

# Navigating the Legal Landscape: A Municipal Guide to Selling Carbon Credits in South Africa

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## ABSTRACT

2005 saw dramatic growth in the global market for carbon credits. More buyers are interested in Africa and prepared to compete for credits through a public tender process provided it is a clear and reasonable process. The South African Constitution says that when local authorities procure goods and services, they must do so in accordance with systems that are “fair, equitable, transparent, competitive and cost effective.” Since 2000, several new laws and related regulations have been adopted to provide substance to this constitutional mandate. The Municipal Finance Management Act (MFMA) and the Supply Chain Management (SCM) Regulations are two such examples that have changed the way municipalities do business. Their goal is to institutionalize openness and accountability, but they also raise questions. For example, do these laws and regulations apply to the sale of carbon credits? If so, what kind of carbon credit tender process will pass legal muster and still attract good buyers on terms that are beneficial to a municipality? Can such a process be concluded in time to take advantage of the time limited opportunity created by the Kyoto Protocol?

In this paper, we will discuss some of the legal issues that confront South African municipalities. We will provide municipalities with a roadmap for navigating the complex landscape of South African legislation, utilizing an approach that will enable them to comply with applicable laws and still realize the benefits of the CDM.

## KEYWORDS

Clean development mechanism (CDM), landfill gas, Kyoto Protocol, local government legislation.

## INTRODUCTION

Despite recent volatility, 2005 saw dramatic growth in the global greenhouse gas (GHG) emissions trading market. As of 31 March 2006, this market was valued at US \$10 billion. Almost half of the emissions that made up that value came from Clean Development Mechanism (CDM) projects in the developing world. There is indeed a vibrant market for carbon credits from CDM projects. The language of the Kyoto Protocol actually uses the term “certified emission reductions” or CERs rather than carbon credits, but for purposes of this paper, we will use the term carbon credits. This includes landfill gas (LFG) projects; in fact, Novo Gerar, a landfill gas project in Brazil, was the first CDM project ever registered under the Kyoto Protocol and LFG projects now account for 10% of all CDM projects worldwide.

You may have heard that the carbon market has been volatile in recent months. In the first two weeks of May 2006, prices took a nosedive, losing up to 70% of their value almost overnight although they have since recovered significantly. The precipitous drop in May was triggered by a handful of EU countries leaking reports, prior to the reporting deadline that their 2005 GHG emissions were below quota. This led to unfounded fears in the market that there would no longer be a need in the EU for carbon credits and so the price fell. Market experts now characterize this price drop as a necessary “correction” after a wild and unsustainable spike in carbon credit prices in the first quarter of 2006. Once all 25 countries in the EU had reported their emissions, it became clear that some countries, particularly Spain, Germany and Italy, remained well above their quotas and continued to have a strong and immediate need for carbon credits. It also became evident from statements made by the EU Commission immediately after the leak that the EU body which is responsible for approving emissions allowance plans for each of the countries of the EU, intends to tighten up on allowable emissions in subsequent years. This will be necessary to ensure that the EU, as a group, will meet its Kyoto target for 2012. Also relevant to this discussion is buyer behavior at the May 2006 Carbon Expo. It was very clear that buyers remain keen to purchase carbon credits and fully expect to need credits now and into the future.

There are many other indicators that the carbon credit market is alive and well and that there continues to be opportunity for new projects in this market. Here are just a few:

- Last year the Executive Board (EB) of the CDM had registered only 5 projects. As of May 2006, they had registered 176.
- Last year there were zero CER's issued. Today there are almost 5 million.
- Last year there were 114 CDM projects in the pipeline, today there are over 760.
- The geography is shifting as well. Last year only 5% of the CDM projects were in China. Now that figure is 67% and continues to grow.
- Last year 43% of the CDM projects were in India, now that number is 3%.
- Latin America had 17% of the projects last year and now has only 8%.
- Africa unfortunately continues to be off the radar screen with very few registered projects although in South Africa alone there are several projects, including at least three LFG projects, en route to registration.

Buyers have started to value geographic diversity in their portfolios and so while South Africa is competing with the rest of the developing world to sell its carbon credits, Africa is currently “hot” and of great interest to buyers.

2005 and the first quarter of 2006 have seen yet another change in the market that portends well for South African municipalities thinking about developing landfill gas CDM projects. Over the past year or so, the market has clearly shifted from a buyers' market to a sellers' market.

Buyers now expect to go out looking for CDM projects, they expect to be required to demonstrate their creditworthiness, to offer some upfront payment and to negotiate other terms to suit seller's needs and most importantly they expect to have to compete for carbon credits. They are, for the most part, keen for credits from Africa and willing to buy credits through a tender process they don't control provided that process "...is clear and reasonable".

So, we must ask: Is there a model municipal tender process for selling carbon credits in South Africa that is clear and reasonable? The unfortunate answer to this question is NO and there are other ambiguities in the process.

In addition to selling carbon credits, CDM projects call for a wide array of services that must be contracted - also through processes that meet the requirements of new laws and regulations. These services may include those of qualified CDM transaction advisors, a firm to undertake preliminary pumping trials, a consultant capable of conducting or overseeing the EIA including the necessary specialist studies, a validator accredited by the Executive Board, and a firm or firms to design the well field and construct the project, among others. In the absence of established court interpretations of these new laws and regulations, there is a tendency for municipalities to take the most conservative view in interpreting them. While we urge municipalities to use caution, to protect the interests of their citizens and to listen to their lawyers, we intend, in this paper, to provide direction, clarity, interpretations and justifications that will help municipal waste managers to implement CDM projects, including "clear and reasonable" tender processes so that South Africa can continue to develop and attract prime buyers to its landfill gas CDM projects.

We discuss below some but not all of the steps in the CDM project cycle. We focus in particular on steps that raise issues related to interpretation and application of municipal legislation and regulations.

## **IMPLEMENTING A MUNICIPAL LANDFILL GAS CDM PROJECT: KEY STEPS**

### **Step 1: Project initiation - identifying a site and appointing transaction advisors**

Once the local authority has **identified a site**, the next step is to **select qualified, experienced CDM transaction advisors**. The advisory team should have the skills needed to address strategic, technical, legal, financial and CDM market issues, educate municipal officials and work with the internal project "champions" to build and sustain municipal support for the project. The team must have experience with the CDM project cycle and the international rules as well as the process required by South African legislation and the Designated National Authority. The team must also help to identify and address upfront obstacles that might otherwise threaten the project if raised only later in the process. Needless to say, selection of the right advisory team is critical.

What are the local government law requirements? The appointment of transaction advisors is an "acquisition of services", to use the language of the local government legislation, and therefore raises supply chain management issues: A municipality must comply with the supply chain management provisions of the MFMA, the SCM Regulations and its own supply chain management policy when it procures goods and services.

The Constitution imposes a fundamental obligation on organs of state, including municipalities, to undertake procurement in accordance with a system which is fair, equitable, transparent, competitive and cost-effective. The MFMA amplifies this obligation through fairly

detailed provisions governing the acquisition of goods and services by municipalities and the disposal by municipalities of goods which they no longer need. The SCM Regulations in turn amplify the supply chain management provisions contained in the MFMA. Specifically in relation to CDM projects, it is important to note that the SCM Regulations prescribe different procurement procedures depending on the value of the goods or services being procured. The transaction advisors in a CDM project will probably need to provide services over the course of 12-18 months and will in all likelihood charge in excess of 200.000 rands. This price tag means that the services can only legally be acquired through a competitive public bid; it is not sufficient for a municipality directly to solicit several competing proposals.

**We recommend** that officials bear in mind that implementation of the MFMA and SCM regulations, particularly where competitive bids are required, takes time and adds to the total project time. This is important because the Kyoto Protocol, as it currently exists, establishes a market for carbon credits only through 2012. Most CDM projects take at least 12-24 months to develop and implement to the point that they are capable of actually delivering carbon credits. So, appointing a consortium that can move quickly and offers the full range of specialist services required (strategic, technical, legal, financial and CDM-related) limits the number of separate procurements which the municipality needs to go through and may therefore offer time and cost advantages.

### **Step 2: Assessing feasibility**

The transaction advisors will assist in the **assessment of preliminary technical, non-technical and financial feasibility**. Much of the work will be done by the advisors themselves but if this step includes a **preliminary pumping trial** (which is prudent and recommended) then an outside service provider is likely to be required. Note that in some provinces a pumping trial can only legally be conducted with **abbreviated EIA approval** from the environmental authorities.

What are the local government law requirements? Again, the appointment of outside service providers to carry out pumping trials or an abbreviated EIA process amounts to the "acquisition of services" and is therefore subject to the MFMA, the SCM Regulations and the municipality's own SCM policy. Assuming that these appointments will cost between 10.000 and 200.000 rands, the selection of a service provider may be done by soliciting formal written price quotations from at least three providers on the municipality's accredited list. If the municipality does not have appropriate accredited service providers on its list, then it may solicit quotations from unaccredited providers provided that they meet the municipality's own listing criteria.

### **Step 3: Selecting the project structure**

The transaction advisors will advise the local authority on **selection of a structure for the CDM project**. This is surely one of the most complex decisions that must be made in the early stages of a CDM project. The primary issue is which structure suits the municipality best. Each structure carries with it different legal considerations that must also be addressed. Some of the options to be taken into account are, first, that the municipality implements the entire project internally; second, that the municipality operates the landfill itself, but outsources the gas extraction and utilization components of the project; third, that where a landfill is already run by an outside contractor, the contractor's brief is extended to include gas extraction and utilization; fourth, that both the landfill operations and the gas extraction and utilization components are outsourced to an outside contractor in terms of an agreement which retains substantial risk for the municipality; and fifth, that both the landfill operations and the gas extraction and utilization

components are outsourced to an outside contractor in terms of an agreement which transfers substantial risk to the contractor.

Most of these options involve the appointment of an outside contractor and therefore trigger the procurement and SCM requirements which have been outlined earlier on. But apart from procurement issues, the decision about the structure of the project also raises other legal compliance issues for municipalities. There are two key questions to ask when assessing the legal implications of the different potential structures. First, does the proposed structure have an impact on the delivery of municipal services? And second, does the proposed structure amount to a public-private partnership?

In relation to municipal services, there is a range of decisions in respect of the delivery of municipal services<sup>1</sup> which triggers an obligation on municipalities to comply with section 78 of the Municipal Systems Act. The decisions relate to how municipal services are to be delivered in a particular municipality: in the example of the municipal service of the operation of a landfill, the question is whether that service will be delivered by the municipality itself, by a municipal entity, by another municipality, by a private operator, and so on. Section 78 prescribes a procedure which municipalities must follow before taking a decision about how municipal service delivery will take place. The procedure includes assessments and feasibility studies and is potentially onerous, expensive and time-consuming. In our opinion, a CDM project on its own is not a municipal service and decisions about the undertaking of a CDM project cannot trigger the obligation to comply with section 78. However, the operation of a landfill site is, in our opinion, a municipal service. Where a municipality wishes to combine the municipal service aspects of landfills with a CDM project – for example to appoint a private sector operator both to operate the landfill and to undertake a CDM project on that landfill on the municipality's behalf – section 78 may well be triggered. If, however, there is an existing private operator of the landfill, extending that operator's scope of services to include operation of the gas extraction and utilization will not necessarily trigger section 78.

**We recommend**, given that analysis of this issue is very fact specific, that the possible section 78 consequences of the available structures be examined by the municipality early on in the process. Sound legal advice must be sought on whether any of the circumstances listed in section 77 of the Municipal Systems Act are present and therefore whether the obligation to comply with section 78 will be triggered.

In relation to public private partnerships, if a municipality wants to outsource the development and implementation of a CDM project, it may well find itself subject to the municipal PPP Regulations and the PPP provisions in the MFMA. The PPP Regulations specify in great detail how municipalities must conclude PPP agreements. The Regulations not only set out the procedure which municipalities must follow when they conclude PPP agreements but also the financial tests a proposed PPP agreement must pass before a municipality may proceed with the agreement. Proposed structures must be scrutinized to determine whether they qualify as PPPs. Probably the most important element of the definition of a PPP relates to the degree of risk transfer to the private party which takes place. In terms of the definition, if a transaction transfers "*substantial financial, technical and operational risks*" to the private party, then the transaction is a PPP (assuming that the other elements of the definition are also met).

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<sup>1</sup> "*Municipal service*" is defined in section 1 of the Systems Act as "*a service that a municipality in terms of its powers and functions provides or may provide to or for the benefit of the local community irrespective of whether –*

(a) *such a service is provided, or to be provided, by the municipality through an internal mechanism contemplated in section 76 or by engaging an external mechanism contemplated in section 76;*

(b) *fees, charges or tariffs are levied in respect of such a service or not*".

If a municipality selects a project structure that meets the definition of a PPP, then it must follow the prescribed PPP procedure. The critical steps in that procedure include carrying out an extensive feasibility study; engagement with the National Treasury and the provincial treasury on the proposed PPP, the terms of the draft agreement to undertake the CDM project which will include the terms of the sale of the carbon credits, the municipality's plan for management of the agreement, the preferred bidder's competency to perform under the agreement, the proposed bid documentation and the evaluation of bids; and a public participation process. As mentioned above, in terms of the PPP legislation there are also financial tests which the proposed PPP must pass: essentially, it must be affordable to the municipality and must provide value for money to the municipality.

**We recommend** that careful analysis of this question be done before any decisions are made by the municipality. Transferring risk to a private party may appear very attractive to a municipality as it contemplates implementation of a CDM project, however, there are significant downsides to transferring risks to such a degree that the project will be deemed to be a PPP. These include the fact that carbon credit buyers are likely to regard as unattractive (and therefore deserving of a lower price) a PPP project because it will require extensive procedural steps, additional public participation, added government involvement and scrutiny of the commercial terms of the deal on top of the other procedural constraints already facing municipalities wishing to undertake CDM projects and the already limited period within which to get them up and operating. We expect that the result of this analysis may well be that the PPP route is not attractive.

#### **Step 4: Securing approval under local and international CDM rules**

The transaction advisors must guide the municipality through the complex steps required by the South African and International approval processes. The scope of this paper does not allow for us to outline these steps in detail, however, we make mention of one step in particular that calls for acquisition of outside services. This step is the **validation** of the Project Design Document (PDD) by the **selected Designated Operational Entity (DOE)**.

The Kyoto International Rules require that the project proponent prepare a PDD that sets forth the baseline emissions of the project, the projected reductions, the proposed methodology for calculating those reductions and a great deal of additional information - all presented strictly in accordance with the rules. That document must be validated by one of a small number of DOE's accredited by the Kyoto Executive Board. Selection of the DOE is very important and should be based on the DOE's real, demonstrable experience with validation and successful registration of projects using the same or similar methodologies. The DOE must be selected through a competitive process but since the DOE's services should cost less than 200.000 rands, the selection of a service provider may be done through solicitation of at least three formal written price quotations. If – as is likely to be the case – the municipality has no DOEs on its accredited service provider list, then the municipality may solicit the quotations from service providers who meet the municipality's accreditation list criteria.

**We recommend** that the process of selection of the DOE be commenced early so that the DOE is in a position to help the municipality to conduct stakeholder processes that meet not only the South African requirements but the requirements under the international rules.

#### **Step 5: Selling the credits, landfill gas or electricity**

That brings us to the heart of the project, the **sale of the carbon credits** (or other downstream products). This step should be managed by the transaction advisors and the local authority.

What are the local government law requirements relating to the process for selling the carbon credits? As has been mentioned already, the MFMA and SCM Regulations contain fairly detailed provisions governing the acquisition of goods and services by municipalities and the disposal by municipalities of goods which they no longer need. Disposals (for example sales by a municipality) are regulated to a lesser extent than acquisitions (for example purchases by a municipality) are. In terms of the regulations, municipalities are required to sell movable assets by way of written price quotations, a competitive bidding process, auction or at market related prices, whichever method is most advantageous to the municipality. Is the sale of carbon credits the kind of sale which is governed by the SCM Regulations? In our view, there is a strong argument that none of the disposals which are likely to take place in order to realize the commercial potential of a CDM project – for example the sale by a municipality of carbon credits or the sale of gas captured from a landfill – amounts to the kind of disposal regulated by the SCM Regulations. The phrase "*goods no longer needed*" suggests that the legislation was designed with tangible assets which were once useful but which are no longer needed in mind – office furniture, computers and motor vehicles, for example. It is artificial and strained to suggest that the disposal of carbon credits or landfill gas is the disposal of goods no longer needed. However, even if the SCM Regulations do not apply, municipalities must, as organs of state, act in a way that is procedurally fair when they sell carbon credits. Whatever method of sale is used must therefore satisfy the requirements of administrative fairness. A competitive tender does meet the requirements of administrative fairness. Accepting an unsolicited offer from a would-be buyer of credits does not.

**We recommend** that the transaction advisors, working with the municipality's in-house legal advisors, be asked to develop a tender procedure that complies with the spirit, and to the extent practicable, the letter of the SCM Regulations. It should also be efficient, streamlined and likely to result in a commercially beneficial deal for the municipality. In our experience, one of the challenges here is to build support within the municipality for departing from standardized tender documentation: the voluminous tender documentation which is typically used for, say, construction contracts is wholly inappropriate for the disposal of carbon credits. Not only is the documentation inappropriate and unnecessary but it will most definitely discourage potential bidders for municipal carbon credits from bidding. As noted in the introduction of this paper, buyers will compete for carbon credits and buyers will participate in a tender process they do not control BUT only if that process is perceived, *by them*, to be fair and reasonable. A process that uses the standard documentation used in construction tenders, which often is more than 50 pages long and calls for information that is irrelevant to a carbon credits sale, will simply not be seen as fair and reasonable.

There is a further provision of the MFMA, in addition to the SCM provisions, that needs to be considered when a municipality sells carbon credits or gas captured at a landfill or electricity generated from landfill gas. Section 14 of the MFMA regulates the disposal of capital assets. It prohibits the disposal by municipalities of capital assets "*needed to provide the minimum level of basic municipal services*".<sup>2</sup> It permits the disposal of other kinds of capital assets, but only in certain circumstances.<sup>3</sup> In our view, none of the products potentially to be disposed of – carbon credits, gas, electricity – are capital assets as contemplated in section 14. "*Capital asset*" is not

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<sup>2</sup> Section 14(1). "*Basic municipal service*" is defined as a service "*that is necessary to ensure an acceptable and reasonable quality of life and which, if not provided, would endanger public health or safety or the environment*". Section 14(6) provides an exemption to the prohibition in a case where the disposal takes place in terms of a framework prescribed by the National Treasury.

<sup>3</sup> Such disposals are permitted only after the council, in a public meeting, has decided on reasonable grounds that the relevant assets are not needed to provide the minimum level of basic municipal services and has considered the value of the assets and what is to be received in consideration for the assets: section 14(2).

defined, but is generally understood to mean assets which are productive – in other words which are used to generate or produce other assets. A municipality's capital assets would include those assets which it needs to fulfill its functions as a municipality, for example the land, buildings, equipment and infrastructure used to deliver municipal services. While a landfill site would constitute a capital asset of the municipality, gas extracted from a landfill site, electricity generated from that gas and carbon credits earned from the flaring of that gas do not in our view constitute capital assets of the municipality. There is therefore a strong argument that there is no obligation to comply with section 14 of the MFMA before disposing of carbon credits, gas or electricity.

**We recommend** that a municipality work with its transaction advisors to develop a streamlined tender process and documentation to be used in that process. The documentation should require potential carbon credits buyers to provide such information as is truly needed to evaluate the offers and not more. The documentation should not exceed 20 pages and should be very clear. The process should provide for a speedy decision about the successful buyer.

### **Step 6: Executing the Emissions Reduction Purchase Agreement (ERPA)**

The current market reality is that any viable commercial deal will be with a foreign company and long-term (i.e. until 2012). Municipal legislation constrains municipalities' ability to conclude such agreements in at least two important ways.

What are the local government law requirements relating to the ERPA? The first and most serious constraint arises from section 33 of the MFMA. In terms of section 33, municipalities may only conclude agreements that impose financial obligations on them beyond the three years covered in an annual budget if they have first followed the procedure prescribed in section 33. If an agreement for the sale of carbon credits endures through 2012 and imposes an obligation on a municipality to pay damages in certain circumstances (for example if it does not deliver all of the credits it promises to deliver), then that obligation will be considered a contingent liability and may well trigger the obligation to comply with section 33. The procedure prescribed in section 33 requires that the draft agreement be publicized and that comments on the draft be invited from the public, the National Treasury, the provincial treasury and from DPLG. At least sixty days must be allowed between the time that the agreement is publicized and the time that it is considered by council. Foreign bidders unused to the regulatory constraints associated with municipal procurements are likely to find the delay between being selected as a preferred bidder and negotiating the final agreement and conclusion of the agreement some three months later, troubling and possibly completely unacceptable. This is particularly true if the market remains unstable and in such a case it will be difficult to persuade bidders to hold their bids open for the time period that compliance with section 33 requires. Even if bidders are willing to keep bids open for long periods, they will factor the risks associated with extended bid validity periods into the price they offer, resulting in a very low price.

The second constraint arises from the restrictions on municipalities' ability to incur debt. One of the restrictions under Section 33 is that a municipality may incur debt only if the debt is denominated in South African rand. The debt may not be indexed to or affected by currency fluctuations.<sup>4</sup> Debt is defined as including contingent liabilities.<sup>5</sup> If, for example, a carbon sale agreement places an obligation on a municipality to pay a penalty if it fails to deliver carbon credits, then the amount of the penalty must be stipulated in South African rand. This will be an

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<sup>4</sup> Section 47 of the MFMA.

<sup>5</sup> Section 1 of the MFMA.

unwelcome provision for foreign buyers, who will factor the risk associated with currency fluctuations into the price they offer.

**We recommend** that municipalities obtain advice on how best to manage the requirements of Section 33 as well as other legislation which applies to the agreement.

### **Step 7: Building internal and external support**

It is probably misleading to describe the need to build internal and external support for the project – and for municipal CDM projects more broadly – as a separate step; this is really an ongoing process which should run throughout the project.

As the initial feasibility study gets underway, municipal waste officials will develop a sense of whether the project is going to be viable. If the project shows good potential, this is a good time to start building support for the project internally. As we have explained, the heart of the project is the **sale of the carbon credits** and the execution of an **Emissions Reduction Purchase Agreement (ERPA)**; the municipality's ability to make the most of the commercial opportunity offered by the project can be either undermined or boosted by how it approaches the sale and the ERPA. Many South African waste managers have been tracking the opportunity for the CDM and therefore understand the basic nature of a CDM project, the project life-cycle and the potential benefits offered to municipalities by these projects. However, explaining the nature and the legal or financial implications of a CDM project to municipal legal and financial officials and SCM practitioners – whose perspective is often shaped by the kinds of procurements which routinely cross their desks – can present challenges. It makes sense to start educating colleagues about CDM projects and the CDM market early. This can help identify and overcome potential obstacles early: for example, support for a departure from standardized but inappropriate tender documentation, or support for the argument that section 14 of the MFMA does not apply to the sale of carbon credits, can be tested early on.

One of the fundamental questions which a municipality's in-house lawyers may want answered is whether the municipality has the legal authority to undertake a CDM project in the first place. Municipalities may not conduct any commercial activity which falls outside their constitutional or legislative powers and functions.<sup>6</sup> Although municipalities are not specifically authorized to undertake CDM projects either by the Constitution or other legislation, there is a strong argument that CDM projects are reasonably incidental to municipalities' effective performance of their refuse dumps and solid waste disposal functions and are therefore within local government's powers. The fact that CDM projects assist municipalities in meeting their obligations to promote a safe and healthy environment supports this argument.

**We recommend** building internal support for the viability of municipal CDM projects from day one. We also suggest that municipalities take the initiative to build external support amongst other organs of state. For example, obtaining the support of the National Treasury for such projects may offer an opportunity to come up with an alternative process from that stipulated in section 33 of the MFMA for municipal CDM projects – one which addresses the concerns of Treasury, but which does not overly constrain municipalities' ability to maximize the potential of these projects.

The potential for South African municipalities with landfills to benefit from the CDM is significant but it requires effective and timely management of the countless legal issues.

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<sup>6</sup> See, for example, section 164(1) of the MFMA.

Knowing how to apply the law without alienating the carbon credit market is the key to a successful project. The market is ready and waiting for South African landfill gas projects.