Developing host country legal frameworks for the Clean Development Mechanism

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Background

Global CDM project development

CDM growth concentrated in China, India, Brazil & South Korea (holding the biggest % of global projects)

Other developing countries (Sub-Saharan Africa) lagging behind and hosting the least number of CDM projects
Background

Reasons for the disproportionate CDM project growth:

Developing countries:

Lack of financing (major reason)

Other reasons:
Lack of capacity amongst stakeholders, awareness, institutional framework, technology, etc

World Bank and other global financing institutions:
Lack of strong and conducive legal & regulatory frameworks
Empirical studies: Predictable and strong legal regimes provide a strong foundation for economic growth and investment.

Secure legal rights afford entrepreneurs and investors enhanced prospects of reward and greater incentive to devote time and resources to new ventures.

Also relevant to CDM investment and project development.

Hence the need for establishing a robust legal framework.
Background

What is the meaning of legal framework?
Developing a CDM legal framework

Legal framework

Set of laws, legal instruments, including the legal institutions within which a particular activity operates

(Simply...the legal space within which to act)
Developing a CDM legal framework

In the CDM context

Legal framework comprises:

Rules for developing CDM projects and trading in CER’s set out in the Kyoto Protocol and Marrakesh Accords (International requirements)

CDM projects also subject to host country legal systems

Both are important considerations for establishing a robust CDM legal framework
Developing a CDM legal framework

International legal CDM requirements

- Ratification of UNFCCC and Kyoto Protocol
- Establishment of DNA

Paragraph 39 of Decision 17/CP1
Governments of CDM host countries party to the Kyoto Protocol have authority to approve CDM projects and transfer CER’s

DNA’s act on behalf of host governments when issuing letters of approval or endorsement
Developing a CDM legal framework

Domestic legal systems

These comprise:

- Legislation/Laws enacted by Parliament
- Statutory instruments issued under specific laws
- Bye laws issued by local authorities
- Legal institutions (e.g. parliament, judiciary, etc)
Developing a CDM legal framework

How to establish a host country legal framework for the CDM
Developing a CDM legal framework

First step: Identification of legal issues in CDM project
Development and implementation (pointers)

Similarity between CDM projects and conventional projects....CDM have added dimension (validation, CER generation, verification and monitoring)

Similarity of legal issues and investment considerations in conventional and CDM projects

Second step:
Determination of laws governing the identified legal issues
Developing a CDM legal framework

Third step:
Consideration of whether or not these laws...  

address the identified legal issues adequately to support CDM project development and implementation

can effectively protect project developers’ investment and project outputs and returns
Developing a CDM legal framework

Most cited legal issues in the CDM context

- Foreign direct investment
- Property rights (title to CER’s and land)
- Classification of CERs
- Taxation of CER’s
- Expropriation
- Environmental management
Foreign Direct Investment

Potential impacts of FDI laws

Require government approval for foreign investment

Impose restrictions on foreign ownership of assets e.g. land

Impose higher taxation rates on the investment

Restrict repatriation of profits through foreign exchange controls, etc.

FDI regulations should be managed in a way that does not unduly hinder investment
Foreign Direct Investment Law

• FDI laws useful mechanisms for attracting investment
• Key considerations for investors

Qs for consideration

Whether or not:
Foreign direct law provisions embrace the CDM

Priority sectors are possible hosts for CDM projects

e.g. food processing, fertilizer and cement manufacturing, building of mini hydro power stations
Property rights

Property right issues particularly important in CDM context:

- Legal ownership of CERs
- Ownership of GHG reductions
- Ownership of land where project is to be located
- Customary land rights
- Foreign ownership of land
Property rights

Legal ownership of CERs

Issues:

• Allocation of title to CER’s and revenues from CER sales
• Transferability of such title

Q: Does property law adequately address these issues?
Property rights

Legal ownership of CERs

**International law presumption:** In the absence of any other laws, legal principles or precedents to the contrary, the host country having agreed to be bound by the Kyoto Protocol:

- Has sovereign rights to GHG reductions and CER’s achieved by CDM projects hosted within its jurisdiction

- May transfer these rights to authorized project participants through Letters of Approval (DNA)
Property rights

Legal ownership of CERs
Despite the presumption, uncertainty may still persist about security of title to CER’s

Uncertainty may prevent CDM project development
Particularly where the nature of the project makes it difficult to ascertain which party has legal title to CERs

(e.g. Hydro power CDM project or land fill project)
Property rights

Legal ownership of CERs

Added dimension:
Argument that reduction of GHGs is the management of a natural resource; responsibility and property of host government

Host government may treat CER’s as sovereign rights that can only be owned and traded for profit by itself

Hence need for absolute clarity as to whether CER’s are a sovereign or private right
Property rights

Proprietary rights to GHG reductions

Legal position: To claim a right to CERs, one must also own the underlying GHG reductions

Key Qs:

Any recognition of GHG reductions and CER’s by property law?

Does property law provide for the taking of proprietary rights to GHG reductions achieved on a piece of land separately and distinctly from other rights attached to such land?

(Particularly important for forestry projects)
Property rights

Proprietary rights to GHG reductions

**Argument:** Since trees located on a piece of land can be classified as a resource forming part of the land...

GHG reductions & related CERs achieved through sequestration of CO2 in trees in a forestry CDM project can be construed as property of the landowner

Inconclusive position leads to uncertainty regarding:

- Project developers' rights to GHG reductions and CERs
- Possibility of other registered property right holders laying claim to these assets
Property rights

Important note:

The sale of CER’s is key source of revenue and financing for CDM projects

Uncertainties regarding the right to claim GHG reductions and ability to sell CER’s may jeopardize project viability

Therefore there is need to clarify:

Status of GHGs reductions and

Title to GHGs (whether or not separate from title to land on which the project is located)
Property rights

Ownership of land where project is to be located

Important questions relate to:

- Security of title to land (Is it demonstrable?)
- Conclusive evidence of ownership of land
- Land rights adequately protected

Vital matters for obtaining project financing and for reducing the project's risk profile
Property rights

Ownership of land where project is to be located

Where project developer does not own land on which project is built:

• **Q:** Whether property law confers on the landowner any rights in respect to the project or the CERs
• **OR** allows the landowner to secure such rights

If property law confers or has potential to confer competing rights to CERs a project developer cannot secure full proprietary rights to CERs
Property rights

Ownership of land where project is to be located

Project developer may find it difficult to sell the CERs where there are potentially conflicting rights to ownership

(Purchasers prefer buying from a seller who can demonstrate full legal and beneficial title to CERs)

Sale of CERs are key source of revenue and financing for CDM project and means of obtaining additional debt equity finance

Obstacles to the sale of CERs may be obstacles to the broader financing and viability of project
Property rights

Customary land rights

Statutory property rights co-exist with customary land rights in most developing African countries

Customary law challenges:
• Customary tenure not formally recorded
• Customary title unregistered difficult to characterize
• No clear boundaries between customary land holdings - overlaps between holdings
Property rights

Customary law challenges

- Needs direct engagement with local land owners to determine applicable customary land law & secure title
- Possibility of traditional leader claiming title to CER’s in return for land use
- Difficulties in enforcing rights where dispute or competing interest arise

These challenges can hinder project development and implementation
Property rights

Foreign ownership of land

Critical issue for investors and financiers
(CDM projects have long term return periods)

Key Q: Whether domestic property laws allow foreign ownership of land

(CDM projects long term)
Classification of CERs

Status of CERs
Has an impact on CDM project development

Classification of CER’s is not specified by CDM Rules
(determined by host countries)

Importance of classification:
Manner of classification raises different Legal implications and requirements

Two options for classifying CERs: Securities or Commodities
Classification of CERs

**Securities:** (e.g. shares, bonds, debentures, etc)

- Subjected to rigorous regulatory and legal requirements (Securities legislation)
- Long procedures for licensing and registration (may delay and increase transaction costs)

  If CER’s are treated as securities it may be difficult to transact their sale

**Commodities:** (manufactured or otherwise)

  Easier to trade and regulation is less rigorous
Taxation of CERs

Trading in CERs is likely to attract some form of taxation

Potential ways of taxing CERs:
- Through direct taxes by retaining proportion of issued CERs
- Taxing the CER revenues
- Taxing indirectly through VAT imposed on goods and services

Key Q: Whether there is clarity in the treatment of CERs for taxation purposes in tax laws
Expropriation

Expropriation in CDM context
Important because of the International Law presumption on host country's sovereign rights over GHG reductions and CERs

The international law presumption:
• allows CDM host governments’ broad discretion in regulating trade and possession of CERs
• may create uncertainty about the circumstances in which project developers’ rights to CERs would be expropriated
• may significantly hinder investment in CDM project development
Environmental management

Relevance of environmental laws and regulations

CDM projects usually subject to EIA requirements

Process of complying with these requirements can enable or hinder CDM investment and make project development costly

Additionally:

Environmental permits, licensing and planning approvals may be required to construct or operate a CDM project
Environmental management

Certain projects may require different permits
(with different costs, conditions and authorities)

CDM projects treated the same way as conventional projects
(without regard to lengthy international CDM approval procedures)

If complying with EIA & licensing regulations is costly and lengthy it an discourage CDM investment
Conclusion

- Property rights issues dominate discussion on the CDM legal framework (Investor interests)
  (protection of project developers’ investment, project outputs and returns)
- Clear and robust domestic legal framework is essential to facilitate CDM project development and implementation
  Recognition of GHGs and CERs by property and other laws is a critical requirement for developing a robust legal framework for the CDM
Way forward

Review of current legislation and other legal instruments (including policy documents)

Addressing identified issues positively