



Joint implementation projects in Ukraine: tips for prospective investors



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Introduction

On 4 February 2004 Ukraine ratified the Kyoto Protocol to the United Nations Framework Convention on Climate Change. This gave Ukraine an opportunity to engage in various types of projects purported at reduction of greenhouse gas emissions (the "GHG emissions"), in particular and especially joint implementation projects (the "JI projects"). JI projects involve participants who made commitments under the Kyoto Protocol and provide them with a possibility to meet emission reduction targets by earning emission reduction units (the "ERUs") from projects in other participating states, which made commitments.

Due to various reasons such as overall Ukraine's suitability for the implementation of JI projects (dominance of dirty and power-intensive industries, skilled and comparatively cheap labour, etc.), as well as the contraction of Ukrainian economy and fall of industrial production in the 1990's (which substantially reduced GHG emissions), Ukraine became a leader among the JI projects' host countries, and an essential partner for meeting emission targets by other parties to the Kyoto Protocol.

Ukrainian legal framework for JI projects

Implementation of JI projects in Ukraine is governed by the Procedure for Preparation, Examination, Approval and Registration of Projects Aimed at Reduction of Volumes of Anthropogenic Emissions of Greenhouse Gases, approved by Resolution of the Cabinet of Ministers of Ukraine No.206, dated 22 February 2006. The procedure is administered by the State Environmental Investment Agency (formerly known as the National Environmental Investment Agency) (the "SEIA") and includes the following steps:

- application for the support to the SEIA, which is completed upon issuance of a letter of endorsement by the SEIA;
- submission of a detailed description of the JI project along with a determination report to the SEIA. This stage completes when the SEIA issues a letter of approval and registers the JI project;
- implementation of the JI project;
- submission of a monitoring report of the JI project to the SEIA for registration; and
- transfer of ERUs to the account of the JI project owner held with the national carbon register. Further, the ERUs may be transferred to the account of any foreign entity held with a foreign carbon register.

Financing JI projects in Ukraine

Financing is an essential part of every JI project. Before engaging in a project, investors and project owners have to determine the best way to structure financing. More specifically, the structure of financing has to be determined and agreed upon before the beginning of the second step mentioned above. One of the documents that the project owner will need to submit to the SEIA to get the letter of approval is a financial plan. The financial plan must clearly specify the structure and feasibility of the planned financing, anticipated investment from the sale of ERUs, including any supporting documents.

Typical financing structures

For many Ukrainian project owners JI projects themselves represent an opportunity to get financing for the modernisation of their outdated and energy inefficient technologies and processes on reasonable terms. In the majority of JI projects the price of ERUs will

cover only a certain, often a small, part of the overall project expenses. Therefore, some form of financing either by the project owner itself, or by investors, banks or other third parties will be inevitable for the project to go forward.

Financing structure is tailored to the specific situation of each JI project and there cannot be a one-size-fits-all advice. There are some projects that are financed by the project owners entirely, though they make up a small minority. More often, financing of Ukrainian JI projects falls into one of the following three structures: (1) technology transfers; (2) secured loans; and (3) payments under an Emission Reduction Purchase Agreement (the "ERPA"). Some projects may be able to benefit from governmental support of some sort.

Technology transfers

As mentioned above, most Ukrainian project owners require modernisation of their equipment and processes. Due to decline of Ukrainian engineering industry and science after the break-up of the USSR, new technologies often have to be imported from abroad. Typically, this is done under leasing or similar contracts.

Under Ukrainian law, leasing payments do not necessarily have to be monetary payments and, although not entirely clear, payments for ERUs in a form other than monetary form should also be possible in Ukraine. Investors in JI projects may transfer technology to Ukrainian project owners in consideration for the delivery of ERUs and possibly other monetary payments if the price of ERUs does not cover the price of the technology in full. Investors will retain title to the transferred technology until the project owner has performed its obligations to investors in full.

If structured this way, such cross-border contract for delivery of technology and ERUs would be subject to certain requirements of Ukrainian law for cross-border barter transactions. Among these, the most important are the denomination of payment obligations in hard currency (ie USD, EUR, JPY, CHF, etc.), no delivery of ERUs before the transfer of technology occurs, transfer pricing rules, etc.

Secured loans

Most JI projects require large-scale long-term financing which can be met by the price of ERUs only in a small part. Ukrainian internal market for financing is limited in its capacity to meet such financing demands of JI projects and, in general, there has been limited experience with project finance mechanisms in Ukraine. For a project owner to seek financing on its own at international markets may also be a problem due to business- and country-specific risks. Therefore, investors and/or parties that investors or project owners may bring into the project will need to extend loans to the project owner to cover most of the upfront project expenses. Repayment of the loan can be structured so that as soon as the delivery of ERUs takes place the parties will offset the price of ERUs against the same amount outstanding under the loan. Loans extended under JI projects are often secured with pledges of properties and property rights of the project owner, suretyships, etc. Under Ukrainian law, cross-border loans are subject to registration with the National Bank of Ukraine and compliance with certain other currency control and tax rules.

ERPA payments

As mentioned above, financing of some JI projects may rely on payments under ERPAs against the prospective delivery of ERUs, similar to other supply contracts. Some JI projects provide for a down payment in the amount of a percentage from the price of ERUs and subsequent payment of the outstanding amounts as soon as

ERUs become available. It is also possible for the investors to make a full upfront payment of the price of ERUs with the obligations of the project owner to deliver the ERUs being secured by a pledge of project owner's property or property rights. The project owner will then be responsible to bring the remainder of financing necessary to complete the project, if necessary. For some projects, especially those involving governmental or municipal authorities and other projects that generate no income on their own other than savings and efficiencies from emissions reductions, ERPA payments become the most common way of getting financing for their emissions reductions projects.

Governmental support

Environmental projects may benefit from state support in a number of ways: financial support (through direct funding, provision of state guarantees, interest reduction under loans attracted from commercial banks) as well as preferential regulation which incentivizes environmental and energy efficiency projects.

The major mechanisms for the provision of state financial support are (1) state support to public private partnerships and (2) financing under various state task programs. The former mechanism was introduced in 2010 with the adoption of the Law of Ukraine "On Public Private Partnership". It provides companies acting as private partners in the framework of public private partnership (through a concession agreement, joint activities agreement or otherwise) with an opportunity to seek funding from the budget or to apply for state guaranties. Although the mechanism is not fully effective yet, the Ukrainian government takes a proactive stance in its implementation.

Further state support may be acquired through specific state support mechanisms, such as task program for energy efficiency and development of renewable energy resources for 2010-2015 and mechanism of reimbursement of interest under loans attracted for projects in the sphere of energy efficiency.

Apart from financial support from the government, environmental projects may benefit from preferential regulation. For instance, the import of energy efficiency materials and equipment are exempt from customs duties and VAT.

Security interests under Ukrainian law

Ukrainian law provides for various tools for investors to protect their investment. These tools range from contractual penalties and security and quasi-security instruments such as mortgages, pledges of different types (eg, pledge of moveable property, pledge of shares, pledge of receivables), suretyships (sureties), etc.

Suretyships

A suretyship is an agreement whereby a third party guarantees to a creditor a debtor's performance of its obligations under a contract. If a debtor fails to perform its obligations, a surety is under an obligation to bear joint responsibility with a debtor under a contract. Suretyships in cross-border transactions should be used with caution due to a number of currency control rules that need to be taken into consideration.

Mortgages/pledges

Ukrainian law provides for obligatory notarisation and state registration of mortgage agreements. Restrictions under Ukrainian law make mortgages of some real estate objects difficult and, sometimes, impossible. Notably, this is the case with certain types of land plots.

The pledge (including mortgage) of objects of state property and municipal property is subject to substantial restrictions. In particular, the following categories of property may not be pledged/mortgaged:

- (i) objects of national, cultural and historic value that are or "intended to be" included in the state register of national and cultural heritage,
- (ii) objects that may not be privatized,
- (iii) property complexes of state and municipal enterprises that are in the process of corporatisation.

In addition, the availability of a specific asset (eg, as stock, inventories, shares in state or municipal enterprises, objects of real estate, etc.) of state and municipal enterprises for a pledge (mortgage) should be determined based on the authority of such enterprises to dispose such asset. Since Ukrainian law allows the use as collateral-only those assets which are freely disposal, due to existing moratorium on disposal of state-owned property, currently the use of such state property (assets) for purposes of creating security interests is problematic.

With the emergence of JI projects in Ukraine, a question of the ability to use ERUs and Assigned Amount Units (the "AAUs") as collateral arose. Applicable Ukrainian legislation envisages the transfer of AAUs

in the amount correspondent to the projected amount of the ERUs as a collateral under JI projects as the security of the investments into JI projects. With respect to pledge of the ERUs, due to the fact that these units arise within the boundaries of a specific project after complex verification procedures, it should be possible for an investor in a particular project to take pledge over these ERUs, however, it may be difficult to pledge these units to a bank or other third party.

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To obtain priority against subsequent security interests in a particular property or certain property rights, investors should take care of all necessary registrations in appropriate state registries of encumbrances.

Title to ERUs

One of the crucial issues that arise in all JI projects is the question of title to generated ERUs and, after conversion from AAUs, their transfer to a carbon register of the investor's country. In this respect, Ukraine is not unique in its approaches, as the concept of creating a commodity of value out of a reduction in GHGs is still a relatively new concept. The issue of how to assign legal title to this new commodity and, indeed, who is eligible to claim legal ownership has not been fully settled. Like many other countries, Ukraine does not have any special regulation of ownership of ERUs.

Based on Ukrainian regulations dealing with JI projects and practice of the SEIA, so far Ukraine has not taken any steps to override a *prima facie* assumption taken by the Kyoto Protocol parties and subsequently supported by practice that project owners have legal title to the emissions reductions and the resultant ERUs created on the basis of that project activity. In light of this legal uncertainty, all ERPAs should clearly provide for all aspects of legal title, including its creation and transfer. As a practical matter, a draft ERPA that a project owner has to submit to the SEIA to obtain a letter of approval should contain clear provisions on legal title to ERUs. This should mitigate the risk of challenging legal title to ERUs, though unlikely, should the Ukrainian government change its position on this matter.

There also an open question whether ERUs can be treated as property, property rights, licenses, etc. Although the debate on this matter is far from being settled with no clear guidance in the law, the practice shows that the status of emissions reductions tends to be closer to property rights, which means that ERUs can be treated as property rights and, thus, can be used as collateral.

Future of JI projects in Ukraine

Over its relatively short history, JI projects have proved to be very successful in Ukraine with Ukrainian companies and the Ukrainian government has realised their big potential and great benefit. However, developments on the international scene still leave a big

question mark about the future of the Kyoto Protocol system and particularly, in absence of the Kyoto or similar framework, whether ERUs issued after 2012 will be recognised elsewhere.

Ukrainian government on a number of occasions expressed its support for JI projects and urged parties to the Kyoto Protocol to reach an agreement so that the international system of recognition of these projects goes forward after 2012. In light of little progress, Ukraine started looking for alternative ways to resolve this issue.

In 2010, Ukraine started negotiations with the European Union on a bilateral agreement recognising ERUs generated in Ukraine in the European Union Emissions Trading Scheme. For the time being, there has been little progress, which is largely due to differences between both parties as to the level of emissions reduction commitments that Ukraine should assume. It is also possible that the EU will impose eligibility criteria for Ukrainian JI projects before ERUs generated under these projects can be admitted into the European system.

Ukraine is also considering developing its internal emissions trading scheme in an effort to develop the internal carbon market and with

hope that it will be easier to negotiate with other emissions trading systems in the post-2012 period. Currently, experts are sceptical about a fully operational Ukrainian carbon market, but welcome all efforts to bring more legal certainty to the legal framework of JI projects.

Although it is premature to predict the future of JI projects in Ukraine, the success and a lot of vested interest in these projects leave some room for optimism that an acceptable solution will be found in the near future. ■

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