

Voluntary Carbon Trades: Issues and Challenges

Mary Anne Sullivan
Partner
June 20, 2008

HOGAN &
HARTSON

© Hogan & Hartson LLP. All rights reserved.

Why Voluntary Trades?

HOGAN &
HARTSON

Chicago Climate Exchange:

- To mitigate risk: financial, operational, reputational
- To reduce GHG emissions
- To prove action on climate to the public, shareholders, rating agencies, customers
- To establish cost effective GHG management systems
- To drive policy based on experience
- To gain recognition as a leader
- To establish a track record in the carbon market

© Hogan & Hartson LLP. All rights reserved.

What do we want in a GHG market?

HOGAN &
HARTSON

Robust markets generally depend on:

- Many participants
- Common demand
- Well understood rules

*Think: toothpaste, stocks, automobiles,
even SO₂ allowances*

*The voluntary carbon market is not, and
probably never will be robust.*

© Hogan & Hartson LLP. All rights reserved.

Market Success Indicators

HOGAN &
HARTSON

APX identifies six market success factors:

- Rigorous measurement, reporting and verification
- Reliable tracking of market activity
- Substantial penalties
- Transparency of market conditions
- Liquid market: banking, borrowing, trading platforms
- Market oversight to prevent manipulation

© Hogan & Hartson LLP. All rights reserved.

**Voluntary market may have none of these
success factors, so don't count on
compliance "credit"**



© Hogan & Hartson LLP. All rights reserved.

What is a voluntary carbon trade or VER?

HOGAN &
HARTSON

- Verified emissions reduction trade, or VERPA: an agreement for the purchase and sale of the GHG reductions resulting from an activity undertaken by another, usually entered into to "offset" direct GHG emissions.
 - It is voluntary in that it is undertaken outside of a legally binding GHG reduction program, such as that established under the Kyoto Protocol.

And in a world without rules, contract is king!

© Hogan & Hartson LLP. All rights reserved.

Key Contract Considerations

HOGAN &
HARTSON

- What is the deal?
 - GHG reductions of a particular vintage?
 - Purchase and sale or retirement of credits?
 - Development of a particular project?
 - If so, is the deal “unit contingent”?
- Who has what responsibilities?
 - Is third-party performance critical?
 - What if the third party fails to perform?
- Should the answers to these or other questions affect payment terms?

© Hogan & Hartson LLP. All rights reserved.

Contract Issues

HOGAN &
HARTSON

- Who is the customer?
 - Tailor the deal to the situation
 - Simple, form transaction for “feel good” trades
 - More rigor to satisfy commitments to particular reductions
 - No standard form fits all situations
- What is the product?
 - Verified GHG reductions, RECs, all environmental attributes?

© Hogan & Hartson LLP. All rights reserved.

• What consequences if change in law?

- For multi-year deal, consider potential effect of GHG legislative mandates

• What measurement, verification and perhaps reporting of GHG reductions is required?

- Lots of accepted verification standards
- Costs and potential compliance value may vary-- although any representations about compliance value should be viewed with skepticism and made with great caution

© Hogan & Hartson LLP. All rights reserved.

• Will the transaction be reported on a registry?

- What requirements/costs does that entail, e.g., is there a baselining duty?

• What non-disclosure obligations apply?

- Different answers for different customers, but seller often insists at least price is confidential

• What dispute resolution terms?

- Disputes happen
- Tailor to margins, amount at risk

© Hogan & Hartson LLP. All rights reserved.

Don't forget standard contract provisions:

- Delivery terms
- Reps and warranties
- Credit terms
- Force majeure (tailor to the deal)
- Measure of damages (remember no liquid market) and limitations on liability
- Default and termination

. . . to name just a few

© Hogan & Hartson LLP. All rights reserved.

What Role for “Additionality”?

HOGAN &
HARTSON

Additionality is at heart of many debates about the value of carbon offsets to climate mitigation efforts.

- The key question stated at its most general level:
 - Would the reduction have occurred in a “business as usual” world, without the incentives associated with a GHG market?
- The Climate Trust breaks additionality down into 3 tests:
 - Regulatory Surplus
 - Implementation Barriers
 - Common Practice

© Hogan & Hartson LLP. All rights reserved.

• Regulatory Surplus:

- Is the project mandated by any existing law or policy?
- For example, is renewable energy generation required to meet a state renewable portfolio requirement?
- If so, it is business as usual, not additional, and does not generate carbon credits.

• Implementation Barriers

- Financial Barriers: Does the project face cost constraints that carbon offset funding will address?
- Technological Barriers: Is the primary purpose or benefit of the project GHG reduction?
 - Efficiency savings **may** defeat additionality
- Institutional Barriers: Are there organizational, social or cultural values that GHG funding will help to overcome?

• Common Practice

- The key question is whether the proposed GHG reduction activity is standard practice for a field or industry.
- May not get the same answer everywhere
- Possible other requirements, e.g., did the project commence before an offset contract was signed?

It is impossible to ignore the subjectivity in many of these tests, and thus the controversy about additionality.

Cautionary concluding notes

- *Carbon trades can be fun and profitable, but there is some snake oil out there.*
 - *Don't let your client end up buying it instead of doing something good for both the environment and the business.*
- *Make sure the investment makes sense.*

For more information on
Hogan & Hartson, please visit us at:
www.hhlaw.com

- Baltimore
- Beijing
- Berlin
- Boulder
- Brussels
- Chicago
- Colorado Springs
- Dallas
- Geneva
- Hong Kong
- London
- Los Angeles
- Miami
- Moscow
- Munich
- New York
- Northern Virginia
- Paris
- Shanghai
- Tokyo
- Winnipeg
- Washington, DC