EP

# United Nations Environment Programme

Distr.
GENERAL

UNEP/OzL.Pro/ExCom/16/5/Add.1
11 March 1995

ORIGINAL: ENGLISH

Executive Committee of
the Multilateral Fund for the
Implementation of the Montreal Protocol

Sixteenth Meeting
Montreal, 15-17 March 1995

## RELATIONSHIP BETWEEN CONTINGENCY, SUPPORT AND INSTITUTIONAL STRENGTHENING COSTS

**(submitted by the World Bank)**

## RELATIONSHIPS BETWEEN CONTINGENCY, SUPPORT AND INSTITUTIONAL STRENGTHENING COSTS

### PAPER TO BE CONSIDERED BY THE EXECUTIVE COMMITTEE AT ITS 16TH MEETING, MARCH 15-17, 1995

**Background**

1. The Executive Committee of the Multilateral Fund for the Implementation of the Montreal Protocol has, over the last three years, approved funds for both project activities as well as the agency costs of preparing and administering those activities. Project costs have supported projects to directly phaseout the production and consumption of ozone-depleting substances (ODS), institutional and strengthening projects to assist the governments of Article 5 countries develop local capacity to implement the Montreal Protocol, and activities to prepare proposals for such projects. Agency costs cover expenses incurred by the four implementing agencies, or in some cases local government agencies and financial intermediaries, as they develop, administer and monitor Fund financed projects.

Approaches to project administration, including involvement of local agencies, as well as the needs of local governments in terms of capacity building to carry out MP mandates have evolved in response to the various needs and requirements of developing and implementing a wide variety of policies, activities and investment projects. Approaches have also evolved to accommodate the different approaches to project execution and implementation adopted by the various implementing agencies. The Executive Committee (EC) has been supportive of these various approaches, realizing that each is more or less suited to the circumstances of particular countries or implementing agencies.

2. As project implementation progresses, and the various implementation approaches are further refined, new initiatives have been identified by the implementing agencies which, if implemented, would contribute to acceleration of project implementation, funds disbursement, and ODS phaseout. Such initiatives were presented at the 15th Meeting of the Fund Executive Committee (EC). These included requests for funding of training of financial intermediaries and ozone unites, and for technical audits upon project completion. This lead the EC to raise certain questions about the relationship between these various types of costs, and whether there was any risk of double counting. The EC's basic questions which will be addressed in this paper are as follows:

- Is there an overlap between Institutional Strengthening activities and those activities typically undertaken by a financial intermediary?
- Why are contingency costs remaining at the 10-15 percent level?
- Should the Fund pay for technical audits?

3. Existing EC guidelines and policy papers cover certain aspects of these issues, but as yet, no paper considers the inter-relationships among various types of costs supported by the Fund. For instance, the EC considered a paper on the use of contingency costs in projects (UNEP/OzL.Pro/ExCom/12/32). The EC has also issued guidelines on eligibility of various components of Institutional Strengthening activities (UNEP/OzL.Pro/ExCom/7/20). In addition, the implementing agencies have at different times, provided clarification on the nature of other activities which are more closely associated with administrative costs.

4. This paper explains the relationships between the two broad categories of activities financed by the Fund; i.e., project costs and agency costs. By defining the costs that are associated with each of these

categories and noting how the different implementing agencies handle administration tasks and charge the fund for those expenses, this paper will address the issues raised by the EC and establish a framework that can be used in the future to consider possible overlap between funding requests and activities that have already been financed.

## Categories of Costs

5. Expenses financed by the Fund fall into two categories: (a) Project Costs; and (b) Agency Costs. The distribution of these cost components among the two cost categories is provided in Annex I.

6. Project Costs, are those expenditures incurred by ODS consuming or producing enterprises to actually phaseout ODS and include both costs of preparing proposals as well as well as the costs of carrying out projects, including costs of equipment, technology and so on. Project Costs also include institutional strengthening expenditures incurred by governments to establish and operate "Ozone Units", the focal point within the government for implementation of Country Programs for compliance with the Montreal Protocol.

7. Agency Costs are the costs incurred by the Implementing Agencies to facilitate the identification and implementation of projects. While agency costs cover a common set of activities for each of the four implementing agencies, the way in which the fund is charged for these activities varies among agencies.

## Review of Cost Components

8. This section provides definitions of each cost component and attempts to clarify confusion regarding potential areas of overlap. (Annex 1 summarizes the relationship between and among the various cost components and project activities.)

### Agency Costs (Costs incurred by the Implementing Agencies)

10. **Implementing Agency Fee (UNDP, UNEP and UNIDO):** Each of the implementing agencies are reimbursed by the Fund for the administrative costs they incur to facilitate preparation of projects, administer project funds and monitor implementation of Montreal Protocol Projects. UNDP, UNEP and UNIDO charge a flat 13 percent of approved project funding as an "administrative support charge." The World Bank, on the other hand, charges the Fund for its costs using a mixture of fee and direct charges as discussed below. The 13 percent management fee charged by UN agencies is based on general UN project guidelines and is not specific to Montreal Protocol operations. UNDP will often engage a local UN agency to administer approved project finances and in some cases will use a portion of its management fee to cover local government services directly related to project finance administration (UNDP in China and India). In some cases, additional agency funds have been provided for "start-up programming costs" in order to sufficiently compensate the agencies for costs associated with project preparation activities (UNIDO did not benefit from this start-up assistance). As documented in "The Administrative Costs of the Financial Mechanism" (UNEP/OzL.Pro/ExCom/14/12), the UN agencies have not recovered all of the administrative costs they have incurred in identifying, preparing and implementing Montreal Protocol projects. For example, UNIDO's costs have been reported at more than 20 percent of total project cost.

11. Activities typically covered under this heading are as follows:

(a) participation in Fund related meetings;

(b) production of and/or comments on policy and technology papers; general exchanges with the Secretariat and other implementing agency;

(c) preparation of annual work programs and progress reports needed by the Executive Committee;

(d) planning and assisting in project formulation missions and evaluating and rewriting project documents (project preparation is funded through project preparation funds);

(e) setting up project implementation proceedings and processing on projects internally;

(f) overall monitoring of project implementation;

(g) recruitment of experts and consultants;

(h) administration of funds including preparation and finalization of legal documents, disbursement of funds, recording keeping and audits as well as supervision of enterprise activities; and

(i) contracting and procurement.

12. **Direct Agency Costs (World Bank):** The World Bank is reimbursed for its direct administrative costs but charges a fee for project administration activities which are contracted to a local financial intermediary. That is, the Bank charges the Fund for staff time and expenses directly related to support of projects but not cost of management review time. These administrative costs include the cost of activities 'a' through 'g' above while the responsibility for administration of funds is typically divided between the Bank's disbursement office, which deals with one government or financial intermediaries, and a local financial intermediary that in turn deals with each of the enterprises for which project funds have been approved.

13. **Financial Intermediary Fee (World Bank):** Unlike the UN agencies which implement projects using their own or local UN staff and consultants, World Bank projects are implemented by the client country governments. Project administration activities that are handled at the local level are covered by a fee which has been up to 3 percent of project costs for World Bank projects. Prior to World Bank and recipient government signing of a grant agreement, which covers a group of approved projects (or in the case of umbrella agreements, approved as well as anticipated approvals), both parties agree on implementation arrangements for how funds will be passed first to the government and then on to beneficiary enterprises. These arrangements usually involve both the government as well as a financial intermediary (FI). The Bank and government typically select an existing FI which has experience with the Bank's regular loan operations and is therefore familiar with the World Bank's procurement, disbursement, supervision and reporting procedures. Given this experience, the FIs provide a significant advantage over newly created government Ozone Units. Moreover, the FI is able to undertake some of the Bank's administrative tasks at a significantly lower cost than the Bank. Whenever possible and deemed appropriate, FIs are selected on the basis of their ability to provide needed services. In cases where such institutions are not available, the Bank must either execute these tasks directly or establish this capacity within the local Ozone Unit or a Project Implementation Unit, as the case may be.

14. FI responsibilities are negotiated up-front and are usually limited to those activities described in 'h' above (administration of funds including project appraisal, preparation and finalization of legal documents, disbursement of funds, recording keeping and audits as well as supervision of enterprise activities) while the FIs oversee procurement, contracting for World Bank projects is carried out by the enterprises themselves. While a 3 percent FI fee has been typical, it is possible, that, if MP portfolios changes and there are an increasing number of small projects, the 3 percent fee will no longer cover the costs of the FI. In this case, a higher FI fee would be required.

15. In a recent case, the Secretariat determined that a request from the Bank for funding for a Technical Audit of the Indonesia ODS I projects should be covered by the funds already approved by the Executive Committee under the Financial Intermediary fee. The 3 percent fee, however, is agreed to cover specific subproject activities not including technical audits at project completion. The FI in Indonesia was contracted to engage in the supervision of the financial procedures, including procurement and disbursement, and financial reporting, and is not, in fact, the appropriate institution for conducting technical audits. Such audits would be conducted by independent technical experts and funded separately from the FI fee.

16. Technical audits will be required as standard practice in some cases, especially where there are safety concerns. The EC may, in fact, want to consider requiring technical audits for such projects as a way of ensuring technical safety. Technical audits are not required on an annual basis, rather, they are conducted at project completion. The average cost for a technical audit of one project using local consultants is estimated to be approximately US$1,000 to US$2,000. The request for technical audits for the Indonesia ODS I subprojects is US$30,000 to audit US$17 million worth of projects. Although it is not presently envisaged to expand technical audits to all investment projects, the financial impact of such an undertaking would amount to an increase of about 0.2 percent of total project cost, based on the Bank's portfolio which has an average project cost of about US$1 million. Costs to technical audits are part of agency costs, but are not costs covered in the FI fee.

17. **Training of Financial Intermediaries and Ozone Units:** Training of financial intermediaries and Ozone Units have been undertaken to support activities covered by Agency Costs to allow for fuller participation of local institutions in the implementation of ODS phaseout projects. Such training expenses fall within the Agency Cost category, and, while the UN agencies draw on resources allocated under their 13 percent management fee to cover training activities, the World Bank has requested training expenses as separate costs under work program amendments.

18. Financial Intermediaries are selected on the basis of their basic ability to provide the agreed services, however, the unusual financing criteria for MP activities require FI staff to become conversant in emerging MP eligibility criteria, including incremental costs, foreign ownership and export market considerations, and retroactive financing allowances. To carry out MP projects, FIs must also develop new procedures for the administration of grants as opposed to loans . With a minimum of training in the specifics of MP operations, FIs can deliver more cost effective project implementation. While start-up training costs could have been built into the fee charged by FIs for their services, these are seen as one-time costs and have therefore been treated separately.

19. In cases where Institutional Strengthening projects have been successful in establishing an "Ozone Unit" focal point for ODS activities within a particular country, implementing agencies have, in some cases, determined that involvement of such units in financial administration of ODS phaseout projects may provide important continuity in project oversight and may also enhance local ownership and support for ODS phaseout initiatives. In addition, local agencies are able to provide closer supervision of on-going activities and are able to provide project administration services at a much lower cost than implementing agencies. Training of Ozone Units is an essential component of enabling institutions created under institutional strengthening projects to undertake project administration functions. Although this training will only be required in a few cases, it will undoubtedly be a useful activity on a case by case basis. In fact, the regional networks organized by UNEP are, to a large extent, dedicated to training of Ozone Units through the exchange of technical and policy information.

20. By way of example, approval of a recent request for technical assistance to the National Environment Protection Agency (NEPA) in China and the China Investment Bank (the FI) was deferred due to the misconception that funding the activity would constitute double financing as CIB is receiving a

FI fee and NEPA has received institutional strengthening. As elaborated below, institutional strengthening does not provide for training representatives of the Ozone Units, in this case, NEPA, in particular aspects of administrating project finances. Given that the main objective of institutional strengthening funds is to strengthen an institution to "facilitate" implementation of ODS phaseout projects, further training to expand the functions of Ozone Units leverages is in investments. Having received its institutional strengthening grants, China would like to utilize NEPA's increased capacity to improve project implementation through its work as a partner with CIB in its role as financial intermediary.

21. While CIB is receiving a fee (in this case the fee is 2 percent) and is essentially capable of conducting the responsibilities of a FI, given the complexities and uniqueness of MP operations, it is in need to training in the specifics of MP project preparation and implementation. In order to make the best use of both NEPA and CIB, a minimum of training is necessary in order to truly facilitate project implementation and ODS phaseout.

22. **Project Costs:** Most project costs are those costs directly related to carrying out approved ODS phaseout investment projects and usually include costs of equipment, technology, installation and trail runs. Issues of concern under project costs are limited to the contingency that is included on top of cost estimates in investment project proposals, and whether or not there is some overlap between expenditures financed under Institutional Strengthening projects and the agency costs as described above.

23. **Contingency:** Contingency allowances are an integral part of the expected total costs incurred by the enterprises during project implementation. Contingency allowances make realistic provisions for uncertainties that may cause departure during project implementation from the base cost assumptions established at the time of project appraisal. Physical contingency allowances provide for additions to the base costs that may arise from changes in quantities of project inputs or in the methods of project implementation. Price contingency allowances reflect anticipated overall and relative increases in unit prices of such inputs and foreign currency fluctuations. Contingency allowances are not designed to fund activities that are in addition to the approved project activities. All of the implementing agencies include a contingency within the total costs of the projects that are submitted to the EC for approval.

24. In the case of UNDP, a contingency of 10 percent is added to the capital costs of the projects as contingencies to cover unavoidable variations of costs due to price increases, currency fluctuations, unexpected difficulties in implementation such as requirements for additional safety measures.

25. In the case of UNIDO, contingency funds are required in order to:

- Compensate for increase in cost of equipment and related services;
- Provide for unforeseen short-term consultancy services;
- Reimburse cost of additional training of technical personnel;
- Reimburse cost of testing by specialized institutions;
- Purchase additional minor items of materials and spare parts necessary during the conversion period.

26. The World Bank's standard practice is to included a 15 percent contingency within its total subproject costs for MP operations. Based on the Bank's general lending experience, a 10 percent physical contingency allowance is included in subproject costs for general civil works projects with predictable uncertainties. Given the relative lack of experience in procurement and implementation for

Montreal Protocol projects, a 10 percent physical contingency is sensible. A 5 percent price contingency, based on projected inflation rates for domestic and foreign costs and foreign exchange fluctuations over the life of the project, is also included within subproject costs. In light of international currency fluctuations and the short time frame for MP subproject implementation, a 5 percent price contingency allowance is also reasonable. Given that experience to date has shown that enterprises are using most or all of the contingency allowance to successfully complete project implementation, the Bank feels that a contingency of 15 percent is reasonable and necessary to ensure full subproject implementation. A 15 percent contingency allowance is, in fact, standard for most engineering firms for international projects.

27. At this point it would be useful to recall some of the points made in document UNEP/OzL.Pro/ExCom/12/32 (The Use of Contingency Costs in Project Proposals) and the Executive Committee's decisions on contingency.

28. Paragraph 6 of the paper states that "...engineering firms operating domestically generally prefer to provide cost estimates at a level of accuracy that approaches no greater than 10 percent of project costs without contingency. This means that contingency cost should not exceed 10 percent. However for firms operating internationally, obtaining cost levels accurate to within 15 percent for projects with international involvement is not unusual. For international work, physical contingency and currency contingencies are often included in the contingency cost estimate."

29. In addition, the Executive Committee adopted the following decisions:

(a) "Implementing agencies should not apply physical contingency charges against known costs for project components..."

(b) Implementing agencies should minimize contingency costs as experience is gained with standard equipment, technology and other project costs and in-field implementation procurement."

30. There is, to date, but limited experience on completed investment projects and final project implementation costs have yet to be compiled by the implementing agencies. UNIDO reports that very recent experience gained from the start-up of project implementation approved at the 13th EC Meeting indicated that the 10 percent contingency will not even cover the negative difference between the funds allocated to the project and the bids received by international companies. UNIDO is presently investigating approaches to dealing with this real shortfall of funds and that a contingency along the lines of that requested by the Bank may be more appropriate.

31. UNDP has reported that it has completed a number of foam-sector projects and that it could be in a position to provide more detailed information on the use of the contingency for the 17th EC Meeting.

32. In conclusion, it would seem that a contingency of 10-15 percent remains a valid reference for projects funded by the Multilateral Fund. There is but limited experience to date from the field which would allow the Implementing Agencies to consider lowering the contingency. With the exception of project which have retroactive financing components at the time of EC funding approval, "known costs" are only truly known after the procurement has been completed and because of the wide geographical distribution of activities, cannot be inferred from past procurement experiences of similar equipment.

33. Finally, as reflected in the legal documents that govern implementation of MP projects, funds approved for projects and contingency funds are distinct from the agency costs that are approved to administer those funds. Contingency funds approved as part of projects may not be used by either the UN agencies , the World Bank, or the Bank's project FIs to cover administration costs. Project accounts and agency administration accounts are kept separate in all cases.

34. **Institutional Strengthening:** As outlined at the 7th EC meeting in June 1992 (UNEP/OzL.Pro/ExCom/7/20), the EC agreed to provide support for an eligible country to "strengthen a mechanism within the country to facilitate expeditious implementation of projects for speedy and effective phaseout of the controlled substances in the country, as well as ensuring effective liaison between the country on the one hand, and the Executive Committee, the Fund Secretariat, and the Implementing Agencies on the other." Indicative levels of funding have been created based on a country's level of consumption of ODS. Institutional strengthening support is limited to capital expenditures (e.g., supply of office equipment), recurrent expenditures (e.g., compensation for dedicated staff), and operational costs (e.g., telecommunication charges, office supplies, etc.).

35. Ozone Units, which are recipients of the Institutional Strengthening assistance, are responsible, in most countries, for larger program, policy and other coordination issues such as monitoring implementation of the Country Program rather than direct oversight of project implementation. The Ozone Units are typically responsible for development of policies and regulations, monitoring overall phaseout within a country, raising public awareness, and serving as a focal point within the government for information on ODS activity. They are, in most cases, newly established institutions within the government which have very little ODS project experience and typically lack experience with implementing agencies. While Ozone Units do not directly prepare projects, they play a role in coordinating the activities of the agencies and establishing priorities for the selection of new investment projects by identifying ODS consuming and producing enterprises and working with those enterprise to agree on sector phaseout schedules and strategies.

36. There is therefore no overlap between the Ozone Units (financed through institutional strengthening projects) and activities covered by Agency Costs, in particular the activities of financial intermediaries. There are nevertheless some cases where Ozone Units, in addition to IS activities, have been assigned with responsibilities that are covered by agency costs as described above. In these cases, the Implementing Agencies and governments have agreed that the most appropriate project implementation mechanisms would require the local Ozone Unit to provide financial administration services, activities not provided for under IS projects[1]. UNDP reports that such arrangements are in place in China and India. The Bank reports that it has developed such an arrangement in China where part of the work typically allocated to the Financial intermediary is being carried out by the local Ozone Unit. In these cases the project administration fees allocated to the agencies have been divided among participating organizations according to their respective responsibilities.

## Further Clarifications on Relationship Amongst the Various Cost Components

37. Each one of the components under study is targeted at achieving a very specific goal or is intended for a specific purpose. Annex 1 outlines the nature of the activities which are undertaken within each of the two cost categories and further delineates how respective agencies charge the Fund for these activities. As outlined, there are areas where activities are (or could be) common among the various components. For example, while the UN agencies charge a flat 13 percent to cover their Agency Costs, the Bank charges some of its Agency Costs directly to the Fund as a part of its administrative work program, while it requests a fee to cover activities that are under taken by financial intermediaries, and additional costs (technical audits and FI training) have been requested as separate work program amendments. The result has been confusion over possible double counting. In addition, the limitations on activities that can be accomplished under institutional strengthening projects, except for very small ODS consuming countries have been poorly understood. Finally, the advantages of training institutions that have been created with support from the Fund to provide services that would otherwise be done by

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[1] In cases where total amount of projects administered by the World Bank for a particular country amount to under US$2.5 million, local support for project implementation is covered by IS projects (Jordan, Tunisia).

implementing agencies at a higher cost may warrant additional consideration. Observations of significance are:

- Contingency costs are not related to any of the administrative costs incurred by the implementing agencies. Contingency costs are part of the Project Costs. Contingencies are typically based on inflation indices and, for physical contingencies, and will be higher for activities where there is little track record of completed costs.

- Institutional Strengthening is usually independent of the other components, although, as was presented in a previous section, certain implementation mechanisms do rely on the Ozone Units that have been established with institutional strengthening resources to support project implementation, particularly where these units are well staffed or no financial intermediary has been identified.

- The costs for Implementing Agency Fee, Financial Intermediary Fee, Bank Administration and FI and Ozone Unit Training are intended to cover the same program management and implementation costs.

- Training or technical assistance to Ozone Units and Financial Intermediaries to perform particular functions related to financial administration of projects are not funded under either Institutional Strengthening or the FI fee.

**Recommendations**

- Costs for training of FIs and Ozone Units to undertake Agency Cost activities should be considered on a case-by-case basis.

- Because there is insufficient information on actual project expenditures, contingency guidelines should not be altered at this time.

- Technical audit fees should be considered be considered as part of Agency Costs on a case-by-case basis.

# Summary of Cost Components

| COST CATEGORY | COST COMPONENT | RECIPIENT OF APPROVED FUNDS | ACTIVITIES COVERED |
|---|---|---|---|
| **Agency Costs** | Implementing Agency Fee | UNDP, UNEP and UNIDO (and in some cases local Ozone Units) | • participation in Fund related meetings;<br>• production of and/or comments on policy and technology papers; general exchanges with the Secretariat and other implementing agency;<br>• preparation of annual work programs and progress reports needed by the Executive Committee;<br>• planning and assisting in project formulation missions and evaluating and rewriting project documents (project preparation is funded through project preparation funds);<br>• setting up project implementation proceedings and processing on projects internally;<br>• overall monitoring of project implementation;<br>• recruitment of experts and consultants;<br>• administration of funds including preparation and finalization of legal documents, disbursement of funds, recording keeping and audits as well as supervision of enterprise activities; and<br>• contracting and procurement. |
| | Direct Costs | The World Bank | • participation in Fund related meetings;<br>• production of and/or comments on policy and technology papers; general exchanges with the Secretariat and other implementing agency;<br>• preparation of annual work programs and progress reports needed by the Executive Committee;<br>• planning and assisting in project formulation missions and evaluating and rewriting project documents (project preparation is funded through project preparation funds);<br>• setting up project implementation proceedings and processing on projects internally;<br>• overall monitoring of project implementation;<br>• recruitment of experts and consultants;<br>• administration of funds to government or financial agent, disbursement tracking and reporting |
| | Financial Intermediary Fee | Financial Intermediary through the World Bank | • administration of funds to enterprises including project appraisal, preparation and finalization of legal documents, disbursement of funds, recording keeping and audits as well as supervision of enterprise activities |
| | Training of:<br><br>(a) FI<br>(b) Ozone Unit | Implementing Agencies, who then use it for approved training activities | Training for FI includes training in MP eligibility criteria, calculation of incremental costs, familiarization with ODS industries and technologies, etc.<br>Training for Ozone Units includes training in disbursement and procurement procedures and other relevant financial administration functions |

| Cost Category | Cost Component | Recipient Of Approved Funds | Activities Covered |
|---|---|---|---|
| **Project Costs** | Contingency (typically 10-15 percent of project costs) | Enterprises through an implementing agency | Uncertainties in project costs that may cause a departure from the base cost assumptions during implementation. Physical contingencies provide for uncertainties in quantities of project input or in the methods of project implementation. Price contingencies reflect anticipated overall and relative increases in unit prices of such inputs and foreign currency fluctuations. |
| | Institutional Strengthening | Ozone Units in client countries through an implementing agency | As defined in UNEP/OzL.Pro/ExCom/7/20, IS funds support a local institution to facilitate expeditious ODS phaseout. Funding is limited to capital expenditures (office equipment), recurrent expenditures (staff salaries), and operational costs (communications, office supplies) |