

Contractual Aspects of Implementing the Clean Development Mechanism and other Flexibility Mechanisms under the Kyoto Protocol

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Abstract

This paper attempts to examine the types of contractual mechanisms that could be used in advancing the clean development mechanism (CDM) and other flexibility mechanisms envisioned under the Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC). It attempts to distinguish the various forms of contracts that could be used to govern CDM Projects, especially with reference to any United Nations Commission on International Trade Law rules or forms.

The tentative findings are that there are a number of contractual forms for implementing long-term international commercial projects. Of these, the Intergovernmental Co-operation Framework Agreement, or that relating to a specific CDM Project, the Concession Contracts, BOT Project Contracts, Joint Venture Agreements (JVA) and the Service Contracts are feasible and viable contractual options because of their inherent flexibility and adaptability in advancing the objectives of the Kyoto Protocol's flexibility mechanisms.

However, they have to be properly drafted to reflect the substance of the agreement, the converging and sometimes conflicting interests of the major participants to these projects. To assist this process, this paper encloses outline standardised agreements for CDM Projects and Service Contracts.

Background

The terms of reference for this paper were laid down as follows:

This paper would examine the types of contracts that would be used between private legal entities participating in the Clean Development Mechanism and possibly other flexible mechanism schemes as envisioned under the Kyoto Protocol. The analysis would attempt to distinguish the types of standard forms that could be used to govern the transactions, particularly with reference to any UNCITRAL rules or forms.

The Kyoto Protocol was agreed upon in December 1997 and the Clean Development Mechanism (CDM) was created at that time as a last minute addition to the negotiated text. The other so-called flexible mechanisms endorsed by the Protocol are Joint Implementation (JI) and emissions trading. JI exists, but only in the form of its pilot phase, Activities Implemented Jointly

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(AIJ). Emissions trading is more established, but even here, there is only one programme which could be described as actually 'established', i.e., the US programme to limit SO₂ emissions.

In terms of contract development, there have been no instances of standard forms developed for the CDM and only a small number for AIJ projects. These are confidential, and do not, in any event, cover the crucial aspects relating to the crediting of emissions, since the AIJ phase involves no crediting. Nonetheless, for the purposes of this paper, some examples of formal AIJ proposals have been assessed with a view to extending some elements of this phase to the development of the CDM. Furthermore, it is hard to see what legal extrapolations pertinent to the CDM could be made to the CDM from an analysis of the US sulphur programme. They are entirely different processes with dissimilar objectives and institutional frameworks.

Beyond the guidelines laid down for the CDM in the Protocol, virtually nothing has yet been agreed upon. To illustrate what an early stage we are in with regard to the CDM, it is worth pointing out that the UNCTAD/UNEP International Working Group on the CDM (established with the backing of the governments of the USA, Canada and Brazil) just held its first meeting in September 1998. It was to address the following aspects of the CDM:

- Project design & implementation
- International trading
- Financial
- Institutional

It is clear that all aspects of the CDM relating to these four elements are still to be worked out in their entirety. This paper attempts therefore to make a small contribution to the process of CDM development by:

- Analysing the background to the creation of the CDM in Kyoto.
- Identifying concerns and potential problems that the CDM must overcome.
- Proposing a list of the elements that should comprise, in essence, the basis of a legally binding CDM contract.

The Kyoto Protocol agreed upon in December, 1997 will, if implemented, transform the way energy is produced and used. The agreement may well turn out to be one of the most significant, in terms of impact on lifestyle, of the 20th century. If the targets agreed upon in Kyoto are to be achieved, it is now virtually certain that the so-called flexibility mechanisms endorsed in Kyoto - emissions trading, Joint Implementation (JI) and the Clean Development Mechanism (CDM) - will be utilised on a large and international scale involving both public and private sectors. It is conceivable, even likely, that the nature and scale of foreign energy investment will change radically.

The basis of all three flexibility mechanisms is trading. Such trading will represent transfers of credits, allowances, permits and quotas, all of which will be linked directly to the reduction of emissions of the greenhouse gases (GHGs) stipulated in the Protocol.

In the case of JI and the CDM, the legal and contractual implications are great. Not only will it be important for contracts to protect the interests of both sides of a project or crediting deal, but it will also be a requirement that the GHG credits which result from it are, as the Protocol puts it, "real, measurable and long-term" and "additional to any that would occur in the absence of the certified project activity."

This will be of added importance for the CDM since the credits which arise from such projects will, in total, permit Annex I countries, i.e., the industrialised OECD countries that have emissions reduction targets under the Protocol, to exceed their combined limits for the 2008-2012 budget period. If the CDM is abused, inaccurate or badly designed, credits will not correspond to genuine reductions and the Annex I target will not be met. CDM contracts must therefore be watertight from both a commercial and an environmental standpoint. Indeed, the two perspectives are inextricably linked.

While it is evident that CDM contracts cannot be devised until the UN process provides a more detailed design framework, this paper seeks to propose a standard form for the future. It is based on an analysis of the Protocol, a review of selected proposals made to the UNFCCC for AIJ project support (Activities Implemented Jointly), analysis of UNICITRAL rules - and some new thinking.

Unfortunately, it has not been possible to obtain detailed contractual information from some of the pioneering AIJ projects. Despite this, this paper hopes to provide a useful contribution to the enormous amount of work that still remains to be done on these exciting and fundamentally important issues.

The U.N. Framework Convention on Climate Change

Since its adoption at the 1992 Earth Summit in Rio de Janeiro, the United Nations Framework Convention on Climate Change (UNFCCC) has been the centrepiece of the international community's effort to meet the most serious global environmental challenge. It has also become one of the most potent global forces influencing the way we live and work.

What led to the Convention? Essentially, the answer is science. While the concept of global warming was developed in the 19th century, it was not until 1988 that UNEP and the World Meteorological Organisation established the Intergovernmental Panel on Climate Change (IPCC). The IPCC was given the task of assessing current knowledge on these issues, predicting impacts and proposing responses.

The first IPCC report, the 1st Assessment Report, confirmed the scientific basis for climate change. The report had a powerful effect on policymakers and led to calls for a climate change treaty. A series of intergovernmental conferences was held, and in 1990, the 2nd World Climate Conference, involving officials from 149 countries, called for a framework treaty. In December 1990, the UN General Assembly approved the start of negotiations and a Convention was finalised on May 9th, 1992, in the short period of 15 months. The Convention was signed by 154 countries in Rio de Janeiro the following month, and has the objective of the “stabilisation of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system.” Developed countries agreed in Rio to try to bring levels of emissions down to 1990 levels by the year 2000.

The Convention also stated that developed countries “may implement policies and measures jointly with other Parties.” This short reference in an otherwise long document sowed seeds for the so-called 'flexibility mechanisms' of Joint Implementation, the Clean Development Mechanism and emissions trading.

It was in the second half of the 1990s that the international response to climate change started to gather impressive momentum. In Berlin in 1995 (the first Conference of the Parties,

COP1) it was agreed that the Rio emissions targets were insufficient, that new commitments would be needed for the post-2000 period and that these commitments should be laid down in “a protocol or another legal instrument” in Kyoto in December 1997.

In December 1995, the 2nd IPCC Assessment Report stated that “the balance of evidence suggests that there is a discernible human influence on global climate”. In July 1996 at COP2, negotiators agreed that the IPCC report justifies “action by Annex I countries to limit and reduce emissions of greenhouse gases”. The 16 months that followed was a high-pressure period of intense negotiation, and the agreement was scheduled to be concluded in Kyoto in December 1997.

The Kyoto Protocol

The Kyoto COP3 was a success for the UNFCCC process. With the agreement on the Protocol in December 1997, the UNFCCC process took another remarkable step; industrialised countries undertook obligations to reduce their collective emissions of greenhouse gases. This is a landmark environmental agreement which, if ratified and complied with, will bring about a transformation in the way energy is produced and used, and in the kind of transport systems we use as well as the way we use them. The socio-economic impact will be great; and it will be global.

In addition, the legal implications will be vast. The issues will range from high-level diplomatic issues relating to the compliance of Parties (for example, what will happen if the EU, consisting of 15 individual Parties, does not achieve its target?) to issues pertaining to a lower level of contractual agreements between private entities in different countries.

What are the main features of the Kyoto Protocol?

1. The main significance of the Kyoto Protocol is that signatories to it have made a legally binding commitment.
2. A second feature is that the Annex I countries have each made signed commitments to emissions limitations targets to be achieved by the years 2008-2012 (the EU, which ratified the agreement as a bloc in May 1998, is a special case). Collectively, the Protocol provides for differentiated, Annex I emissions-reduction targets that amount to an average reduction of 5.2%. The six gases covered are CO₂, CH₄, N₂O, HFCs, PFCs and SF₆.
3. Of especially great interest is the inclusion of the flexibility mechanisms of JI, CDM and emissions trading. These are market mechanisms can be used by countries to achieve their targets. The CDM was a real surprise and emerged from the negotiations very much at the last minute.

Joint Implementation (Article 6)

Annex I Parties can trade among themselves (transfer to, or acquire from) emission reduction units (ERUs) resulting from projects aimed at reducing emissions from sources or enhancing removals by sinks in any sector of the economy. JI is subject to further guidelines for implementation.

The Clean Development Mechanism (Article 12).

The role of this mechanism was defined in the Protocol as a means of assisting non-Annex I Parties in achieving sustainable development and in contributing to the ultimate objective of the Convention, and to assist Annex I parties in achieving compliance with their emissions-reduction targets.

Under the CDM:

- Non-Annex I Parties will benefit from project activities resulting in certified emission reductions (CERs).
- Annex I Parties can use the CERs to contribute to their compliance with a part of their targets.
- CERs must be certified by operational entities to be designated
- Modalities and procedures are to be elaborated
- Participation in the CDM is voluntary and may involve public and private entities
- CERs obtained during the period from the year 2000 up to 2008 can be used towards compliance in the first commitment period (2008-2012).

Note that CERs will be additional to the overall assigned amount for Annex I.

Emissions Trading (Article 17).

Parties are allowed to participate in emissions trading for the purpose of fulfilling their commitments. The COP is required to define the relevant principles, modalities, rules and guidelines, in particular for verification, reporting and accountability for emissions trading.

It is vital to keep in mind that the new mechanisms that have been legitimised by the Kyoto Protocol must be designed and used to deliver emissions reductions. All three mechanisms contain issues that still need a great deal of working out if this objective is to be achieved. Questions that need to be answered include the following important examples:

- How can transparency, efficiency and accountability be assured?
- To what extent can the trading of permits, ERUs and CERs be used to deliver the overall Annex I commitment?
- Who will be liable for traded units which are based on unfulfilled contracts (for example, if an energy saving CDM project does not deliver the reductions promised)?
- How can the major problem of assessing project baselines for CDM and JI projects be resolved?

Finally, there is one critical difference between JI and CDM that makes the unresolved issues relating to the CDM quite critical. This is that banking of CERs is allowed from 2000, for use in the budget period. ERUs cannot be banked and thus have no commercial significance until 2008.

Implementation of the Kyoto Protocol: The CDM and other Flexibility Mechanisms*Why the CDM?*

Two of the great debates leading up to Kyoto were related to the use of flexibility mechanisms by Annex I countries and the involvement of non-Annex I countries in the process. At Kyoto, a compromise was reached. Flexible mechanisms including the CDM would be allowed, but non-Annex I country involvement was postponed, with the exception that they these parties may voluntarily participate in the CDM. The CDM thus represents a central compromise that is a key to the unfolding of the Kyoto process.

It must be re-emphasised that the CDM has twin objectives: to promote sustainable development in non-Annex I countries, and to assist Annex I parties to achieve their new emission limitation and reduction obligations. All CDM proposals, contracts and projects must meet these objectives, and must be seen to meet them overtly, transparently and unequivocally.

The Actors

There will be two main kinds of actors in the CDM process:

- The bodies defined by the Protocol
- The parties to a CDM contract.

The bodies are defined by the Protocol in Article 12 (4), which states that, “The Clean Development Mechanism shall be subject to the authority and guidance of the COP and be supervised by an Executive Board of the CDM.”

In addition to supervising the overall operation of the CDM, the Executive Board's main order of business will be to approve and ensure certification of all relevant projects. CERs must:

- Require the approval of each Party involved;
- Provide real, measurable and long-term benefits in limiting climate change;
- Demonstrably reduce emissions that are additional to any that would otherwise have occurred.

As set out in the Protocol, the CDM must be administered through three bodies:

- The COP - authority and guidance;
- The Executive Board - supervision;
- The 'operational entities' - certification; these will be designated by the COP to certify the CERs, and must therefore be backed up by independent auditing and verification bodies.

The exact roles of the three bodies, and the linkages between them, remain unclear. For example:

- What would be the constitution of the Executive Board, who would be on it and how would it function?
- Who can certify CERs according to what guidelines? It would make sense for them to be appointed on the basis of expertise with project development and financing.
- What will be the precise relationship between the three bodies?

- Should there be internationally agreed criteria for empowering independent certification authorities, keeping in mind that the CDM is a 'market mechanism' which should not be constrained by bureaucratic procedures?

These and other aspects of the design and administration of the CDM remain by and large unresolved. If it is to go forward in practice in the year 2000, then COP4 in Buenos Aires will need to make significant progress in resolving these issues.

The parties to a CDM contract may be private or public. It is likely that the substance of the contract will vary according to whether the parties are both public, both private or one of each. For the purposes of this analysis, and as laid down in the terms of reference, it is assumed that the two parties are private, but that both may also be subject in turn to legal commitments or obligations to their governments, which are Parties to the UN Convention.

The CDM contract - starting points

It appears that the following are the central and minimal requirements for any CDM contract:

- The CDM contract may be a commercial, quasi-commercial, or simply an intergovernmental agreement. A direct CDM Project agreement between private parties for the purpose of making profit would certainly qualify as 'commercial'. If it involves a sponsor and a host government with a government agreement, it would not, strictly speaking, be 'commercial,' because of the introduction of a "service" element. However, such agreements could qualify as "quasi-commercial". But, an agreement between two governments for the carrying out of a CDM Project would be an intergovernmental agreement;
- It envisages a long-term arrangement because it involves the execution of continuing obligations over a lengthy period of time (usually counted in years);
- It possesses an international or foreign element in contrast with a strictly domestic contract between citizens of one particular country;
- It involves the transfer of appropriate technological know-how and financial resources to the host country;
- The home country gains credits from complying with its emission limitation or reduction commitments under the Protocol.

The CERs arising from a CDM contract will have a cash value which, one assumes, makes the project viable from the donor's point of view (there may of course be other incentives available to either party to facilitate the project). Nonetheless, this critical new element has significant implications for the contract.

What will be the main issues that must be covered by the contracts between the parties involved in CDM projects? The nature of a contract between the two parties to a CDM deal could be quite complicated. It will not only need to satisfy as well as protect each of the parties in the same way that any commercial contract would; but it will need to be of a form which would ensure that it is consistent with the requirements of the Convention, the Kyoto Protocol and any other subsequent agreements or requirements laid down by the COP or the Executive Board.

The consideration of the contract must also involve an assessment of the converging as well as conflicting interests of the various actors involved. The COP is the overall governor of the UN process. Its aim will be that Parties meet their obligations. It is not so much concerned as to

whether there are CDM projects or not; but if there are, they must deliver watertight and meaningful credits, and sustainable development. Since the COP has delegated administration of the CDM to the Executive Board, which in turn will require operational entities to certify the CERs, all three have a direct and converging interest in these twin aspects. They are central to the CDM contract.

The private parties will have divergent interests that can nevertheless be achieved by a common project. The investor, in coarse terms, wishes to minimise expenditure and maximise income while achieving a maximum number of emission credits. It is not so much concerned with the delivery of sustainable development, provided the project delivers enough emission credits to legitimise the contract.

The host wishes to maximise technological assistance, investment and its share of any income stream. It may also be interested in the general objective of sustainable development. It will only have an interest in the number of emissions-reduction credits to the extent that there should be sufficient credits to encourage the investment to take place; however, if the host is entitled to a share which can be used in due course, it will also have an interest in maximising both the number of credits and/or its share of that number.

As for the home countries (Annex I Parties), granted that they would hope to accomplish the broad objectives of achieving compliance with their quantified emission limitation reduction (QELR) commitments in CDM Projects, it is equally likely that such projects may be viewed as convenient alternatives to taking hard but realistic decisions affecting industry, and by extension, their respective national economies back home.

The implications of all these issues and concerns are clear:

- Particularly if credits are shared between the two parties, both will have a clear interest in maximising - perhaps over-estimating - the number of credits available from the project. CER certifiers must be clear that the contract assesses the number of credits accurately;
- Only the COP and Executive Board will have an interest in the promotion of sustainable development within the project contract. It remains to be determined how this should be dealt with contractually - the issue is famous for its lack of clarity.

The CDM contract - issues to be covered

The fundamental features of the contract will therefore be as follows:

- A definition of the project;
- Commitments by the donor in relation to financial investment, GHG reductions (see below), project performance, technology co-operation and sustainable development;
- Commitments, if appropriate, from the host in relation to site and/or project ownership, provision of goods and services in relation to effective operation of project and sustainable development;

Specific aspects to be covered would include the following:

- Arrangements for the ownership of the project site, project and CERs arising from project;

- Detailed identification and quantification (over the full life cycle of the project) of greenhouse gas sources and sinks at the site and which are included in emissions baseline, together with assumptions and uncertainties;
- A project schedule and timetable, including the period during which emission reductions will take place with year-by-year forecasts of reductions;
- Estimated total CO₂-equivalent emissions reduction accruing to the donor investor (and host if credits are to be shared) over a specified period. Note that Art. 12 (5) states that emission reductions should be real, measurable, long-term and additional;
- Emissions monitoring process and data collection procedures;
- Procedures for updating estimates of emission reductions;
- Arrangements for independent auditing, external verification and certification;
- Assuming that certification takes place before the transfer of credits, enforcement mechanisms will need to be laid down in the event of non-compliance;
- Penalty arrangements in the event of non-compliance by either party, in particular in the event of emission reductions being lower than estimated;
- Commitments relating to Article 12(2) that the CDM should help developing countries achieve sustainable development. All non-GHG environmental impacts of the project should therefore be detailed;
- Commitments relating to Article 12(8). The contract should determine what share of the proceeds are allocated to cover administrative expenses and/or assistance to Parties for adaptation to climate change.

An Illustration

An illustration of a CDM project might be as follows. The investor or donor might be a European electricity company which is participating in a domestic emissions trading system applied by its government as a means of achieving its Kyoto target. The electricity company comes to the conclusion, after allocation of permits by the government or regulatory body, that it would be more cost-effective to invest in a CDM project than to undertake mitigation efforts domestically.

It identifies a major opportunity for an industrial co-generation project in Asia. This project is not economic because of the artificially low price of industrial power in the country (this raises other CDM issues: if the host country liberalised its power market, the co-generation project could become economic without credits), but the European company estimates that the project would save about 100 kT of CO₂ over a ten year period and it could therefore acquire a corresponding amount of CERs. Given its forecast of the value of credits, it decides that the project would now be profitable. It opens talks with the domestic power monopoly and they agree to proceed with a CDM agreement on a BOOT 10-year basis.

The project is certified by an operational entity and the CDM Executive Board endorses the estimate of credits. The project proceeds and the European company derives its credits over a ten year period. At the end of the period, it makes its credits available for sale within the domestic trading market, or in the international trading market to offset some or all of its own excess emissions.

Sustainable development is promoted through the replacement, by the co-generation plant, of the host industry's brown coal boilers and the financial resources flowing into the host country's national economy.

Other mechanisms of implementation: Emissions Trading and Joint Implementation.

Emissions trading and JI already exist. Emissions trading is taking place within the US Sulphur Programme to combat acid rain, and there are other more minor examples. In addition, BP and other global companies are introducing internal trading trials. JI is taking place within the framework of the AIJ (Activities Implemented Jointly) programme in the form of a series of pilot JI projects, under the supervision of the Convention.

As far as both emissions trading and JI are concerned, the Protocol makes clear that all the rules and guidelines for their operation have yet to be decided. Much of this will need to be done at COP4 in Buenos Aires.

Standardisation and CDM Projects***A standardised contract for the CDM?***

Is it possible to have a standardised CDM Project Agreement? The question of standardisation has elicited much controversy in contract law. In relation to a CDM project, the main argument against a standardised agreement would be that not all CDM projects will be exactly alike and so standardisation could undermine the potential for flexibility and dynamism in achieving contract objectives. Given widely varying cultural and commercial circumstances in different countries, a case-by-case approach seems legitimate.

Nonetheless, it is likely that the Executive Board of the CDM will lay down a series of contract guidelines that will need to be met in order to secure the achievement of the goals of the Protocol. Some of the advantages of standardisation include the following:

- Standardisation facilitates the conduct of commercial/investment transactions thus saving costs and time;
- It facilitates the comparison and evaluation of contractual responsibilities and associated risks, if these are based on the same well-known contractual terms;
- It makes financing easier, since financiers would be familiar with contractual terms;
- It enables the parties to plan ahead and to have effective control, monitoring and supervision of projects;
- It reduces the tendency for the private sector to exploit its financial and technical advantage in the course of negotiations with national or local authorities;
- It may facilitate sub-contracting and negotiating of other project-related contracts;
- Standardised project agreements are more carefully drafted and as such are usually of a higher quality;
- Standardisation does not necessarily preclude introducing special conditions if needed, thus ensuring flexibility and dynamism.

It could be contended, however, that standardisation is not very common or appropriate in long-term contracts but rather, as an instrument for short-term, immediately consumable transactions.² There is, however, a growing trend in standardising long-term agreements even in the natural resources sector as evidenced by the tendency of host countries to draw up similar model contracts to govern such transactions. This is equally true at the international level, where the United Nations Industrial Development Organisation (UNIDO), the International Chamber of

² T. W. Waelde, *Modelvertraege unde zwischenstaatliche Kooperationsabkommen: Formen der verflechtung zwischen Recht und Wirtschaft, Jahrbuch fuer Rechtssoziologie und Rechtstheorie*, 1982, p. 372.

Commerce (ICC), the Association of International Petroleum Negotiators (AIPN) as well as the World Bank have been working on and even published some standard terms.

Then, even if standardisation of CDM Project contracts were preferable, the issue arises as to the type of contract to be adopted. Does the UNCITRAL practice or laws provide any guidance?

UNCITRAL was created in 1966 in order to enable the UN to play a more active role in reducing or removing legal complications in the free flow of international trade. It has accordingly produced a continuous flow of studies, standard terms (for documentary credit) and model rules or laws (for arbitration and procurement) in areas of international trade law for national enactment.

So far, however, there are no particular UNCITRAL rules or forms for CDM Project contracts. This is understandable, as this mechanism was invented post UNCITRAL, and could not have been contemplated by UNCITRAL rules or forms. In the circumstances described in the scenario above, recourse would have to be had elsewhere for any further analysis on the possible types of contracts for CDM Projects. It is pertinent to stress though, that whichever type of contract is eventually adopted, a conciliation, mediation and, or arbitration clause should be a must for every such contract.

Possible Contract Types for CDM Projects

Generally speaking, there are already a number of example contracts which have been negotiated since the Kyoto Protocol was agreed upon, most of which would not squarely fit into the CDM Project framework because these later projects were obviously not originally contemplated by such contractual arrangements. But, considering the substance of CDM Projects, other examples of inter-governmental agreements such as Intergovernmental Co-operation Agreements, Concession Contracts, BOT Project Contracts, and Joint Venture and Service Contracts deserve closer analysis because they have certain features which make them more easily amenable to the kinds of agreements envisioned under the CDM.

Intergovernmental Co-operation Agreements

These are agreements entered into by governments for and on behalf of their respective sovereign states and can be of a general, framework nature or relate to a specific CDM Project (for a simplified diagrammatic representation of these agreements, see Appendix I). They usually provide, among other things, procedures and joint institutions for co-operation programming, for project preparation and evaluation as well as for implementing projects and monitoring their performance.³ These ongoing efforts to develop suitable intergovernmental co-operation contracts can be complemented by the further deliberations of the COP under the Kyoto Protocol. Intergovernmental agreements relating to specific CDM Project(s) could contain provisions relating to:

- The partial, or full assumption of risk of non-performance of such projects by their respective home countries. Where projects are initiated by private legal entities, the home states should bear partial assumption of risk. But, full assumption of risks should be borne by home states if projects are initiated by their respective public sectors;
- Provisions regarding financing and market access conditions to enable the proper and effective implementation of the CDM;

³ T. W. Waelde, "Methods and Mechanisms for International Industrial Co-operation", UNIDO Industry 2000 - New Perspectives Collected Background Papers, Vol. 2, UNIDO/IOD.325 19 December 1979, p. 40.

- Host state guarantees regarding stability of the enabling regulatory regime, including the terms of the CDM agreement; and
- Host state guarantees relating to the uninterrupted supply of energy and natural resources, where these are applicable to the CDM Project.

Some of the advantages of intergovernmental co-operation agreements include the following:

- This type of agreement seeks to link project contracts with international law through home state commitments to assume performance responsibility;⁴
- It provides a convenient framework for project agreements on the enterprise level by shielding such enterprises from the vagaries of host country regulatory regimes;
- The reduced number of participants allows commitments to be more concrete and precise in terms of specific sustainable development goals and strategies or quantified emission limitation and reduction objectives (QUELROs);
- Since this type of agreement can take a variety of forms, it is flexible enough to correctly reflect the degree of state intervention in concrete cases of co-operation at the project level;
- The rules or terms of the agreement may be bilaterally negotiated, thus allowing innovative solutions and a gradual evolution of the entire process.

The main disadvantage of these types of agreements stems from the assumption of the equal bargaining power of the respective parties, which is not usually the case. Indeed, it is not unlikely that the unequal bargaining power and the inadequacy or absence of experience on the part of developing countries will result in an agreement that reflects this lopsided relationship in favour of the industrialised country. The solution lies in drafting such agreements to meet the differing, legitimate expectations of the parties. This would imply, *inter alia*, that:

- The agreements should not be exclusively reflective of the defensive interest of the investing or exporting countries;
- They should equally reflect elements of the collective interests of developing countries and actions in keeping with those interests such as technology co-operation, financial resources and respect for sovereignty over natural wealth and resources;
- They should contain concrete commitments from the parties aimed at creating a package of mutually beneficial interdependence.

Concession Contract

The term “concession” connotes “ownership” or, what in common-law systems is described as a “free-hold interest”. It is an arrangement whereby the private sector is granted the right to develop a public infrastructure project. The concession system has become transformed in the light of the exigencies of modern international commercial transactions. The following are some of the features of the modern concession contract:

- It gives exclusive right to the concessionaire to undertake its operations in a given area, including other ancillary operations within a certain duration with the possibility of renewal;

⁴ T. W. Waelde, “North/South Economic Cooperation and International Economic Development Law: Legal Process and Institutional Considerations”, 23 *German Yearbook of International Law (GYIL)* 79 (1980).

- The concessionaire has exclusive rights to manage its operations without undue interference from the host government;
- It sets out clear commencement, work, and other obligations, which may include the filing of work reports;
- It involves a simplified tax system that enables the concessionaire to effectively amortise its investments within a reasonable period of time;
- Pricing is always set by the concessionaire but, with government supervision;
- Dispute settlement is usually by ad hoc arbitration with the laws of the host country and international law as the choice of law clause;
- There is a possibility for revocation in exceptional circumstances.

The concession system has been modified in recent times to accommodate various other types of projects, with a considerable reduction in host government participation and control. It is possibly one of the most attractive options for CDM Projects, since it enables the private sector to exercise a free hand in developing and managing the project, with minimal host government interference. Innovative contractual clauses can be drafted to synchronise with the objectives of the CDM.

It is important to note that, in all contract types, the problematic issues are always in investment guarantees: non-expropriation, repatriation of investment/revenues, stabilisation clauses and duty free imports, just to mention a few. These issues deserve much more than a mere mention here. While in theory, the foreign private investor can obtain maximum government guarantees for the security of his/her/its investments by very clear contractual provisions, in practice, the government has some shrewd ways of bringing about tangible changes or the termination of an agreement.

Non-consensual modifications of economic development agreements may arise outside the realms of clear cases of breach of contract or force majeure from:

- (a) government's unilateral action taken on the ground of public purpose;
- (b) a fundamental change of circumstances rendering the performance of the agreement unduly onerous or wholly or partially fruitless

Traditionally, foreign private investors have tended to protect themselves by contractual devices such as inserting stabilising clauses, choice of law clauses and arbitration clauses. The stabilisation clause aims to protect the original contractual terms from future legislative changes of the host state, which may have negative repercussions in terms of taxation, environmental controls and other regulatory matters. The choice of law clause is usually aimed at subjecting the agreement to some other law (usually international law or general principles of law) besides the laws of the host state, which could be changed at will. The arbitration clause is usually aimed at choosing a neutral forum for settling disputes that may arise from the agreement. The combined effect of these clauses is to internationalise the contract.

While there have been a number of very persuasive objections to the theory of internationalisation, current trends appear to favour a delicate balancing of the often conflicting interests of foreign private investors on the one hand and host governments on the other. This approach involves the recognition that no sovereign state can divest itself of its primary responsibilities of protecting public interests and promoting sustainable economic development on the one hand, and ensuring some adequate guarantees against the consequences of unilateral

government action on the other. These responsibilities may involve an obligation to renegotiate contracts if and when the original contractual equilibrium has been modified by a fundamental change of circumstance. Such a clause affords the possibility for the “dynamic stability” of the original contractual terms.

BOT Project Contracts

According to the UNCITRAL,

BOT is conceived as a way to reduce pressure on the use of public funds for project financing and to promote the transfer of technology through the involvement of the private sector in financing, building and operating infrastructure projects. In its most basic form, a BOT project is where the Government grants a concession for a period of time to a consortium for the development of a project. The consortium finances or arranges for financing for the project, constructs the project, and operates and maintains the facility during the life of the concession. Meanwhile, through sale or charge for the use of the facility or its products, the consortium recovers returns on its equity and pays off its debts. At the end of the concession period the project is transferred to the Government.⁵

The potential advantages of using the BOT Project contractual approach to both the private and public sector are illustrated in Table 1 below:

Table1:
Potential advantages to both private and public sector of using BOT approach for infrastructure development

Private Sector	Public Sector
<ul style="list-style-type: none"> • Gives private sector a free hand to finance the project, rather than depend on contribution from host government, which may cripple project because of government’s other commitments. 	<ul style="list-style-type: none"> • Use of private sector financing to provide new sources of capital, which reduces public borrowing and direct spending and which may improve host government’s credit rating.
<ul style="list-style-type: none"> • Ability to accelerate the development of projects that would otherwise have to wait for, 	<ul style="list-style-type: none"> • Ability to accelerate the development of projects that would otherwise have to wait for,

⁵ See Netscape - [UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW Twenty-sixth session Vienna, 5-23 July 1993], “Possible Future Work: Note by the Secretariat”, Web site: <<http://www.his.com/~pildb/acn9-378.htm>>, (visited 08/03/98), p. 5 of 7, para. 3.

and compete for, scarce sovereign resources.

and compete for, scarce sovereign resources.

- Use of private sector initiative and know-how to reduce project construction costs, shorten schedules and improve operating efficiency.
- Private sector is responsible for the operation, maintenance and output of the project for an extended period (normally the government would receive protection only for the normal construction and equipment warranty period).
- Involvement of private sponsors and experienced commercial lenders, which ensures an in-depth review and is an additional sign of project feasibility.
- Able to recoup the costs of technology transfer, training of local personnel and the development of national capital markets towards the transfer of the project.
- Private sector establishes a benchmark against which the efficiency of similar public sector projects can be measured and the associated opportunity to enhance management of infrastructure facilities.
- Use of private sector initiative and know-how to reduce project construction costs, shorten schedules and improve operating efficiency.
- Allocation to the private sector of project risk and burden that would otherwise have been borne by an already encumbered public sector.
- Gives government a breathing space to source indigenous and skilled manpower comparable to the private sector.
- Public gains from technology transfer, the training of local personnel and the development of a national capital market.
- Public sector can measure its efficiency against the benchmark established by the private sector in respect of similar projects and associated opportunities to enhance management of infrastructure facilities.

Source: Adapted by authors from UNIDO BOT Guidelines (Vienna: UNIDO. 1996), p. 7.

BOT Project Agreements may be said to be modified versions of the concession contract. There can be considerable diversity in their form and content, ranging from “huge, complex contracts, tailor-made for a particular infrastructure project to straightforward and to some extent standardised contracts for each infrastructure sector, as in China’s BOT programme.”⁶ To this extent, they can be said to be as flexible and dynamic as compared to concession contracts. Again, in view of the fact that in the construction, implementation and maintenance of some CDM Projects, like their AIJ counterparts, science, engineering and construction works would play a considerable role, the attractiveness of BOT Project Agreements can not be over-emphasised.

However, they have to be specially and carefully drafted to fit into the legal systems within which they are to operate. Legal systems that are less supportive of, or less transparent to, the BOT

⁶ UNIDO, Table 1, at p. 226.

approach may require far more comprehensive provisions in BOT Agreements than those that are more supportive or transparent.⁷

D. Joint Venture Agreements (JVA)

The “joint venture” is “a business arrangement in which two or more parties undertake a specific economic activity together”. Although there are different variants of joint ventures (JVs), they are generally a popular way of pooling together scarce financial and technical resources for the purpose of carrying out a commercial undertaking. The JV contract spells out the terms of the joint venture, especially the financial commitments of each partner and the modalities for sharing of profit, which need not necessarily be in equal proportion. In the energy sector, host governments see JVs as an effective way of participating in the development of their natural resources, with the concomitant prospect of technology transfer.

The CDM will involve an arrangement between non-Annex 1 and Annex 1 Parties, by which the former benefits from project activities resulting in certified emission reductions and the latter may use the certified emission reductions accruing from such project activities to contribute to compliance with part of their quantified emission limitation and reduction commitment. In practice, though, both industrialised and developing countries could use private and public entities to undertake CDM joint ventures (CDMJV). Clearly, a CDM joint venture agreement (CDMJVA) would be the most appropriate framework to guide the commercial and legal relationship between such entities. A standardised CDMJVA can be adapted to take care of the special requirements or substance of the clean development mechanism. Table II is an attempt to summarise some common advantages and disadvantages of the JVA.

Table II: Some Common Advantages and Disadvantages of the JVA

PROJECT DEVELOPERS VIEW POINT	HOST GOVERNMENT'S VIEW POINT
-------------------------------	------------------------------

Advantages

- | | |
|--|---|
| <ul style="list-style-type: none"> • Moulding a project in a form which is compatible with government policies • Minimising political risk • Improving predictability and stability of operational conditions • Providing a communication channel to the | <ul style="list-style-type: none"> • Maximising national sovereignty • Receiving subsidised or risk-free participation • Sharing in the rewards of value added • Influencing training, education labour |
|--|---|

⁷ A supportive regulatory framework could contain, for example, a Law, Regulation or Code like the Indiana code 22-3-2-15 Enacted 1929, Amended 1991, where “BOT agreement” was defined as “any agreement between the state or a political subdivision and an operator to construct, operate, and maintain a public facility and to transfer the public facility back to the state or political subdivision at an established future date.” See Netscape - [IC Title 36, Article 1, Chapter 14.3, Section 4], Website: <<http://www.law.indiana.edu/codes/in/36/36-1-14.3-4.html>> (visited 08/03/98), p. 1 of 2; A supportive legal framework could also contain and publish general project eligibility criteria and national rules, which are not incompatible with the provisions of the Kyoto Protocol as the Czech Republic already has done for JI development projects. See Netscape - [JI Project development in the Czech Republic], Web site: <<http://www.vol.cz/nondek/jicz/websi2.htm>> (visited 08/06/98), p. 1 of 2.

government

recruitment and labour policies

- Availability of tax or other investment incentives
- Influencing decisions on sourcing and pricing of plant, equipment, production inputs and services
- Influencing destination and pricing of products
- Minimising any perceived adverse effects of FDI

Disadvantages

- “Soft” value of host country’s capital contributions
- Need to contribute capital or other assets
- Less efficient decision-making and financing structures
- Need to offer tax incentives
- Exposure to risk of loss of confidential commercial information and know how
- Exposure to business risks
- Exposure to risk of incompatibility with government bureaucrats
- Exposure to risk of incompatibility with foreign partner.

Source: Adapted from R. Pritchard et al., “The Use of Joint Ventures in FDI”, in R. Pritchard ed., Economic Development, Foreign Investment and the Law: Issues in Private Sector Involvement and the Rule of Law in a New Era (London: Kluwer Academic Publishers, 1996), p. 178.

Two observations should be made here. The first relates to the varying objectives of the joint venture partners (investor on the one hand and host government on the other). Whereas the host government would be more interested in attaining sustainable development, including technology transfer for the benefit of the national economy, the investor would be more interested in making a profitable return on its investment. The second relates to the host government’s ability to meet its cash-call obligations (in practice, usually the responsibility of the appointed government agency, or public enterprise). Many feel that cash-strapped non-Annex I countries can hardly be expected to meet their financial commitments under the JVA.

However, in no contractual arrangement is an investor’s objective identical with that of the host government. Furthermore, fears about the host government’s inability to meet its cash call obligations under the CDMJVA would be arrested by Article 12(6) of the Protocol. And, even if the CDMJVA is not a favoured option because of host government involvement, it is, nonetheless, an attractive option for several companies willing and able to pool their resources to undertake a CDM Project in a non-Annex I country.

Risk Service Contracts

This is usually a camouflaged concession, BOT or joint venture arrangement. In risk service contracts, the services of an investor, who assumes the legal status of “contractor”, are hired by the sponsoring (hiring) state. In the case of a CDM arrangement, the task of the contractor would be the construction, maintenance and implementation of the CDM Project, or the training of personnel for the purposes of managing any such project. After successful execution of the contract, the contractor is reimbursed for its costs and investments and paid for its services by the sponsoring

state. The contractor bears the entire financial risks of the undertaking and is reimbursed after its successful execution. This explains why it is sometimes referred to as the “Risk Service Contract”.

The main distinction between risk service contract and the joint venture or sole-investor arrangement is that in the former, the contractor provides a service, and gets its payment from the sponsor, while in the latter, the investor puts up risk capital and gets its return from an expected flow of profits from the venture (usually shared in the case of a joint venture).

A further distinction should be made between a risk service contract and a real service contract. Whereas in the former, the host or sponsoring state pays for the services of the risk service contractor, in the latter, someone else pays. The latter situation may arise where, for example, a home country, or international agency hires the services of an independent contractor (service contractor) to undertake certain services for the benefit of a third party beneficiary which is also a host country. In this situation, there is no contractual relationship in the legal sense of the term (privity of contract) between the host country and the service contractor as such, since the service contractor receives payment from the sponsoring home state or international agency. Exceptionally, there could be a sub-contract between the service contractor and the host country for the rendering of the particular service it has been hired to perform, even when the sponsor is not the host country. Even in this latter situation, the service contractor gets paid by the sponsoring agency rather than the host country. Appendix III, Figures III and IV are attempts to illustrate the real service contract for purposes of clarity. An example of the real service contract is the Phare/Tacis Multi-country Project.⁸ In that project, for instance, the contracting authority, the European Community (EC) hires a consortia (service contractor), comprised of two or more partners with a view to provide, among other things, training and a good level of understanding of the Energy Charter Treaty and the Protocol on the part of selected key personnel of each of the Phare partner countries. This is done with a view to bringing their legislation in line with ECT requirements and harmonising their legal, policy and institutional framework with the EC.⁹ The consortia (Service Contractor) does not get paid by the beneficiary countries, Central and Eastern European Countries (CEEC), but by the sponsor or contracting authority, the EC. Similarly, the COP could, in addition to arranging for funding for CDM Projects, hire a Private or Public entity as service contractor to construct and implement a CDM mechanism in a non-Annex I country. While this would be with the consent of the parties, the service contractor would not get payment from the host country, but instead from the COP. Details regarding quantification and allocation of credits can be worked out within the framework of the service contract. The table of contents as well as an explanation of the general conditions for service contracts financed from the Phare/Tacis Funds are also included as appendix III for illustrative purposes.

As in every other contractual arrangement, the potential for conflicts always exists in the real service contract because of its peculiar arrangement. The real service contractor may be bound under the real service agreement not to indulge corrupt officials of, for example, the host country or to abide by certain standards. This may however pose practical difficulties, as the host country may set its own agenda in the “national interest”, including the imposition of import duties and levying of taxes. These are no doubt very thorny issues in practice since poor governments can not easily refrain from either levying taxes or imposing duties on imports. If these difficulties are not

⁸ Energy Charter Treaty Project III, Phare Multi-country Project No. B5-97-042.

⁹ “Phare” means “European Community assistance programme for the reconstruction of the economies of Central and Eastern Europe.” “Tacis” means European Community assistance programme for Technical Assistance to the Commonwealth of Independent States and Mongolia.”

anticipated and an amicable resolution properly provided for, the effective execution of the real service contract is bound to be prejudiced.

Possible Contract Types for Other Flexibility Mechanisms

The contract forms for ET and JI are simpler than those for the CDM in the sense that there are already a number of pilot projects implementing the former mechanisms. Since emissions, or emissions reductions, amount to tradable commodities in the ET mechanism, a simple standardised contract for the buying and selling of ‘permits’, ‘allowances’ or ‘emissions reductions’ by which one Party agrees to sell and the other agrees to buy such tradable commodities could be drafted. Besides, precedents already exist in the United States, where ET has been successfully employed in limiting emissions of sulphur dioxide (SO₂). However, considering that assigned amounts, defined by article 3 of the Protocol, may be traded, an emissions trading contract (ETC) within an umbrella or framework intergovernmental agreement is possible.

Also, since JI envisages Annex I countries undertaking GHG reduction projects within other Annex I countries, by means of which reductions are credited to the country financing the project, while debiting the excess reductions of the host country, an intergovernmental agreement that defines the framework for this joint venture relationship between the home country and host country is appropriate as a necessary starting point. However, considering that countries can authorise private companies to develop JI projects, while reserving the powers of approval, certification of emissions reductions, and or monitoring and verification, for themselves, the option of using either an intergovernmental framework agreement or an intergovernmental agreement relating to a specific JI Project is not a *sine qua non*. On the contrary, the JV, BOT or even Service Contract are equally feasible and viable options. Whatever contract form is employed for JI, it is the substance of the contract that really matters. Such a contract has to state very clearly, *inter alia*:

- How to establish a baseline for the calculation of real emissions reductions of projects;
- How to monitor, verify and certify real emissions reductions;
- How to scale down the administrative and transaction costs of projects.

At the risk of sounding repetitive, it must be reiterated that a big issue will be investment guarantees, in particular tax and import duty issues. A review of intergovernmental and inter-organisational/government agreements such as Tacis EC and UNDP agreements indicates that there is always a promise by the beneficiary host government to provide import duty exemptions and impose no taxes. But, these promises would be difficult, if not impossible, to adhere to in practice, since developing country governments are urgently in need of revenue for the development of their national economies. The prudent approach seems to be to anticipate these potential disruptive tendencies in an investment regime and to provide adequate safeguards that would not only minimise the damage to investment, but also enable both parties to renegotiate the original terms of the contract where a fundamental change of circumstance so dictates.

Conclusions and Recommendations

This paper attempts to examine the use of contracts for achieving the clean development mechanism (CDM) and other flexibility mechanisms envisioned under the Kyoto Protocol (“the Protocol”). It takes the view that, while Intergovernmental Co-operation Agreements (capital letters?), the Concession Contract, the BOT Project Contracts, Joint Venture Agreement (JVA) and the Service Contract are preferable because of their inherent flexibility and adaptability in advancing the objectives of these flexibility mechanisms; in practice, it is the substance of the agreements in

question rather than the form that matters most in terms of effectiveness. It is also necessary to add that these distinct forms can be used for perhaps 3 broad scenarios:

- An intergovernmental agreement (either a framework agreement or one relating to a specific project) between two or more Annex I countries for emissions trading, which may be accompanied by a specific standardised emissions trading agreement;
- An intergovernmental agreement between two or more Annex I countries, which may be followed by a specific Concession, BOT, JVA or Service Contract in respect of a JI Project;
- An intergovernmental agreement between Annex I and non-Annex I country, followed by a specific Concession, BOT, JVA, or Service Contract in respect of a CDM project in a non-Annex I country.

However, certain general principles are fundamental for any contract to be effective both in terms of the relationship between the parties to the agreement and in terms of achieving general contract objectives. These include but are not limited to the following principles:

- Full conformity with the requirements of the UNFCCC, the Kyoto Protocol and any subsequent agreement relating to the CDM. In particular, the contract should define the emissions reduced (CERs); how they should be measured, verified, certified and shared between the contract parties; how the project stimulates sustainable development; liability arrangements in the event that the project fails to deliver the contracted CERs.
- Equity or fairness and transparency in apportioning rights and obligations between the parties. This may involve “affirmative action” to counteract unequal development and compensate for the structural weaknesses of developing country party;
- Cost effectiveness in the pursuit of contract objectives;
- Unambiguous stating of terms, which should include modus operandi for implementation and enforcement, financial mechanism, dispute settlement, liability and compensation for damages or failure of the undertaking;
- The principle of both host and home state co-responsibility for international economic and environmental co-operation.

Appendix II attempts to fashion a table of contents for a standard CDM Project contract as well as a summary explanation of what the various sub-headings should include. However, these should not be taken as sacrosanct, considering that different local conditions and project types or objectives could dictate justifiable modifications to this model.

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Appendix I

Diagrammatic Representation of the use of Intergovernmental Annex I and Non-Annex I Parties' Cooperation Agreements for CDM Projects

Figure I: Intergovernmental Framework Agreement

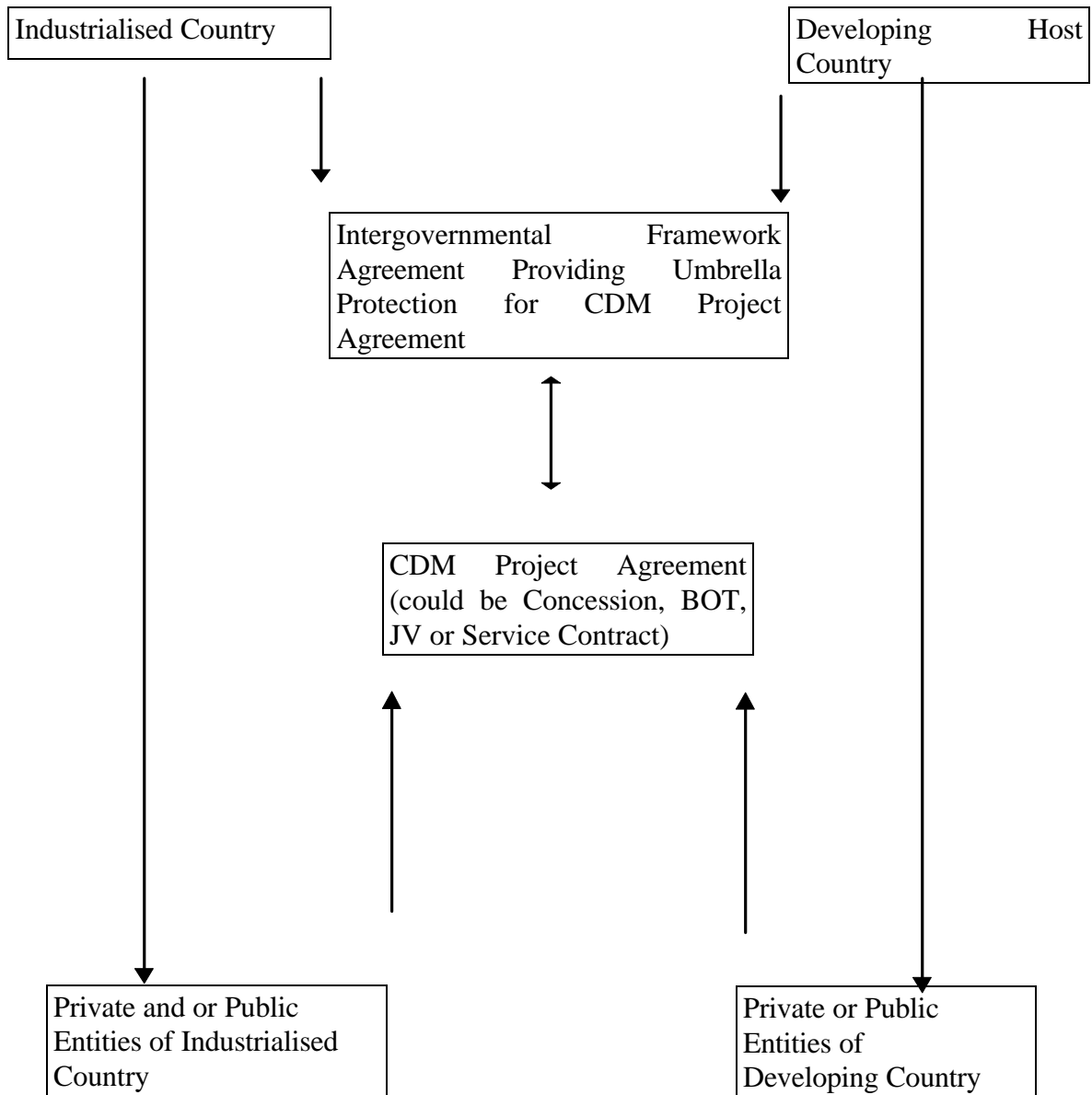
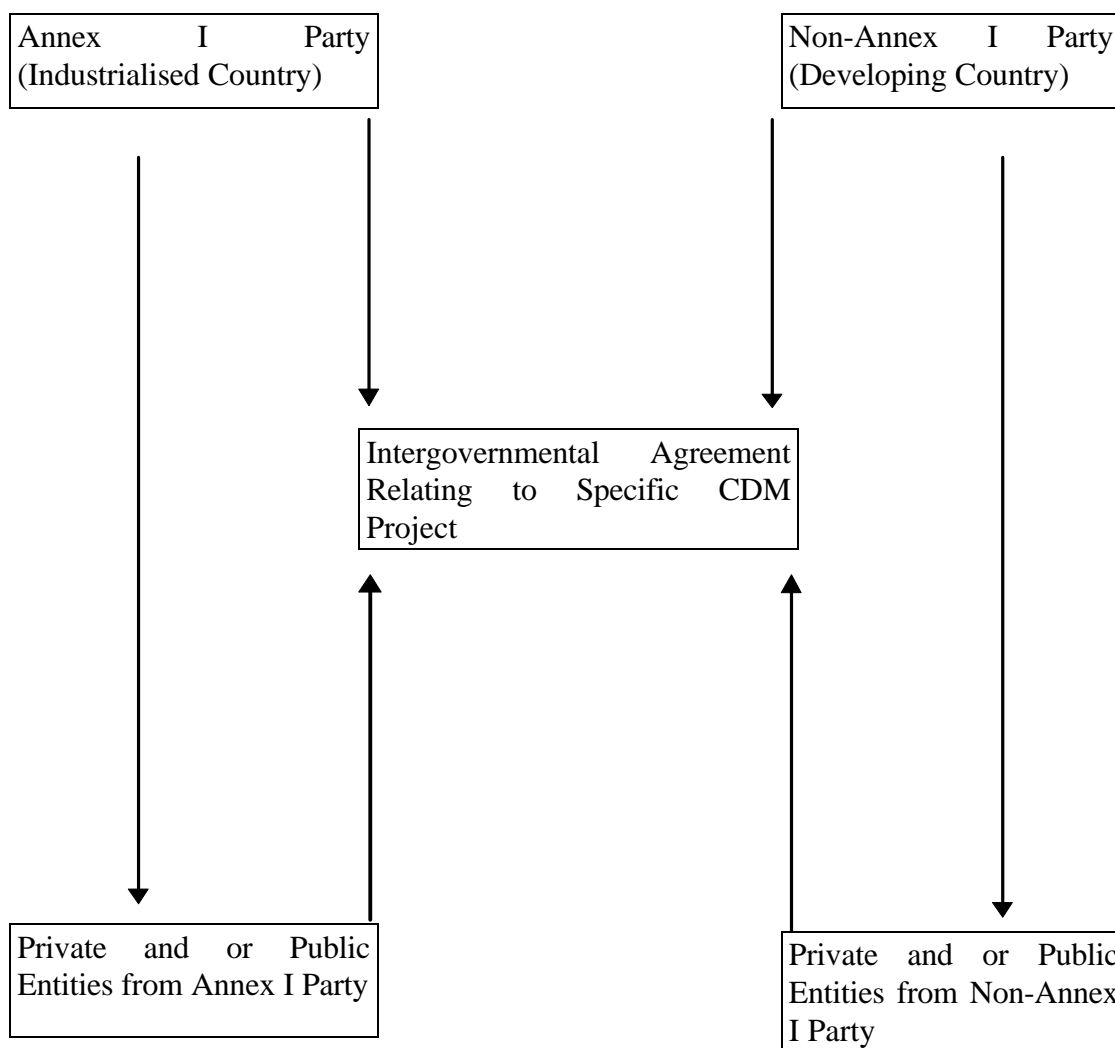


Figure II:
Intergovernmental Agreement Relating to Specific CDM Project



Appendix 2

Summary Explanation of a Standardized Agreement for a Clean Development Mechanism (CDM) Project.¹⁰

Commencement: This is the beginning of the agreement, which details the date of commencement as well as the names of the relevant parties. The host government or its appointed representative or agency should be one party, while the concessionaire(s) or a company that has been formed for the purposes of the project (CDM project company) should be the other party.

Recital: This is the section that begins with “Whereas”, and often provides background information regarding the project and the context in which subsequent sections of the agreement become necessary. While *strictu sensu* the recital does not form part of the agreed terms, it may be admissible in evidence to prove the contextual framework of the agreement.

Chapter I: Purpose of the CDM Project Agreement:

1. **Interpretation:** This should provide definitions of the key terms employed in the CDM Project agreement. It should include terms such as “CDM Project”, “Project Company”, “Associated Company”, “Minister”, “Secretary”, “Principal”, “Exceptional Circumstances”, “Concessionaire”, “Documents”, “Maitre d’Oeuvre”, “National Defence”, “Safety”, “Security”, “Conference of the Parties” or “International Agencies”, etc.
2. **The CDM Project and its characteristic:** This should describe in some the CDM Project, its characteristics or what it would comprise of, including how it intends to operate. It might be necessary to specify details of scientific specifications into an Annex.
3. **Coming into Operation and Duration:** This should set out the conditions precedent for the coming into operation of the CDM Project as well as the time when it is expected to lapse. Perhaps, these may be without prejudice to other subsequent provisions relating to renewal and transfer of the CDM Project.
4. **Acquisition of Land and Ownership of the CDM Project:** This should state the availability of land for the project and the ownership of the project. The state or its agency might have to undertake to make land easily available for the project and that, for a certain duration, ownership of the project shall vest in the Project company or concessionaire.
5. **Financial Requirements:** This section might require considerable flexibility and dynamism, since financial requirements may defer from one project to the other. Nevertheless, it might be necessary for the concessionaire to guarantee the availability of funds for the completion of the project and implementation thereof. Conversely, the concessionaire may wish to disclaim liability in the unlikely event that there is an inadequacy of finances to complete or implement the project. In the latter case, the provisions regarding termination of the project would become applicable.

¹⁰ The compilation of this table of content and the accompanying explanations of its content, has been adapted from two principal sources: Niclisch (Hrsg.), Rechtsfragen privatfinanzierter Projekte: National und international BOT-Projekte (Heidelberg: Muller, Jur. Verl., 1994), pp. 93-117 and UNIDO, UNIDO BOT Guidelines (Vienna: UNIDO, 1994).

Chapter II: Construction of the CDM Project

6. Independent Project Managers (Maitre d'Oeuvre): The parties to the CDM Project contract may wish to spell out how to appoint one or more persons (nationals of either or both parties) as project managers, and to whom the project managers should be responsible to.

7. Monitoring of the Design Phase: The concessionaire should be required to submit details of the CDM Project design to the Conference of the Parties, which may wish to confirm that the project is fit for its purpose. In case of differences of opinion between the Conference of the Parties and the Concessionaires, it may be necessary to state how this is to be resolved, preferably amicably by an amendment of the design and technical specifications.

8. Contract Procedures: It might be necessary to set out contract procedures if there are no such procedures to be followed by the Concessionaire. Such contract procedure might become another annexure to this agreement, which should be scrupulously followed by the Concessionaire and sub-contractors. Issues such as tenders, supply of spare-parts or procurement and discrimination against nationals of either parties should be spelt out in the contract procedure.

9. Monitoring of Construction Works: This would require the Concessionaire to furnish to the Conference of the parties periodic reports with a view to establishing that the construction works are in compliance with the project design and cost estimates.

10. Timetable: This should state when preparatory works are to be carried out from the date of commencement of this agreement and the date of probable completion of the project.

11. Inspection and Bringing into Operation: The relevant government ministry or agency may have to inspect the project upon completion and submit its inspection report to the Conference of the Parties, which may wish to verify that all technical specifications have been met and give approval for the commencement of operations.

Chapter III: Operational Phase

12. Commercial Policy: The concessionaires should have a free hand in price determination irrespective of domestic laws relating to price control and tariffs. It should undertake to treat its customers, consumers or end users, including third parties without discrimination on grounds of nationality or user status. This should not preclude the concessionaire from adjusting its price or tariff in accordance with commercial exigencies. Concessionaire should also undertake to make public its prices and or tariffs in the manner agreed upon between itself and the government agency or ministry.

13. Environmental Policy: Provisions should state the general environmental policy of the Concessionaires in terms of reducing greenhouse gas emissions (GHGs). But that, this would be accomplished without deteriorating environmental quality of the other environmental media, such as land and water.

14. Public Order and Operating Rules: This should state that regulations relating to public order will be prescribed by the competent organs of the host country. But, that the Concessionaire shall submit the operating rules of the CDM project to the Conference of the Parties, which may approve same within a specified period of time otherwise, the operating rules shall be deemed to have been approved.

15. Maintenance and Continuity of the CDM Project: This should require the Concessionaire to maintain the CDM Project in good condition and repair as would be necessary for it to be used for the purpose for which it is designed and constructed. The concessionaire should have the right to bring the project into temporary closure for the purpose of carrying out maintenance works, provided adequate notice has been given to the competent authorities (governmental departments, general public and Conference of the Parties).

16. Safety, Security and Control: The Parties to this agreement should undertake to ensure the safety and security of the project. In particular, the Concessionaire should undertake to abide by all regulations relating to safety and security, which are binding on it through the Principals, or by the Conference of the Parties in relation to the project. Control of the Project shall vest in the Concessionaires at all times until ownership or control is transferred in the manner specified under this agreement.

17. Sub-contracts relating to Ancillary Facilities: The Concessionaire may freely enter into any contracts for the operation of any ancillary facilities that may be open to the public or of benefit to Users or Customers of the CDM Project. Provided that such ancillary facilities would be necessary in achieving the purpose of the project.

Chapter IV: Common Provisions

18. Rights and Obligations of the Government: The government should have right of access to the project facility, collect samples of product or emissions for testing and verifications and the right to request further and better particulars in relation to any matter it deems necessary to appraise the continued viability of the project. The obligations should include at the minimum provisions protecting the project or concessionaire against the adverse consequences of laws and regulations. The government should also facilitate the Project company in obtaining necessary permits and approvals and streamline the bureaucratic process associated with the project's implementation. Other general obligations may extend to import and export permits; tax and duty incentives; employment permits; access to public utilities; performance guarantees for public sector entities associated with the project operation and protection from competition.

19. Rights and Obligations of the Concessionaire: The Project Company or Concessionaire should have the right to operate the facility with minimum interference from government or its agency, the right to set its own prices or tariff and to petition the government or its agency in respect of any matter it deems contradicts the letter or spirit of this agreement. Minimum obligations of the concessionaire should include undertaking to comply with the laws and regulations of the host country during project implementation; environmental protection; safety standards; use of competitive national constructors, goods and services; protection of labour rights, employment and training of nationals etc.

21. Common Obligations: Provisions which require joint commitment of the Parties to this agreement include those on *force majeure* and rights in relation to project documents, including ownership and design of drawings; confidentiality as to information and documents obtained; obligation to cooperate; and warranty against improper payment.

22. Sharing of Costs and Revenues: Again these provisions should be flexible allowing the Parties to specify how they intend to share certain specified costs and revenues from the project. However, this should be without prejudice to the fact that the Concessionaire should by and large

have a free hand as the principal cost bearer and revenue collector, at least until such a time when the project is transferred.

23. Joint and Several Liability of the Concessionaires to the Principals: This may simply state that the obligations of the Concessionaires to the Principals under this agreement shall be joint and several.

24. Liability with respect to Consumers/Users and Third Parties: It may be necessary to state clearly as between the Concessionaires and Principals, who is liable for damages to third parties or Users, which should ideally be the Concessionaires. While the Concessionaires may wish to indemnify the Principals from any claim from a third party or User, this should not extend to those damages which can be attributable to default of the Principal.

25. Insurance Obligations: It may be necessary to spell out this in more detail in an annex. In general, the Concessionaire should undertake to take out an insurance cover as described in annex III and maintain same throughout the duration of the project. Copies of such insurance cover shall be submitted to the Conference of the Parties, who shall ensure that they are in conformity with Annex III.

26. Exceptional Circumstances and Force Majeure: Provisions should set out the circumstances to be regarded as exceptional such as war, invasion, riot, nuclear explosion, radioactive or chemical contamination or ionising radiation, effect on the natural elements, including geological conditions (earthquakes), which it was impossible to foresee, strike of exceptional importance and duration, or the behaviour of one Party causing serious and certain damage to the other Party. These should be without prejudice to the right of either party to contest the grounds of exceptional circumstances by arbitration.

27. Interruption of Construction or Operation by order of the Principals: It would be necessary to state that the construction or operation of the project shall not be interrupted except in such circumstances as have been stated in this agreement. This should be without prejudice to compensation to be paid to the concessionaire as would be determined by the competent arbitrage body.

28. Penalties for Breach: This should enable the Principals to levy a penalty for breaching the obligations under this Agreement, provided that the Concessionaire has been given an opportunity to remedy the breach in question within a definite time frame.

29. Relations with the Conference of the Parties and other International Agencies: There should be a provision which incorporates article 12(3)(b), (4)-(8) of the Kyoto Protocol, which stipulates the functions of the Conference of the Parties serving as the meeting of the Parties to the Protocol under the supervision of the executive board of the clean development mechanism.

30. Free Access for Supervisory Personnel: This should authorise personnel of the Conference of the Parties as well as other authorised personnel of the host government to have access to all parts of the CDM Project for the purpose of carrying out any of their functions or to inspect and investigate any matters relating to its construction or operation. The Concessionaires should undertake to cooperate with such persons, provided that there is minimum disruption to the construction and operation of the project.

31. Duties, Charges and Taxes: All duties, charges and taxes levied or to be levied shall be the liabilities of the Concessionaire and, shall be in accordance with national law. However, such duties,

charges and taxes shall not either expressly or impliedly amount to a creeping expropriation of the project.

32. Transfers of Funds and Financial Settlements: This should permit the transfer of any funds, subject to any applicable procedures required under the national laws. It might be necessary to ensure that such transfers are facilitated and not unduly encumbered in bureaucratic red-tapism.

33. Assignment and Security: The Concessionaire may assign its interest in the undertaking or create any form of security over this agreement or its rights thereunder, provided that the consent of the Principals have been first had and obtained with the understanding that such consent shall not be unreasonably withheld.

34. Provisions relating to Lenders and Principals: This provision should enable Lenders and Principals exercise their rights to substitute the original Concessionaires in the event that the latter are unable to perform their obligations under this agreement. The substituted entities should however have financial and technical competence to continue and operate the CDM Project. But, this must be with reference to the Conference of the Parties. Details of the grounds for substitution and resolution of conflicts can be spelt out in an Annex IV.

35. Intellectual Property and Confidentiality: This provision should get the Concessionaire to undertake to make all documents in respect of the project available to the Principals, Conference of the Parties and other competent authority designated by them. The latter Parties should equally undertake to hold such documents in strict confidence and not to disclose same unless for the purposes of the project.

Chapter V: Renewal and or Transfer Issues

36. Conditions for Renewal or, transfer and timing: This may provide that at a reasonable time before actual transfer or renewal, the Parties to this Agreement will get together to work out the modalities for such transfer arrangements, including the conditions precedent or subsequent for such transfer or renewal and timing. It may include inter alia, the scope of such transfer such as improvements, buildings, machinery, equipment, fixtures, fittings and spare parts to be transferred. In order to ensure that the host government does not inherit a "shell" as opposed to a viable project, it may be necessary to include clauses on adequate maintenance of project assets to be in good working order, usual wear and tear excepted, but up to a minimum standard of quality of fitness.

37. Transfer of Insurance and Concessionaire's warranties: This may require the Concessionaire to provide warranties to the host government with respect to the project assets to be transferred, including unexpired warranties available to the Concessionaire either by contract or by law. Perhaps, the Concessionaire's contractors and suppliers should be made to consent to such an assignment as part of the original contractual documentation or, enter into a sub-contract with the host government guaranteeing their continued commitment to the original contract.

38. Technology Transfer: Under this provision, it may be necessary to specify that, an appropriate number of copies of plans, drawings, blueprints, operating manuals, instructions and computer programs (including licences to operate such programs, where applicable) be turned over to the host government at the time of the transfer. Transfer provisions should include the training of local personnel during the original duration of the contract so as to make operation and maintenance of the project facilities easier.

39. Definition and Allocation of Transfer Costs: While there can no hard and fast rules about this, it is important to specify what direct and indirect costs are associated with any transfer and how to allocate this cost between the Concessionaire and the host government. These should include for instance the transfer or stamp duties, recording costs and notarial fees, fees for new permits and approvals, employees termination costs, costs of training local personnel, fees to third parties, etc.

40. Transfer or Renewal Procedure: This is set out quite clearly the procedure to be followed for transfer or renewal. Such procedure should be as simple as possible and avoid unnecessary bureaucratic bottlenecks.

Chapter V: Termination of the Concession Period

41. Termination by reason of Exceptional Circumstances or other events: In this event, any of the parties should have apply to the arbitral tribunal to formally terminate the project agreement. In that case no compensation may be paid, except the Principals have received net financial benefits, in which case some nominal some could be paid to the Concessionaire.

42. Termination on Grounds of National Defence or War: In this case, the Principals should pay the Concessionaire compensation to be determined by the arbitrage tribunal.

43. Termination by reason of the Fault of the Concessionaires: Here the Principals should give notice of the breach and a specified time within which to allow the Concessionaire rectify the breach. Where this fails, the Principals should give notice to the Lenders, who may wish to exercise their right of substitution. Where this happens, the project shall be deemed to be continuing.

44. Compensation for Termination: The Principals should undertake not to terminate the Project agreement except in such circumstances as specified in this agreement. Otherwise, the Concessionaire shall be entitled to compensation which should include both *damnum emergent* and *lucrum cessans*, account being taken of any mitigation of loss, which the Concessionaire should have taken.

45. Consequences of the Concession Period Terminating: This should state that this Agreement shall cease to have any effect upon such termination of the Concession Period. This should be without prejudice to any rights and obligations which have accrued prior to such cessation.

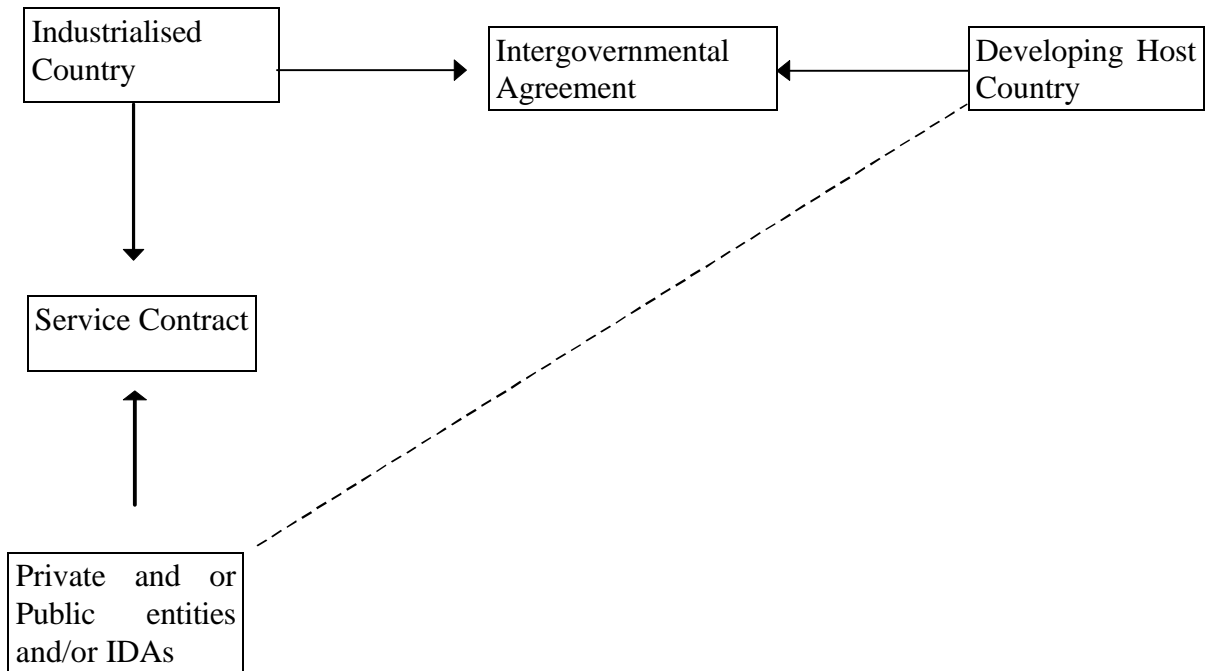
Chapter VI: Disputes, Laws and Rules

46. Settlement of Disputes: Any disputes between the Concessionaire and the Government Agency or any of the Principals shall be submitted to international arbitration at the request of any of the parties. The arbitration shall be conducted in accordance with the UNCITRAL Rules of International Commercial Arbitration

Appendix 3

Diagrammatic Representation of Forms of Service Contracts for the Benefit of Third Party Beneficiary (Developing Host Country)

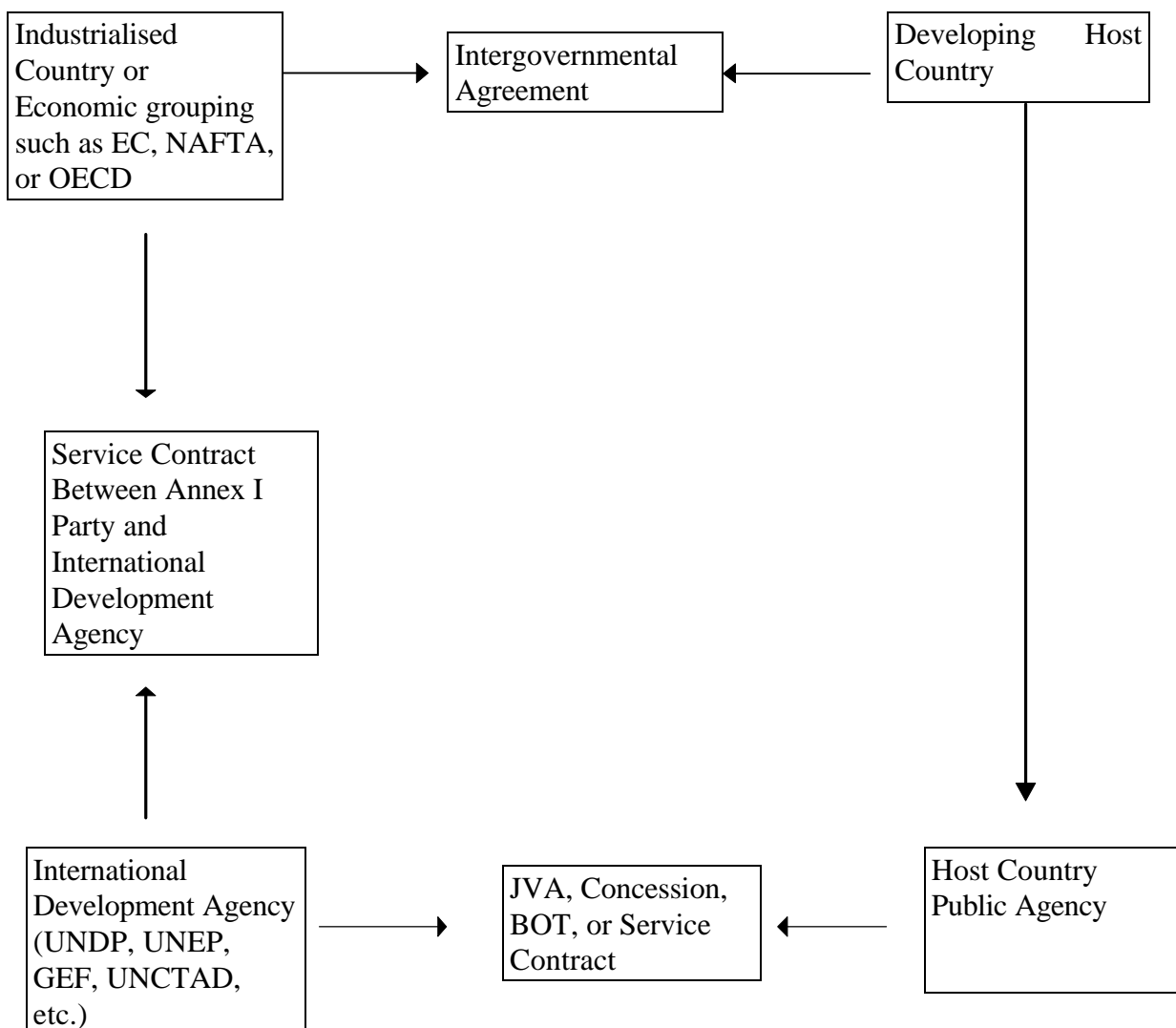
Figure III: Real Service Contract Between Industrialised Country and International Agency for the Benefit of Third Party Beneficiary (Developing Host Country) within the Framework of an Intergovernmental Agreement



Some observations: In this type of contract as depicted above, no contractual relationship (privity of contract) exist between the service contractor (Private and or Public entities or International Development Agency). The real service contract is between the industrialised country and the Private and or Public entity. Accordingly, the service contractor gets paid not by the host country but by the industrialised country party.

Appendix 4

Figure IV: Real Service Contract Between Industrialised Country and PPEs or International Development Agency for the Benefit of Developing Country Party



Appendix 5

Summary Explanation of Phare/Tacis Service Agreement

1. Definitions: This defines the key terms in the contract document such as “Contract”, “Contractor”, “Contracting Authority”, “Guarantor”, “Partner Institution”, “Partner State”, “Phare”, “Services”, “Services”, “Tacis” and “Terms of Reference”.

Computation of Time-Limits: This clarifies how the days and months signified in the contract are to be counted, including the implication of the last day of the time-limit falling on a public holiday.

2. Assignment: Stipulates how the contractor can validly assignment its interest under the contract to a third party and the legal implications thereof.

3. Sub-contracting: Stipulates the conditions in which sub-contracting can be valid and the implications of any valid sub-contracting vis-à-vis the Contracting Authority.

4. Consortia: Provides for the members of contractor’s consortia to be equally bound jointly and severally by the terms of the contract. And, the discretion of the Contracting Authority to terminate the Contract in certain circumstances in which any member of the consortia either withdraws or is wound up.

5. Supply of information by Contracting Authority: Obliges the Contracting Authority to supply any information relevant to the performance of the contract to the contractor.

6. Financial Control and Audit: Provides for responsibility of contractor to maintain sufficiently detailed and accurate financial and other records of work performance under the contract as well as reimbursement expenses incurred by it.

7. Monitoring and Evaluation: Gives the Contracting Authority the discretion to appoint a Third Party (Monitoring Personnel) to conduct monitoring and evaluation of the Contractor’s activities. Contractor is obliged to co-operate fully with such monitoring personnel.

8. General Obligations of the Contractor: Contractor to abide by all laws and regulations in force in the state contract is to be carried out and ensure same for all its employees, dependants with due diligence, due care and efficiency.

9. Code of Conduct: Provides that contractor shall at all material times act loyally, impartially and faithfully to the Contracting Authority; respect the cultural, political and religious practices in the Partner state and maintain confidentially in respect of information or the results of its undertaking.

10. Representation towards Third Parties: Provides that Contractor shall not without the written consent of the Contracting Authority, make representations to Third Parties which may bind Contracting Authority.

11. Communications: Contractor shall follow guidelines of the Contracting Authority when undertaking communication activities concerning the Phare/Tacis Contract, which are annexed as “Annex F”.

12. Intellectual Property: Provides that all results, patents and documents obtained by Contractor in the course of performing the Contract shall remain the property of the Contracting Authority.

13. Specifications and Designs: These are to be done in accordance with accepted and generally recognised systems acceptable to the Contracting Authority; specifications, designs relating to procurement of goods and services are to be prepared impartially to promote competitive tendering.
14. Permits and Licenses: Provides that Contractor is responsible for obtaining the necessary permits and licenses for the execution of the Contract; and Contractor to ensure such processes are not unduly delayed.
15. Independence: Contractor is not to put itself in a position which would compromise its independence or those of its staff. Otherwise, Contracting Authority can terminate contract without prejudice to compensation for damages to be paid.
16. Exclusivity: Unless otherwise provided, staff and personnel involved in the performance of specific assignments under the Contract are to undertake such task without carrying out other tasks from third parties.
17. Provision of Personnel: Contractor is not to make any modifications to the list of Staff enclosed to the Contract without written consent of the Contracting Authority.
18. Logistics and Administrative Support: Provides that Contractor shall provide appropriate and adequate administrative and logistical support services at its head office or field offices for carrying out contract.
19. Reporting: Contractor is obliged to furnish Contracting Authority with periodic reports on its services, special reports on implementation difficulties or technical omissions in the terms of reference, confidential reports at the conclusion of the Contract.
20. Eligibility of Staff: Contractor and its Staff shall not be members of the Contracting Authority's staff or closely related or involved with the Contracting Authority in an employment or other contractual capacity.
21. Delays in Performance: Provides that Contractor to commence performance of the contract within 30 days after the date on which Contract takes effect; Undue delay may lead to termination of Contract without prejudice to the payment of liquidated damages.
23. Extension of Period of Performance: Contractor may request an extension of the period of performance of the Contract in certain circumstances and such permission shall be granted by Contracting Authority.
24. Variation of Services: The Contracting Authority may vary terms of original Contract after due consultations with the Contractor without prejudice to the payment of fair compensation to Contractor and cost of such modification to be fully borne by the Contracting Authority.
25. Working Days: These are to be computed in calendar days and evidenced by time sheets submitted by the Contractor.
26. Contract Amount: These are those stated in the Contract and can not exceed the maximum amounts so stated.

27. Payments: This specifies that payments are to be made; in ECU, in a designated account specified by the Contractor at an agreed exchange rate.
28. Payment Procedure: This sets out detailed payment procedure which both Contracting Authority and Contractor are to comply with.
29. Travel and Transport: Contracting Authority undertakes to reimburse all travel expenses of Contractor's expatriate staff incurred in the performance of services and the circumstances when such reimbursements are to be made.
30. Payment Schedule: This sets out how payments are to be made; within sixty days of receipt of the request for payment and deemed to have been made on the date on which they are debited to the Contracting Authority's account.
31. Advances: Where so provided, advances may be paid to the Contractor to meet expenditure resulting from commencement of Contract, provided such is not to exceed thirty-five per cent of the total of fees and direct expenses as defined.
32. Guarantee: Where a guarantee is required as security for advances to be paid, such guarantee shall be in the full amount of the advance to be paid and no such advance shall be paid without such guarantee.
33. Reimbursement of Advances: Provides that reimbursements are to be made by deduction from interim payments and spread over in such a manner that the advance payments shall be totally reimbursed when total sums due to the Contractor reaches certain percentage limits.
34. Payment to Third Parties: Provides that all orders for payment to third parties shall be carried out only after a valid assignment which should have been notified to the Contracting Authority.
35. Taxation: While taxes, duties and charges shall be exempted from Community financing, the Contractor is responsible for complying with all tax laws applicable to him in respect of revenue received.
36. Liability: The Contracting Authority disclaims liability for any damage suffered by the Contractor himself or by its staff during the performance of the Contract. In particular, all claims for compensation, repairs, life, accident, and other insurance of Contractor or staff working under it are excluded.
37. Purchase of Equipment: Provides that all equipment to be purchased pursuant to the Contract shall be undertaken in accordance with the standard rules and procedures of the European Community for the purchase of equipment.
38. Medical and Insurance Arrangements: Provides that Contractor is to ensure staff working under it are all insured in the context of the contract.
39. Penalties and Liquidated Damages: Makes provisions for penalties and liquidated damages in respect of replacement of experts listed in Annex C and other delays in the performance of the Contract and the basis of calculation of such penalties and liquidated damages.
40. Responsibility of the Contractor towards the Contracting Authority: Reaffirms Contractor's responsibility to effect full performance of the Contract, remedy any defect arising thereof and

protect as well as indemnify Contracting Authority from all claims of damages arising from Contractor's default.

41. Termination by the Contracting Party: Makes detailed provisions of circumstances in which Contracting Authority can terminate the Contract and the required notification to be given to Contractor, provided all reasonable and unavoidable demobilization expenses have been settled.

42. Termination by Contractor: Gives Contractor equivalent power to terminate the Contract where the Contracting Authority consistently fails to perform its own obligations under the Contract. This is without prejudice to any costs that may have been incurred by the Contractor or rights reserved to the Contracting Authority under the Contract.

43. Force Majeure: This gives either party an excuse for not performing obligations under the Contract as a result of circumstances beyond their respective control. The term "Force Majeure" is to be defined in accordance with European Community legal jurisprudence.

44. Law of Contract: Provides that all texts of the Contract shall be interpreted in accordance with the provisions and principles of the law of the European Community.

45. Duration of the Contract and Date of Effect: This is specifically provided for in the Contract. The legal duration starts on the date the Contract is signed by both Parties.

46. Amendments or Additions to the Contract: Provisions of the Contract including annexes shall only be amended by means of a supplementary agreement to be signed by both parties.

47. Resolution of Disputes: Except as otherwise provided for under the Contract, all disputes are to be referred to the exclusive jurisdiction of the Courts of Brussels, Belgium.