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EXECUTIVE COMMITTEE OF
THE MULTILATERAL FUND FOR THE
IMPLEMENTATION OF THE MONTREAL PROTOCOL
Sixty-second Meeting
Montreal, 29 November - 3 December 2010

Addendum

WORLD BANK'S WORK PROGRAMME AMENDMENTS FOR 2010

This document is issued to **add** the “Concept note on scaling up financing for meeting Montreal Protocol obligations and beyond” to the World Bank’s work programme amendments for 2010.

CONCEPT NOTE

SCALING UP FINANCING FOR MEETING MONTREAL PROTOCOL OBLIGATIONS AND BEYOND

Background

The decision of the Parties to the Montreal Protocol to accelerate HCFC phase-out in 2007 held much promise for the environment; not only in terms of moving an impressive record of ozone protection measures to an earlier completion but by recognizing the relationship of these measures to the climate. Part of Decision XIX/6 also assured countries operating under Article 5 that full incremental costs for accelerated HCFC phase-out would be covered. It is only now, nearly three years later, as Article 5 countries complete their data surveys and draft HCFC Phase-out Management Plans under the Multilateral Fund (MLF) and the Executive Committee's HCFC policies evolve, that the actual funding requirements are better understood.

One of the most prominent aspects of Article 5 country consumption of HCFC is the rate of growth in a relatively short period. This rate of growth is directly related to economic development in emerging economies which are rapidly building a consumer-base, particularly in the refrigeration sector where the rate of growth has reached 20% in some cases. Consequently, HCFC-22 represents more than 80% of total HCFC consumption in developing countries. Moreover, the rapid growth has resulted in an actual volume of consumption of HCFCs that is double that of the volume of CFCs at their peak of use...the consumption baseline of HCFCs in metric tonnes risks to be 3-4 times that of the CFC baseline for these countries.

Decision XIX/6 also brought needed attention to the linkages between the phase-out of ozone depleting substances (ODS) with other environmental benefits, notably climate benefits. This relates to not only seeking alternatives with low global-warming potential but also taking advantage of low carbon emissions from increased energy efficient equipment and minimizing HCFC emissions during the long phase-out period. Developing countries therefore have the political and environmental impetus to go beyond a simple replacement of ODS but to ensure that the alternatives also do not have climate repercussions.

As a result of concern regarding these two issues, discussion in the MP community on project funding has been increasingly linked to the possibilities and options for leveraging additional support to the MLF – if it becomes necessary for ensuring that countries can first and foremost meet their MP obligations as well as to assist countries that wish to include climate co-benefit considerations into their HCFC phase-out programs, in accordance with Decision XIX/6 of the Parties.

Scaling-up MLF Funds to Address Possible Funding Gaps and Phase-out with Climate Benefits

The need for additional funding to complement the amount traditionally provided under the MLF can be considered as a matter directly related to compliance. In order to meet the basic, incremental costs related to the HCFC freeze and 10% reductions in developing countries,

preliminary World Bank analysis shows that MLF financing would most likely have to be increased. To further incorporate climate benefits for countries wishing to do so which in some cases would involve conversions and technologies not considered eligible or considered a technology upgrade, even more financing would be needed.

Given the institutional and policy framework created through the MLF which has proven extremely effective in supporting Article 5 countries in phasing out Annex A and B substances, the most ideal starting point for increased financing is the MLF itself. There is value in seeking other sources of financing such as under GEF or carbon finance, however, augmenting available funds for programming now under the MLF removes some uncertainty particularly with the first HCFC phaseout obligations right around the corner. Thus one proposal to augment financing would be to take advantage of the predictability of regular contributions to the MLF and utilize market mechanisms to raise funding as required for project implementation under the MLF.

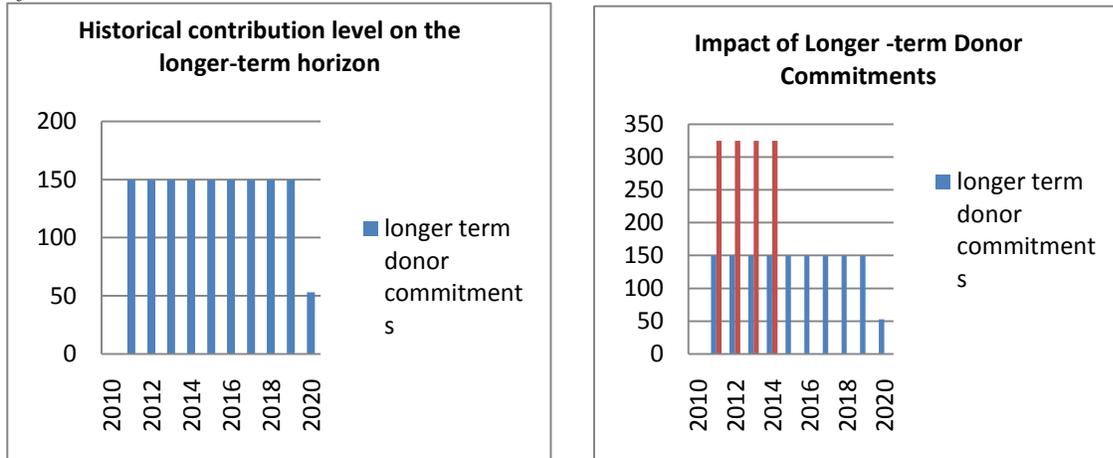
Market Mechanism Options for Raising Required Funds

Scaling-up the current available levels of MLF funding can be approached in two complementary ways, with both options involving slight changes to the financing structure of the MLF. These changes would not affect the projects' "business as usual" implementation under the first option (i.e. the role of the Executive Committee in taking decisions on what, and how much to fund projects,), while the second option would require some change.

1. Monetization of donor commitments to scale-up MLF funding. In order to address a possible funding deficit by 2015 and any additional gaps in future years, one possible approach would be to take advantage of the donors' ongoing support to the MP and its programs and monetize *future* donor commitments, which have historically been stable and consistent in value in the twenty year history of the MLF. This approach would imply using market instruments that would allow the MLF to borrow against future commitments in order that funds are available as needed for MLF project financing requirements. Following a long-term trajectory, repayment of the borrowing made by the MLF would stem from future donor commitments. This approach would build on the successful pilot of the International Finance Facility for Immunization that used capital markets to monetize long-term legally-binding donor commitments for promoting accelerated immunization of children worldwide. More information of this financial mechanism is summarized in the annex.

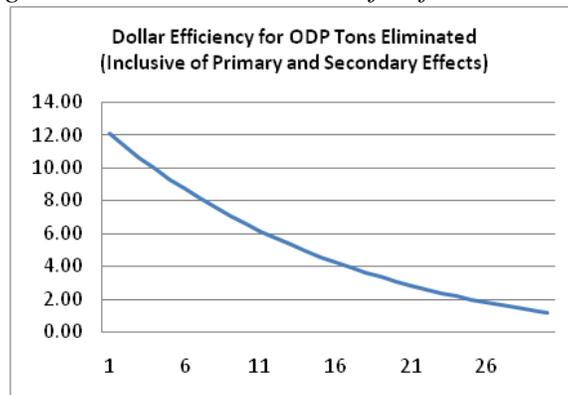
The frontloading mechanism that would be designed to meet the objectives of the MP would take into account the specific nature of the MP and MLF. The design of the potential financial structure would depend on the nature of the MP donors' future commitments, their willingness to extend their commitment periods, ability to scale up immediate contributions, the need to provide credit enhancement to the future flows, and other policy and institutional considerations.

Figures 3 and 4. Long-term MLF contribution levels based on historical data versus the impact of donor commitments



Using market mechanisms to frontload the MLF’s future cash flow contributions stream would involve paying financial returns to the market participants (capital markets, financial organizations, etc), resulting in an additional cost to the MLF. While increasing the overall costs to the MLF to implement its agreed target reduction, the borrowing costs would be more than offset by the environmental “return” of such frontloading. MLF projects clearly demonstrate significant environmental benefits when making funds available earlier. More immediate financing would also support CO₂ reductions from more energy efficient technologies, avoidance of HCFC leakage over time and reduction of HCFC banks and servicing needs. The diagram below quantifies the environmental benefit of borrowing against future commitments: US\$1 spent in year 1 buys 12 times the environmental benefit than US\$1 spent in year 30¹.

Figure 5. Environmental Benefit of Frontloading

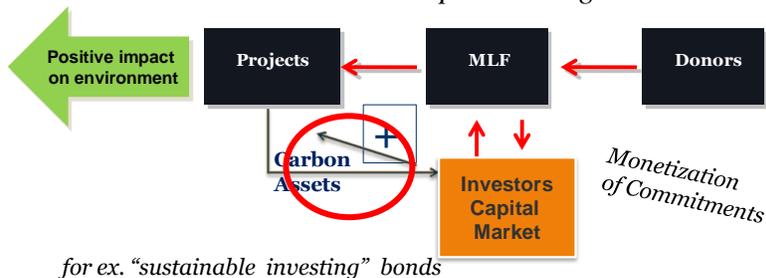


2. Monetizing future carbon credits to finance the costs of climate-ozon benefits. Carbon assets, once verified, become entitlements to the project entity, and are redeemable in the future. Various mechanisms exist to monetize these assets such as primary market carbon funds and secondary market exchanges, although these do not directly address the need to increase the

¹This analysis is based on the conservative assumption of zero inflation throughout the considered period.

amount of project finance at an early stage of the project. Carbon credits redeemable in the future could be used by the project entity to increase the financing available at an early stage of the project. It may be possible to advance financing (e.g. commercial loans, bonds) against these future carbon assets to fund projects before the assets are generated, using the future stream of carbon revenues to repay the financing, over time. As with the previous approach, the result would be an acceleration of funds available for ozone-related project finance.

Figure 6. MLF Process with Scaled-up Financing and Carbon Assets

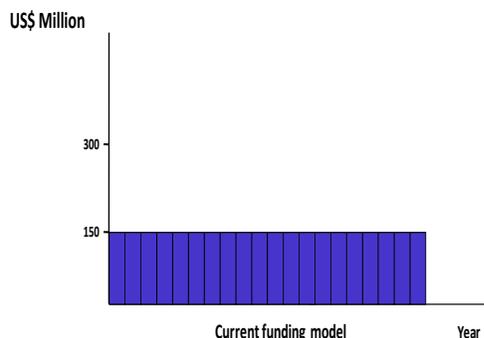


In addition, it may be possible to use carbon assets to enhance the creditworthiness of projects, which would enable financial entities (banks, investors or multilaterals) to improve the terms of financing (such as increased financing amounts, decreased cost of financing, increased loan maturity, etc.). As a credit enhancing instrument, asset titles would be transferred or posted as collateral to the benefit of financiers, to reduce the potential loss to the financier in case of a default by the borrowing entity. This approach entails the most uncertainty and would have to be more carefully evaluated to determine if it can be a viable mechanism.

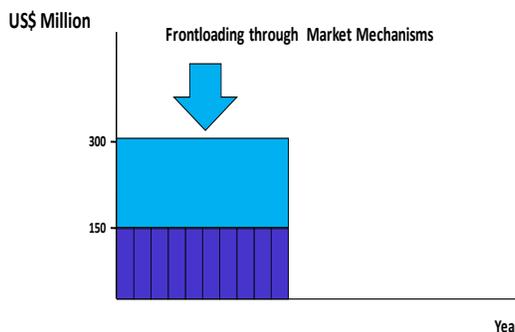
The sequence of these possible approaches for providing financing under the MLF of the Montreal Protocol, in terms of funds available for immediate disbursement, is depicted in the figures below following the baseline scenario.

Figure 7. Current MLF Funding Approach plus the three Proposed Mechanisms to Scale-up Funding

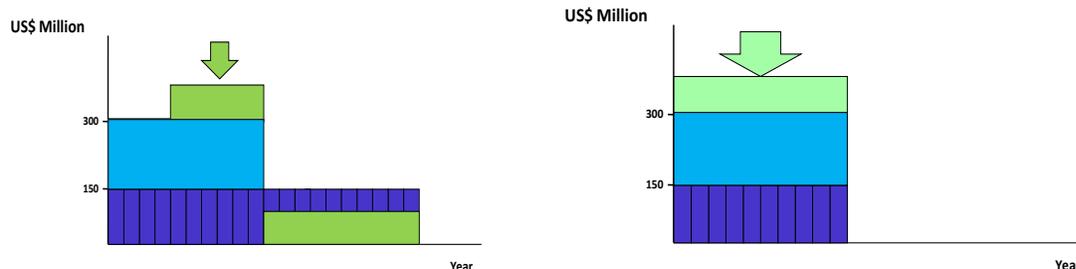
Business as Usual



Advancing Funding through the Market



Potential Revenue from Carbon Markets **Additional Project Financing Using Future Carbon Revenue**



These complementary approaches would maximize the level of upfront financing. In fact, because of the inherent link between new alternative technologies and climate and energy efficiency at the project level, it is easily foreseeable that MP projects lead to climate benefits, which in turn can generate carbon assets that would help finance MP project activities.

Other sources of funding, such as GEF or carbon funds, should also be sought to complement MLF funding particularly where MP projects intersect with the climate agenda, in order to maximize ozone and climate benefits, thereby accelerating the benefits resulting from the reasons mentioned above (HCFC bank avoidance and leakage, energy efficiency, etc.).

The market mechanisms presented above entail some inherent financial and market risks. Some of these risks were addressed in the structure of the vaccination program (the IFFIm project) in the Bank upon which the current concept is based. In brief, these risks could be managed through adequate financial policies, with innovative approaches to sharing or distributing the risk (depending on the structure chosen in the end), and with the MLF contracting the expertise and experience needed to manage such worthy endeavor.

Objective

The objective of this proposed resource mobilization activity is to further develop the concept outlined above of scaling-up funding within the existing replenishment and financing framework of the MLF.

Scope of the Work

Using the example of the IFFIm project which has successfully employed the use of commitments by a group of donors to raise upfront money for scaling up vaccination for children, the work would entail developing various donor scenarios to contribute to a program to scale up MLF financing for both the first approach, monetization of commitments and the second approach, monetization of future carbon credits. The key aspects to investigate will be donor support, scenarios of increased funding to the MLF, the costs of frontloading, the risks, and the financial mechanisms (such as bonds, IBRD balance sheet, etc) to employ.

The scenarios would give the Parties, particularly donors, concrete examples of how they might contribute to these approaches within the parameters of their governments and political systems. These examples would look at various timeframes, amounts (partial commitments, full

commitment) and forms of contributions and commitments vis-à-vis front loading needs and cash flow requirements of the Fund in the short and longer term. Analysis would focus on funding required as compared to the global demand for and capacity to absorb specific project activities (financing funding gaps, accelerating HCFC phase-out and financing climate benefits). The work would identify in more concrete terms the possible risks and corresponding structures and approaches to mitigate the risks and lay-out the roles of the different MLF actors in this proposed scheme. It would consider the legal and governance implications of the financial mechanisms chosen to scale up the funds. Finally, the proposed resource mobilization study would delve into the environmental and economic benefits of frontloading for stepped up replacement of HCFCs.

Approach

The work will require analyses and a feasibility study on the level of demand as well as on the level of the markets. Thus funding scenarios will be elaborated in consultation with various types of donors (based on their political/governance systems) and 1-2 country case studies will be developed to capture demand and capacity to absorb scaled-up financing.

Timetable

Upon approval by the MLF Executive Committee of the resource mobilization study to explore approaches to scale-up funds under the MLF through monetization of donor commitments and of carbon credits, the work would unfold immediately on two tracks, consultations with donors and analysis and feasibility work. A work plan will be prepared (which would be submitted to the Executive Committee for its information at the 63rd Meeting) to capture required consultations and associated locations. Every effort would be made to combine these consultations with various international or regional meetings of concerned ministries. Consultations would be scheduled between the 62nd and 64th Executive Committee meetings.

The analytical and feasibility work would require 10 months from approval in order to be able to factor 2009 and 2010 HCFC consumption and production data from Article 5 countries in the analyses as much as possible.

Preparation Cost Breakdown

Element	Description	US\$
Development of green financial products and cash-flow scenarios	Expert time (internal Bank and external financial engineering specialists, carbon market specialists, etc..) to develop a range of green financial products and overall cash-flow scenarios	130,000
Travel for Donor Consultation Meetings	Travel to relevant Parties to discuss means of financing, involving review of various existing funding mechanisms, including CDM and non-CDM methodologies, identification of potential sources of financing, and development of approaches and project models for securing such resources	50,000
Development of country-specific scaled-up financing proposals	Design and development of at least 5 tailor-made financing scenarios and proposals for scale-up, informed by in-depth consultation with interested donors	70,000
Total		250,000