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Executive Committee of
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PROJECTS THAT MIGHT REALIZE NET INCREMENTAL SAVINGS

(DRAFT)

1. The Multilateral Fund was established to support developing country efforts to phase out ODS through the financing of agreed incremental costs associated with such efforts. Incremental costs of project proposals submitted to the Executive Committee for consideration are calculated on the basis of capital and operational (recurrent) costs. Operational costs occur when a new technology results in higher operational costs than the old technology. Such costs are added to the capital costs in determining eligible grants.

2. Operational savings occur when a new technology results in less operational costs than the old technology. Such savings are netted out in determining eligible project grants. Net operational savings occur when operational savings are greater than operational costs. Net incremental savings (the absence of incremental cost) occur when net operational savings are greater than a project's capital costs.

3. At its Eleventh Meeting, the Executive Committee requested the Fund Secretariat to prepare a policy guidance paper on potential funding options for projects that realize net incremental savings and could realize significant ODS reductions (UNEP/OzL.Pro/ExCom/11/36, para. 70) but might nonetheless not be undertaken due to the inability of the companies involved to obtain financing. The request to consider this issue was the result of a recommendation to defer action on two foam projects in Egypt due to the significant negative impact of potential operational savings (UNEP/OzL.Pro/ExCom/11/36, para. 66).

4. Although these projects would result in ozone depleting substance (ODS) phase-out and they are similar to other foam projects already funded in Egypt and elsewhere, the impact of potential operational savings from these projects would result in a reduced grant amount which will not be sufficient to purchase the capital equipment necessary for conversion and ODS phase-out. The two Egyptian enterprises informed UNDP that they could not start converting to non-ODS substitutes without having the capital cost made available to them.

5. Both the Parties and the Executive Committee have addressed the issue of savings in the determination of incremental costs. The Indicative List of Categories of Incremental Costs (UNEP/OzL.Pro.2/3, Annex IV and UNEP/OzL.Pro.4/15, Annex VIII) states that savings and benefits must be taken into consideration when assessing incremental costs. As a result, savings are deducted from incremental costs to determine the grant amount. Consequently, projects with net incremental savings are not eligible to receive grants.

6. The Executive Committee's Implementation Guidelines address the issue of projects with net incremental savings that have short payback periods:

> "Assistance for investment projects shall generally be provided in the form of grants. However, where the investment project has a short payback period (i.e., 1-2 years), financing may take the form of highly concessional loans. If an implementing agency believes that a highly concessional loan is appropriate for a particular project, it shall recommend this action at the next meeting of the Executive Committee. The Executive Committee shall make

the final decision on the terms of assistance" (UNEP/OzL.Pro/ExCom/3/18/Rev.1, Annex III, Section V, para. 3).

7. Under these guidelines, projects with net incremental savings, although not eligible for grants, may be eligible for funding on the basis of concessional loans. However, it should be noted that, to-date, this mode of financing has neither been requested nor recommended by any of the implementing agencies.

8. Theoretically, most projects that result in short term cost savings would be undertaken independently of Fund resources. The projected level of savings, for a given project, may not necessarily serve as an adequate incentive for the enterprise to use its available capital. Further financing from other sources may be difficult to obtain or overly risky, given interest rate fluctuations in some countries.

9. The issue of lack of access to loan capital is a significant problem in developing countries with limited capital availability. In some cases, companies with projects that will result in net savings may not be able to find a lending institution willing to support a loan request. For many companies, the average expected return on investment for capital is higher than the average case in developed countries. If companies did have access to capital, depending on the return to the ODS project, they might prefer to invest the funds in more highly profitable activities.

10. Through its Eleventh Meeting, the Executive Committee has approved 12 project proposals that have had a positive incremental cost despite having net operational savings. Net operational savings may occur in projects where the substituting chemical or conversion technology results in less (lower) operational costs. Thus far, net operational savings have occurred in some aerosol, foam and solvent projects. This is because the first two convert to much less expensive hydrocarbons and the other converts to aqueous solutions.

11. For the 12 projects with net operational savings, the calculation of operational savings is determined on the basis of current or projected prices of the controlled substance; the prices of the ozone-friendly alternative; other operating costs such as utilities and labour; amount of ODS phased out; and, the period of calculating operational costs.

12. Both ODS and alternative prices can vary significantly from country to country. The future costs of CFCs will depend on several factors which may result in either additional incremental costs or savings. The costs of substitutes in the future may also vary since the Committee has already seen significant cost variations in substitutes from country to country.

13. The two projects, referred to in paragraph 3 above, were originally presented with the support of the implementing agency with the same estimated cost of the ozone-friendly alternative, hydrocarbon, as was used in a similar project approved for Malaysia. Upon review by the Secretariat, it was determined that the current price for hydrocarbons in Egypt was US $1 per kilogram lower than that used in a Fund project approved earlier. The recalculation of incremental costs resulting from the use of local cost estimates resulted in significant operational savings which reduced the grant amount to below zero, in one case, and an amount insufficient

to cover enough capital costs to proceed with the project without additional assistance in the other case. Consistency and equity dictate that project requests adequately reflect both current international (or, in the case of producing countries, eligible local) costs and reasonable expectations for future costs.

14. It thus transpires from paragraphs 10-12 above that the calculation of operational savings is sensitive to small variations in the price of substitutes and to the quantity of controlled substances to be phased out. Further, lack of available funds may mean that projects that would phase out larger amounts of ODS in the most cost-effective manner possible would not receive funding and be implemented, while those with smaller amounts of ODS to be phased out and lower levels of cost-effectiveness would be funded. Thus, by providing funding to the lower-ODS consuming companies, the Fund may indirectly provide a competitive advantage vis-a-vis other companies that do not receive the grant.

15. Eligible project costs are also dependent on the transition period of calculating incremental operational costs. The issue of a transition period has been discussed by the Executive Committee before and it was decided that:

> "Given the uncertainty associated with projecting future cash flows, recurrent (operational) costs would be considered for a transitional period as defined in the document (UNEP/OzL.Pro/ExCom/10/39) and its Annexes. In cases where recurrent costs were not considered as defined in the document and its Annexes, a justification for that approach must be given to the Executive Committee by the implementing agency" (UNEP/OzL.Pro/ExCom/10/40, para. 171.b.).

16. The Annexes in document ExCom/10/39 specify the transition period for operational costs for up to four years. If the transition period were reduced, less savings would have been deducted from the capital costs which might provide sufficient funds to meet the cost of capital equipment. Thus, if the transition period for operational costs were reduced to one year or not considered in determining grant amounts and operational benefits were treated in the same manner, all grants would at least pay for the capital costs for a conversion project.

17. An additional mechanism for supporting efforts of companies with phase-out net incremental benefits occurs inadvertently in the project preparation process. It sometimes happens that in the process of preparing a project's feasibility, the implementing agency demonstrates to the company the financial viability of the conversion. It might be sufficient that through project preparation efforts supported by the Fund, a more cost effective and profitable technology is identified and the feasibility study to implement such a technology is provided.

18. Some of the cases and conditions for funding projects with net incremental savings were discussed at the last Executive Committee Meeting. Concern was expressed that companies whose conversion projects had net incremental benefits might decline to undertake projects without support from the Fund, thereby delaying phase-out. This is especially the case where, as discussed above, the market is not competitive or there is a lack of access to capital.

19. One of the primary reasons for assisting projects with net incremental savings is that they result in the elimination of ODS which is the main goal of the Fund. The Fund has already financed activities that facilitate ODS elimination but do not directly result in ODS phase-out as do projects with net incremental savings. Paragraph 1(a) of the Indicative List states that "the evaluation of requests for financing incremental costs . . . shall take into account the most cost-effective and efficient option . . . ." A project with operational savings deducted from the capital costs result in higher cost-effective measurements than the same project with no operational savings. Higher-consuming companies have a larger market and, due to economies of scale, are likely to be more efficient than smaller-consuming companies.

20. A significant possibility for addressing this issue is for projects to be considered within the context of a sectoral strategy for all sector companies which could address any possible unintentional distortions. The sector strategy could contain a request for funding and a plan for the distribution of the country's total sectoral incremental costs to achieve the goal of the phase-out of all ODS in the sector. The strategy could include funds for both projects with and without operational savings and the distribution of funds could be based on grants, concessional loans, co-financing from other sources or any combination thereof.

Conclusion and recommendations

21. The Parties and the Executive Committee have addressed the issue of savings and determined that only incremental costs should be financed with grants and projects with net savings may be funded through concessional loans. Although Fund activities currently demonstrate that projects with incremental savings are feasible (through the financing of project preparation), such projects may be good candidates for concessional loans from the fund or other sources.

22. It is, therefore, recommended that consideration of projects with net incremental savings might be provided through the consideration of sector strategies for each country. In such strategies, the impact of funding one company's project over another could be assessed and remedial action recommended as part of an overall sector plan that might include both grant and loan components. The modalities of providing concessional loans should be elaborated.

23. It is further recommended that to ensure equitable treatment between Article 5 countries, while dealing with operational costs and savings, the CIF (cost, insurance and freight) prices of ODS and their recommended substitutes should be used in the calculation of operating costs, except where either the controlled substances or their substitutes or both are locally produced. In such a case, local prices, excluding taxes, should be used.