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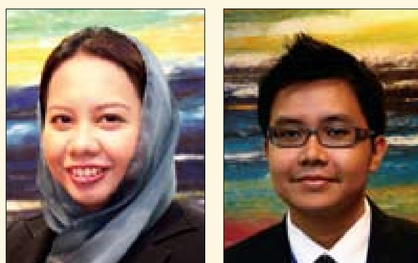
Carbon transactions under the Kyoto Protocol: the Malaysian scenario



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The Kyoto Protocol (the Protocol) is an international agreement linked to the United Nations Framework Convention on Climate Change which was adopted on 11 December 1997 and came into force on 16 February 2005. The Protocol, which has been ratified by Malaysia, encourages a reduction in the emission of harmful gases from industries, and sets binding targets for 37 industrialised countries (Annex I countries) and the European community for reducing greenhouse gas emissions. It also provides the following flexible mechanisms (known as Kyoto Mechanisms) to allow for the commercialisation of carbon trading to lower the overall cost for parties involved in achieving emissions targets:

- *Joint Implementation:* whereby an industrialised country may fund emission reducing projects in another industrialised country as an alternative to reductions in their own countries;
- *Clean Development Mechanisms (CDM):* whereby industrialised countries may fund emission reducing projects in a developing country (non-Annex I countries) as an alternative to more expensive emission reductions in their own countries. Certified Emission Reductions (CERs) – essentially units that represent the reduction of one tonne of carbon dioxide equivalent – can then be issued under supervision of the CDM Executive Board;
- *Emissions Trading:* whereby parties to the Protocol needing to emit an amount of a pollutant exceeding the capped amount are able to purchase greenhouse gas emission from other companies or other parties which emit less greenhouse gases in order to reduce their domestic emission reduction targets.

The structure and financing of CDM projects

Parties may consider three possible business models with regards to the structure and financing of CDM projects: the unilateral, bilateral or multilateral model. The bilateral model allows a degree of flexibility as parties may opt (subject to the laws of the jurisdiction involved) for foreign direct investment or a joint-venture type of arrangement, whereby parties may agree on the share of equity, financing and the allocation of the expected CERs.

As a developing country with limited experience on the intricacies involved in carbon transactions, it is understandable that Malaysia only recognises the bilateral model, as the model tends to emphasise Annex I countries making an equity investment, thereby placing them with a more proactive role in CDM project formulation.

Emission Reduction Purchase Agreement (ERPA)

The ERPA is one of the key documents in executing CDM projects, and parties are strongly advised to consider the following when negotiating and finalising an ERPA: a) who the parties to the ERPA will be; b) quantity of CERs to be delivered, delivery mechanism and the length of crediting period (fixed or renewable); c) evidence of the validity of the CERs being contracted; d) price and terms of payment (whether payment is on delivery or based on key milestones in the project cycle); d) taxes and costs relating to the registration of a project with the CDM Executive Board up to the point of the issuance of CERs; e) extent of warranties and representations by both the buyer and seller; f) liabilities and indemnities; g) possible shortfalls or failure to deliver the CERs; h) governing law and arbitration; i) Force Majeure and changes in law; j) termination events and remedies; and k) boilerplate clauses.

Finalising an ERPA has been proven to be a lengthy process and entails careful consideration of diverse aspects by both seller and buyer. The International Emissions Trading Association, a non-profit organisation tasked to establish effective systems for carbon trading, provides standard ERPA templates for adoption by buyers and sellers. The template, however, tends to favour buyers and in the context of the bilateral model, an effective ERPA should therefore identify concrete milestones, address possible shortfalls and endeavour to provide the best commercial terms for both parties to the transaction.

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