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CONCESSIONAL LOANS

(A Concept Paper submitted by the United States of America on Concessional Financing)

A Concept Paper by the United States of America

Concessional Financing

Article 10 of the Protocol states that "the Multilateral Fund shall meet, on a grant or concessional basis as appropriate, the agreed incremental costs"

To date, the Fund has acted almost exclusively on the basis of grants, rather than on a concessional basis, to meet the agreed incremental cost of phase out projects. A number of countries have realized that by limiting the use of Fund money to sponsor only grants, the Fund may not be following its full mandate under the Protocol and using its limited resources in a manner that yields the greatest ozone layer protection benefits possible. Indeed, this was the impetus behind decision 7/22 action 10 of the 7th Meeting of the Parties which called for the use of concessional loans to be initiated by the end of 1996. More recently, this issue has been under discussion by an Executive Committee contact group during the 25th and 26th meeting.

During the deliberations of the contact group on concessional lending, many contact group members raised legitimate concerns and fears about the use of concessional lending. On the other hand, some members outlined potential ways in which concessional lending could work in the Multilateral Fund context. After hearing a presentation of the work of the contact group, the 26th meeting of the Executive Committee, in paragraph 81 of its report noted the conclusion of the contact group that "it would be useful to more fully develop potential models for such financing, and provide examples, which, to the degree possible, describe how the fears [expressed by some contact group members] are addressed." This paper, which uses and expands on previous concept papers and the work of the contact group, is a first effort to meet the ambitious goal noted by the Executive Committee. This paper attempts to respond to the legitimate concerns and fears that were raised by some of the contact group members. It then presents a conceptual framework for the use of concessional financing. Annex 1 to the paper provides examples and work remaining.

Addressing the Concerns Expressed About the Use of Concessional Financing with Multilateral Fund Resources

1. The Fund should not be a loan Fund. We agree. The use of loans should be seen as a compliment to the use of grants: One significant fear expressed by members of the contact group was that the use of loans would turn the Fund from a grant mechanism in to one that gave out exclusively loans. We believe this issue must be addressed directly - because, we share the belief of Article 5 countries that most eligible incremental costs should continue to be paid for through grants. Indeed, in all of the deliberations, both private and public, that have occurred on the potential use of loans, we have not heard anyone express the opinion that the Multilateral Fund should shift its primary focus from its traditional use of grants to fund eligible incremental cost. Under any scenario discussed, grants would continue to predominate the funding of projects where there are eligible incremental costs. It is anticipated that at full implementation, no more than a fraction of all projects with eligible incremental costs considered by the Fund would be financed by Fund sponsored loans or have even a small Fund sponsored loan

component. Accordingly, we hope that the continuing discussion will not be seen as a debate between the use of loans and the use of grants, but rather as a discussion of the circumstances under which loans can, consistent with Article 10 of the Protocol, be used in addition to the use of grants.

2. Multilateral Fund Loans Should not Increase the Foreign Debt of Any Country - We agree. Many participants in the loans discussions have expressed a concern that Multilateral Fund loans should not increase the foreign debt of any country. We completely concur. Instead, we believe that the beneficiary company should be responsible for repayment of the loans, not the government involved.

3. Loans Could be Complicated. We agree. Administrative Efficiency Should be Sought: A number of members of the Contact group suggested that using loans would be administratively difficult and potentially costly. Indeed, we must admit that the Fund has little experience with loans, and would not be likely to be a low-cost provider. Accordingly, one need not think of loans as only coming from the Fund to a firm. Instead, we should consider the distinct possibility that the Fund or its implementing agencies would use banks or other financial intermediaries to administer the loans, much the way the World Bank currently uses financial intermediaries for its projects. In this way, the Fund could possibly limit the use of its resources to buying down the interest on the loans, paying related administrative fees, and insuring their repayment.

4. Loans Should Have a Relatively Short Payback Period. We agree.

A number of members of the contact group noted that it does little good to have funds returning to the Fund or the country a decade after the project was approved. The Fund should focus on the return of loans over a 1-4 year time period. If this means that a smaller loan component would be provided, that should be considered.

5. Loans Should Not Automatically be Applicable to SMEs. We agree. Many contact group members expressed the fear that loans would be used primarily for SMEs, and that SMEs would never accept concessional loans. First, it should be pointed out that no one expects loans to be used primarily for SMEs. While SMEs may be involved with some use of loans or revolving funds in some profitable situations where we currently allow funding, loans should be expected to be used primarily for larger firms who are in a stronger position to pay them back. However, we truly question the expressed fear that SMEs would never accept loans. Globally renowned and successful efforts such as the Grameen Bank* prove this statement wrong. Further, the US has used revolving Fund types of situations with small-scale MAC servicing shops, and this type of financing was welcome. While again, loans to SMEs would not be expected to play a large role, the fact is that it has been demonstrated in many countries that SMEs would be willing to accept loans to advance their work. Generally, however, our belief is

* The Grameen Bank of Bangladesh has been very successful in providing small loans to small businesses.

still that the Executive Committee must, over time, find innovative ways to deal with the SME sector in countries. This may or may not involve some revolving loan type of activity.

6. We Should Seek a Win/Win Scenario: We agree.

A. Loans to Cover Some Agreed Increment Cost Now Could Lead to Agreement to Use Loans to Cover Some Profitable Projects Later. While the use of loans could be expected to evolve over time, at the current time, we envision the use of loans primarily to cover currently eligible incremental costs in specific cases or on project types where it is clear that full grant funding is not essential to ensuring implementation of the project. A significant remaining task will be to define the conditions under which loans would be used. (That issue is discussed below). Currently, we see a secondary use for loans for demonstration projects - where loans can be used on small projects to prove that those project types are profitable in their own right. By proving the profitability of such projects, the use of a small amount of Multilateral Fund funds as a loan can leverage significant private sector funds to achieve ozone layer benefits. The Fund recently approved a prototype for such projects at its 26th meeting in the case of Thai chillers.

To the degree that there is agreement to use loans to cover certain cases of agreed incremental costs now, we are open to the possibility that an equal or greater amount of Fund resources would be used in future years to sponsor projects that once could have faced incremental costs, but due to the passage of time, now face substantial benefits. We believe this is a critical point that all Article 5 parties must examine carefully. At this stage in the phase out, incremental costs exist in many cases because the cost of CFCs are much cheaper than the cost of alternatives. However as production of CFCs decreases, and the remaining producers follow their economic interests and begin to charge monopoly/scarcity induced prices for their product, the costs of CFCs can be expected to rise above the cost of alternatives. The result of this change will be that projects which once had eligible incremental costs would be faced with having no eligible incremental costs. Instead, these projects would be cost effective in their own right, and they would not be eligible for Fund assistance under the Fund. Perhaps a specific example would be illustrative.

At the last Executive Committee meeting, we approved two foams conversion projects in Indonesia that consumed 10 and 30 tonnes of CFC 11 respectively. These projects had incremental capital costs in the range of \$30-\$45k, and incremental operating costs in the range of \$80k to \$150k. The main factor in the incremental operating cost was the cost of the replacement chemical. The price of CFC 11 used in the project was \$2.00/kg, while the price of the replacement chemical was over twice the cost of the CFC. However, when the price of CFC reaches \$5.20/kg, the total incremental cost for each project becomes zero, since the operating costs would turn into operating savings which would cancel out incremental capital costs.

Indeed, at some point in the next five years, the scarcity induced, increased price of CFCs is going to mean that these types of projects can be expected to predominate. However, just because a project is not eligible, does not necessarily mean that it does not need assistance to convert. There may be cases in which firms caught in this situation will not be able to find funds to make the capital changes needed to phase out of ODS. At that time, given the absence of

affordable options, Article 5 countries can be expected to push for the use of loans. However, in the absence of agreement to use loans now to cover agreed incremental costs in a manner clearly within the bounds of Article 10 of the Protocol, it may be difficult to gain agreement later to use a similar amount of funding finance profitable projects where the operational benefits outweigh any eligible incremental cost. That is why it is critical to establish a loan mechanism in the Fund at this time - to aid the Fund, the ozone layer and Article 5 parties - both now and in the future.

The future ineligibility of a conversion project for grant funding due to the inevitable rise in the price of CFCs addresses the issue of fairness between companies raised by a number of members of the contact group. Is it fair, they ask, to give one firm in the same country a grant, but to give another firm in the same sector in a country a loan? Indeed, this is a significant issue. We believe that the answer to this question is found in the indicative list that was negotiated by Article 5 and Article 2 countries at the inception of the Fund. Paragraph 1d of that list states "The funding of incremental cost is intended as an incentive for the early adoption of ozone protecting technologies." The clear conclusion that can be drawn from agreement on this principle was that all countries participating in the negotiations understood that early requestors of funding would get favorable treatment. Accordingly, we believe it is fair to carry through with the intent of the Parties to use concessional lending to meet agreed incremental cost, and to treat more favorably countries that moved for early adoption of ozone protecting technologies. However, we too do have some concerns about the future. Specifically, if the current context prevails, we will face a different issue than the disparate treatment of providing the early requestor with a grant and a later requestor with a loan. If there is no agreement on the use of loans now, the question will be - is it fair that some firms who came in early got grants, while other firms who waited got nothing at all. What is being offered in this context would change the latter dynamic now and could lead to a change for the future. Agreement on the use of loans now to cover agreed incremental cost in cases where the firms involved can afford it, can lead to agreement to allow firms in the future who will not be able to afford conversion alone, to be eligible for a loan. While this is clearly a win/win situation, it would require a broader vision and focus on the future than that which has prevailed in the discussions to date.

B. A Portion of Loan Repayments Could be used to Augment Institutional Strengthening Efforts or for other targeted in country uses: In addition to the win/win scenario noted above, there is also the potential for a more immediate type of win/win scenario. In general, we believe that loan repayments should primarily be used to extend the Fund's money by funding other eligible projects - thereby creating a win for the ozone layer. However, we believe that some portion of the loan funds repaid could, under certain circumstances, go toward augmenting current institutional strengthening activities in the country sponsoring the project, or towards projects targeted in the country supporting the loan project.

Annex 1 - Examples and Work Remaining

A. Implementation of Specific Projects

i. Self-contained government plan/on-lending relating to specific projects

The government of an A5 country may agree that an eligible firm is fully able to convert on its own with less than full grant funding, but nonetheless, may need a short-term loan to cover a portion of its costs (Note: this was, in concept, the case in the Turkey Arcelik project approved at an earlier Executive Committee meeting and referred to in 24/46). In such cases, the Committee may provide a grant to the government (specifically for the firm) for the full eligible cost of the project with the understanding that a specified portion would be paid back by the firm to the government. In such cases, the funds paid back could be directed toward future government directed ozone projects in the country. Further, it may be agreed that 15 - 25% of the loaned amount [up to [\$x]] could be used by the government to augment existing institutional strengthening money that the Committee had provided to the country. Using such a structure, something on the order of 75 - 85% of the funds paid back would be available to finance additional projects in the country. This would extend Fund resources consistent with the Protocol, ensuring that Fund grants are available only where they are really needed. It could also provide additional institutional-strengthening funds to the government to allow it to undertake additional activities.

Analysis: This is a win/win type of scenario, in which the firm is judged by the government to be financially strong and not in need of a full grant, the loan money paid back goes to support other ozone projects in the country, and some portion of the funds goes to augment NOU activities. It is a bottom-up example that was proposed by the government; it was not required by the Fund. The loan is a complement to a grant, not a replacement for a grant. The loan does not increase foreign debt. The firm owes the money back to the country in the manner directed by the country - it does not owe the money back to the Fund.

Work Remaining to Implement

An on-lending mechanism such as that described above can work on virtually any type of project. What would be needed would be for the Excom to decide what controls it would like to see on the reuse of funds paid back to the government.

ii. Fund-sponsored loans for specific projects

In this example, the implementing agency, working on criteria to be developed by the Excom, determines that a firm does not need the total amount of the eligible project cost in the form of a grant. Using the agreed criteria, it therefore approves the project with a grant/loan component. The funds could be paid back from the firm to the agency or its financial intermediary, which could in turn return the funds to the Multilateral Fund for general reuse. Alternatively, the loan

could come from a Bank, with the Fund being responsible solely for paying down the interest rate and/or covering the administrative fee and insurance. The latter example would spend a limited amount of Fund money, while the former example would, assuming full repayment, spend less Fund money (for administration only), but would have a larger sum of money tied up for a period of years until the loan was fully repaid.

Analysis: This would operate under a top-down approach in which the Fund guidance (which would need to be developed) was applied to the firm determined to be financially able to undertake the project without full grant financing. The firm would be financially liable for repayment through the implementing entity - foreign debt would not be increased. The loan portion would be a complement to a grant portion.

To encourage countries to develop loan proposals, the Committee may decide to differentiate repayments that come from “top-down” Fund-assessed loans (in which case, there would be general reuse of loan money) and those coming from “bottom-up” country-initiated loans (in which case the loan repayment could be directed for in-country use and a portion could be used by the NOU).

Work Remaining to Implement

To implement such a system, the Executive Committee should ask the Secretariat to work with the implementing agencies to identify parameters that could be used to judge whether specific firms requesting grants would be in a financial position to implement the projects with less than full grant support. Then, the Excom would have to decide what portion of the funds returned should go to the Fund generally, and what portion (if any) should go to the government to facilitate NOU enhancement or reuse on in-country projects. If in-country use is authorized, requirements related to targeted re-use of loan payments would have to be articulated. In that regard, the Secretariat should be asked to work with the agencies to develop guidelines for the use of funds repaid through loans. Depending on the operational modality selected, work would also have to be initiated with either regional development banks or in-country banks to establish loan arrangements.

B. Implementation of Sector/Refrigerant Management Plans

i. Self-contained government plan/revolving funds

The government and implementing entity may propose the implementation of Sector or Refrigerant Management Plans (RMPs) at a level that assumes that some portion of the total funding will be paid back to the government for reuse in plan implementation. For example, it is likely that many RMPs will envision the development of leak prevention and recycling activities within the country. The EC may decide to provide loan funding for a percentage of the cost of the plan based on an assumption that a portion of the cost would be paid for by repayment by plan beneficiaries based on a portion of the value of the benefit they received through, for

example, recycling machine/leak prevention activities. For example, firms may be asked to “rent to buy” the recycling machines for an amount which is 30 - 50% of the profit they earn from capturing and reselling the CFC over a period of a year or two. Depending on the value of the payments, this could result in the user paying for half of the machine or more. The money they pay in rent could then go to the government or implementing entity toward the purchase of additional machines for redeployment in the country, or toward other activities useful to implementation of the RMP.

Analysis

This is a bottom up approach in which the firms would be liable to repay the loans/pay the rent, thereby ensuring that the loans did not add to national debt. If the firm did not pay the rent, the machine could be redeployed to a firm that would use it more fully. It is a win\win situation in which funding repaid is targeted to help the country get additional equipment or fund other RMP related activities. Similar on lending plans have already been used in some bilateral projects dealing with MAC recycling. They have been developed in a collaborative approach between the bilateral and the country. Management for repayment has worked through either the NOU or the implementing agency.

Since 1994, the USEPA and UNDP, working with four countries, have been implementing recycling projects. Although each project differed in some respects, several included a revolving fund mechanism that worked on a rent/buy back principle. Under some of these projects, the Fund initially pays for the full cost of providing MAC technicians with training and recycling machines. However, these machines were only provided for a specified period. If, after that initial period, the user determined that it can make a profit, the user paid 40-60% of the cost of the machine to take over full ownership of the machine. This has two major benefits. First, it ensures that equipment purchased by the Fund is put to maximum use to reduce the use of new ODS - if the machine is not being used, the technician has an incentive to turn it in. Second, the money received from technicians for the purchase of the machines is then used to facilitate the purchase of additional machines that are placed with new users under the same conditions. In this respect, this type of project is similar to an on- lending situation. It leverages the resources of the Fund, while ensuring that machines provided to the firms are well used. This mechanism may be particularly well suited to facilitating implementation of refrigerant management plans.

Work Remaining to Implement

While such projects are currently in implementation, and work on new ones could start at any time refinements using local banks could be developed. Experience has demonstrated the time intensive nature of establishing initial loan agreements with lending entities. However, it is anticipated that the first agreements in any country could be used for subsequent loans with little modification.

ii. Fund directed loan/on lending plan

In this scenario, the EC could establish specific criteria for application of loans for a portion of RMP implementation to cover areas such as those mentioned above. As described in case A above, the loans could then either be repaid to the Fund through the use of financial intermediaries (in which case the repaid funds would be generally available for EC redeployment), or be repaid directly to the country and used to offset future requests for the funding of phaseout projects in the specific country.

A second possibility would be to have the Fund (either through the government or an implementing agency) direct that certain related capital equipment would not be given outright to beneficiaries, but would be sold at a percentage of the total cost with no down payment; users would have to make quarterly payments (either to the government, or a financial intermediary working for the Fund). This is a case similar to that discussed above. For example, this could be used in recycling projects, with recipients agreeing to pay, for example, 25-50% of the expected value of the amount of CFC estimated to be recycled until the agreed machine cost was paid off. In such cases, the Fund could recoup a substantial part of the money invested for the equipment, and/or could ensure redeployment of some equipment if it were not being used effectively (as demonstrated by the inability of the recipient to generate enough money to make its payment).

Analysis: This is a top down approach in which the Excom would establish guidelines to be implemented by the agencies. Individual businesses would be responsible for loan payment, so there would be no increase in foreign debt.

Work Remaining to Implement

Revolving fund systems like the one noted above seem particularly well suited to cases where the capital goods being provided through the Fund are readily mobile, and there is likely to be a benefit that accrues to the user of the machine. However, there may be other cases in which such systems can work effectively. In this regard, we should ask the Secretariat to work with the agencies to try to identify cases where revolving funds can be most useful.

Unsettled Issues

It has been clear for some time that many Article 5 countries have been reticent to agree to the use of concessional funding. However, it is equally clear that concessional funding is included in the Protocol, and is strongly desired by many Article 2 countries.

The Parties in 1995 called for the use of concessional loans to be initiated by the end of 1996, to the extent that the need and demand exist. It is now over two years later. Some Article 5 parties express a belief that the need and demand do not exist. At the same time, these parties express a belief that the resources available through the Fund are currently inadequate, and that they can not get funding for all of the projects that they seek, including those in the SME sector. We

respectfully suggest that this demonstrates the need and demand for concessional loans, and that concessional financing will be critical if the Fund is to facilitate meeting the 50% reduction step in 2005. Accordingly, we believe that a way must be found to use them now to leverage the existing resources in the Fund, consistent with the negotiated agreement of both Article 2 and Article 5 parties under the Protocol. We therefore propose that we continue to work together to address the legitimate concerns that we each have, and develop a workable modality for the use of loans. This will allow us to leverage the use of the funds available, to ensure maximum protection of the ozone layer, and full and timely compliance by all.