CURTIS

JANUARY 2005

ENVIRONMENTAL CLIENT ALERT

KYOTO PROTOCOL TO ENTER INTO FORCE ON FEBRUARY 16, 2005: THE MARKET FOR GREENHOUSE GAS EMISSIONS CREDIT TRADING IS OPEN

INTRODUCTION

On February 16, 2005, the Kyoto Protocol will enter into force, making ambitious greenhouse gas (GHG) emissions reduction requirements mandatory for 36 developed countries and economies in transition. Emissions trading is an integral part of the Kyoto Protocol scheme. To ensure that they will meet these reduction requirements, a number of countries and private entities have already begun implementing programs to sell and acquire GHG emissions allowances and credits.

On November 18, 2004, a Brazilian landfill gas-to-energy project became the first GHG emissions reduction project registered as a clean development mechanism (CDM) project activity. Emissions credits generated through this and other registered CDM project activities will be purchased by countries or private entities and applied toward their Kyoto Protocol emissions reduction requirements. Thus, this monumental step not only clears the way for many more projects currently awaiting registration and in development, but also invigorates the GHG emissions credit trading market.

Multilateral and private financial institutions worldwide are already participating in this emerging market. Foreseeing increasing demand on the part of developed countries and economies in transition and an opportunity to meet this demand through the generation of emission reduction credits, financial institutions are creating funds to invest in emissions credit generation through CDM projects.

REDUCTION REQUIREMENTS: THE KYOTO PROTOCOL

The Kyoto Protocol, adopted in 1997 by the parties to the Framework Convention on Climate Change, establishes specific GHG emissions reduction requirements for 38 developed countries and economies in transition. The average reduction requirement for these countries, which include, among others, Japan, Canada and all member countries of the European Union, is 5.2 percent over 1990 levels. Under the Protocol, these parties are required to achieve the reductions between 2008 and 2012 and to demonstrate progress toward achieving the reductions by 2005.

When Russia deposited its Kyoto Protocol instrument of ratification with the United Nations on November 18, 2004, a 90-day countdown to the Protocol's entry into force began. With Russia's ratification, the Protocol has now been ratified by 128 countries, 36 of which are subject to the reduction requirements and collectively account for 61.6 percent of the total 1990 carbon dioxide emissions by such countries.

TRADABLE EMISSIONS CREDITS: PURCHASE AND GENERATION

BUYERS

To meet their obligation to demonstrate progress toward their emissions reduction requirements by 2005, many parties to the Protocol have already established mechanisms for the trade of emissions allowances and credits. Japan, Canada, some of the countries of the European Union and other developed countries are already actively trading or purchasing credits. Private entities are also trading credits to meet emission reduction requirements imposed by Protocol parties.

The European Union has established the Emissions Trading Scheme (EU ETS), through which emissions allowances and credits may be traded Union-wide. CDM credits may be traded through EU ETS and may be applied toward emissions reduction requirements in Europe.

The EU market officially launched with a warm-up phase on January 1, 2005 (though emissions allowances have been actively traded on the market since early 2003). Trading of allowances through EU ETS ranges between 50,000-300,000 tonnes per day. To date, nearly 10 million tonnes of emissions allowances have been traded through EU ETS – making it the world's largest multi-country, multi-sector greenhouse gas emissions trading scheme.

Since the launch, the price of allowances for delivery in 2005 has fallen to approximately 6.75 euros per tonne from a high of over 8 euros per tonne late last year. But now that the Kyoto Protocol's entry into force is certain and reduction requirements are a reality, trading volume and prices are expected to increase.

CDM PROJECTS

Purchase of GHG emissions reduction credits generated by CDM project activities carried out in developing countries is an appealing option for countries seeking to reduce the cost of compliance with Kyoto Protocol reduction requirements. However, only certified credits generated by registered CDM project activities may be used to achieve reductions required by the Kyoto Protocol. To register and generate tradable certified credits, project activities must meet design and monitoring requirements and must maneuver the complex registration process established by the United Nations. CDM project activities must obtain various government approvals and submit extensive English language project design documents for rigorous review and public commenting. Credit purchase and sale agreements are often also in English and governed by New York law.

The first project activity to successfully maneuver this process is the Brazil NovaGerar Landfill Gas to Energy Project. Implementation of this project activity began in January 2004, and the project is projected to generate nearly 1.9 million tonnes of emissions reductions over the course of 7 years and even more in subsequent years as the project is renewed for additional periods. The credits generated by these reductions will be purchased by the World Bank Netherlands Clean Development Facility on behalf of the Netherlands Government.

EMISSIONS CREDIT TRADING: THE MARKET IS OPEN

With parties already seeking to purchase emissions allowances and reduction credits to apply toward their Kyoto Protocol reduction requirements, the trading market is open. Public and private financial entities are establishing mechanisms to participate in the market and take advantage of the opportunities it provides.

Multilateral financial institutions, including the World Bank and the European Bank for Reconstruction and Development, have already established funds to invest in project activities that will generation tradable emissions reduction credits. These funds are targeted to investors who seek credits to apply toward their Kyoto Protocol reduction requirements. Credits obtained by the funds from their investment activities will be distributed among the investors.

Private entities such as commercial banks and other financial institutions are also now investing in the trading market. Commercial banks and other financial institutions are participating in funds established by multilateral financial institutions and are exploring independent fund strategies, such as credit aggregation. Credit aggregators are purchasing and managing the delivery of emissions reduction credits for sale to their investors. Through economies of scale and risk management, credit aggregators are reducing both the cost and risk faced by their investors.

LEGAL CONSIDERATIONS

The new GHG emissions trading market presents new opportunities and significant legal issues. The legal status of tradable credits is still unsettled and may vary from country to country. Credits may be treated as commodities in one country, securities in another and as other financial instruments in a third. Interests in credits, such as options, may require different legal treatment than the underlying credits themselves. Also, the method for perfecting a security interest in credits may vary from country to country.

The production and trading of credits through CDM projects creates new legal issues, such as the definition and allocation of the CDM asset, and puts a new spin on common project finance issues, such as changes in law.

Furthermore, funds looking to invest in GHG credits or projects must consider the unique nature of this asset in structuring and managing funds. Market participants, including project developers and operators, financial institutions and investors, must understand and navigate these various legal schemes in order to effectively protect their positions and take advantage of the opportunities presented by the market.

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ABOUT CURTIS

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