

What the US can learn from the CDM

As US policy-makers, businesses and investors prepare for a federal US carbon market, they would do well to learn some of the lessons from the Clean Development Mechanism, says **Patrick Traylor**

The value of transactions under a US federal cap-and-trade programme to control greenhouse gases (GHGs) could range from \$10 billion–50 billion annually by 2015. These estimates – published in June by London-based analyst New Carbon Finance – suggest that \$2.6 billion–12 billion of the total will be invested each year by 2015 in GHG reduction projects across the US. At this level of investment, it is imperative that the financial market systems developed to support a GHG cap-and-trade programme facilitate, and not hinder, investments in GHG-reduction projects.

Policy-makers developing a US GHG trading system can look to the experiences within the existing Kyoto Protocol Clean Development Mechanism (CDM), and learn from some of the difficulties it has faced. Below, we identify a number of opportunities to make the project financing of US GHG reduction projects more efficient.

Investors in CDM projects typically posit two questions that must be answered affirmatively before they invest: will the project generate a profitable number of ‘certified emission reductions’ (CERs, or carbon credits); and will the investor get paid? The CDM process injects significant uncertainty into the answers to these questions. As a result, commercial and investment banks have left to a large extent much of the market to specialised GHG investment funds and development banks.

For example, the CDM process does not include a simple mechanism by which investors may assert their ownership interest in CERs created by the project. The inability to attach and perfect a security interest in CERs – often the only asset in a project with meaningful value – makes it very difficult to originate secured loans for CDM project development. Of course, there are complex solutions to this problem, but with this complexity come higher transaction costs, and ultimately less efficient investment.

The CDM process also does not provide a one-stop location for project permitting and engineering information, nor does it provide for an assessment of the likelihood that a project will produce a certain number of CERs. Project financiers rely on the representations of the project developer that the GHG pro-

ject will secure all local construction and operating permits, that the device itself will be constructed and operated properly, and that it is capable of producing the CERs estimated by the CDM project design document. Collecting this information in a due diligence process creates significant transactional inefficiencies.

Any developing US GHG trading system should carefully avoid these and similar project finance inefficiencies. We make four suggestions: first, regulators should design the GHG allowance accounts as hybrid compli-

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ance and asset accounts. Second, the commercial laws in the jurisdiction in which the compliance/asset accounts reside should provide for easy attachment, perfection, and foreclosure of security interests in the contents of the accounts. Third – much like the mortgage industry – project and finance-related documents should be standardised. Last, a single coordinating point of contact with respect to environmental and related permitting would greatly facilitate investments in projects that have completed all required permitting.

□ *Hybrid compliance-asset accounts* The compliance account model for sulphur dioxide allowance trading under the Clean Air Act is insufficiently flexible to allow for efficient project financing of GHG reduction projects. Unlike cash accounts to which security interests attach, once GHG reduction credits are, for example, deposited to GHG compliance accounts under the US north-eastern states’ Regional Greenhouse Gas Initiative, it will be very difficult for secured parties to assert their ownership interest in the credits. The emerging US system should include components of both the compliance account and the asset account models to facilitate the attach-

ment, perfection and foreclosure of security interests in GHG credits.

□ *Security interests in compliance-asset accounts* In a federal system, the physical location of the compliance-asset accounts will likely be in a single state jurisdiction. So that security interests in GHG credits may be efficiently attached, perfected and foreclosed, the laws of the jurisdiction in which the compliance-asset accounts are located should ensure security interests in GHG credit assets.

□ *Standardised documentation* Standardised project and credit trading documents – letters of intent, emission reduction purchase agreements, engineering design certifications, and GHG credit generation engineering validation documents – should be standardised to allow project-finance sources to confirm quickly the existence and design of a project, as well as the terms by which resultant GHG credits are monetised through sales.

□ *Coordinated permitting* The ‘coordinating agency model’ – in which a centralised agency coordinates the issuance of environmental and related permits – would facilitate efficient GHG project investment. The state of New Hampshire uses this model for siting new energy facilities. The model would be particularly useful for smaller-scale projects for which permitting due diligence is a disproportionate percentage of the transactional costs.

In conclusion, the CDM has highlighted the need not only for confirmation of overall GHG reductions by projects, but also for efficient project finance and market trading mechanisms. As the US moves toward a GHG regulatory model, the transactional requirements of GHG reduction project investors should be an important consideration. A coordinated approach by leading investors that expect to play a role in the domestic GHG market could have a significant impact on the contours of the US programmes under development, and would result in a more efficient use of capital in the reduction of GHG emissions. ■

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