyer’s ERPA Term Sheet

1) In groups of 4, assume the role of seller/project developer and review the **ERPA term sheet that you have received from a buyer** (handout) in respect of your CDM project
2) Discuss in your group the **risks and issues** raised by each of the terms as put forward by the buyer
3) Agree in your group on **counter-proposals** that you would put back to the buyer in the negotiation that better protect and reflect the seller’s interests

– Appoint a **rapporteur to report back** to the wider audience

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