



**United Nations
Environment
Programme**

Distr.
LIMITED



UNEP/OzL.Pro/ExCom/13/45
17 June 1994

ORIGINAL: ENGLISH

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

Thirteenth Meeting
Montreal, 25-27 July 1994

**MODIFICATION IN THE INDICATIVE LIST OF CATEGORIES OF
INCREMENTAL COSTS UNDER THE MONTREAL PROTOCOL**

(Submitted by the Government of India)



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GOVERNMENT OF INDIA
MINISTRY OF ENVIRONMENT & FORESTS

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Anil Agarwal
Deputy Secretary (Ozone)

No.F. 5(2)/141/94-IC-1
Date: 6.6.1994

Dear Dr. El-Arini,

It may kindly be recalled that the proposal of India for "Modifications in the Indicative List of Categories of Incremental Costs" under the Montreal Protocol was discussed in the 12th meeting of the Executive Committee. The Committee agreed to request India to revise its papers and resubmit it in good time with a request that the Executive Committee consider the revised paper at its next meeting and transmit it to the Open Ended Working Group Meeting in July, 1994. The paper has been revised and has already been sent to the Ozone Secretariat for consideration of the Open Ended Working Group Meeting in July, 1994.

I have the honour to enclose the revised paper on this subject with the request that it be placed for consideration of the Executive Committee in its 13th Meeting scheduled in July, 1994.

With regards,

Yours sincerely,

(Anil Agarwal)

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1. India had submitted a proposal on "Modification in the Indicative List of Categories of Incremental Costs" under the Montreal Protocol for consideration of the 12th meeting of the Executive Committee. It was discussed and the Executive Committee agreed to request India to revise its paper and resubmit to the Executive Committee and also transmit to the Open Ended Working Group. In response to the wishes of the Executive Committee, the proposal has been submitted for consideration of the Open Ended Working Group in its meeting in July, 1994.

2. During discussions in the 12th meeting of the Executive Committee, several members felt that the Executive Committee requires a mandate from the Open Ended Working Group to consider the proposal. Several others felt that no such fresh mandate was necessary. We are of the view that the Executive Committee does not require such mandate afresh and the Committee is competent to discuss and decide the issue.

3. Article 10 of the Protocol provides that a financial mechanism shall be set up to enable Article 5 countries to comply with the control measures. Accordingly, the Multilateral Fund has been set up which provides funds to cover incremental costs of the ODS phase out programme. The Indicative List of Categories of Incremental Costs recommended by the Executive Committee in its eighth meeting was approved by the second meeting of the Parties and the same is valid today. A copy of the list is enclosed. It is noteworthy that para. 2 of the List states, "If incremental costs other than those mentioned below are identified and quantified, a decision as to whether they are to be met by the financial mechanism shall be taken by the Executive Committee consistent with any criteria described by the Parties and elaborated in the guidelines of the Executive Committee."

4. We feel that the current Indicative List of Categories of Incremental Costs adopted by the meeting of Parties was meant to be an indicative list. The Meeting of Parties had given necessary mandate to the Executive Committee to interpret the List to meet the objectives of the Protocol. However, the experience has shown that the Indicative List has acquired the force of law. It has no longer remained an indicative list but has tended to become immutable and the final list. It has, therefore, become essential to adopt the amendments proposed in this paper.

5. It will be seen that incremental cost is admissible to establish facilities that fall in three categories:

- (a) for supply of substitutes of ODS;
- (b) to replace their use in manufacturing as an intermediate good; and
- (c) to replace them in their end use.

In the case of facilities for supply of substitutes of ozone depleting substances (ODS), the incremental cost is admissible for:

- (i) Cost of conversion of existing production facilities;
- (ii) Cost arising from premature retirement or enforced idleness of production capacity;
- (iii) Cost of establishing a production facility for capacities equivalent to capacity lost when plants are converted or scrapped;

- (iv) Net operational cost;
- (v) Cost of import of substitutes.

6. For replacing the manufacturing facility which uses ozone depleting substances as an intermediate good, incremental cost is admissible for, among other items, cost of conversion of existing equipment and product manufacturing facilities.

7. It may be seen in para 5 (i) above that incremental cost of conversion of existing production facilities is eligible. Similarly in para. 6 above, incremental cost of conversion of existing equipment and product manufacturing facilities is eligible. If a facility is not an existing facility, it will not be eligible for incremental costs. It will be seen that the above arrangement does not provide for -

- (i) Incremental cost to establish new production facilities for
 - supply of ODS substitutes,
 - use of ODS substitutes in manufacturing as an intermediate good,
 - or end use of ODS substitutes
 - to cover rapidly increasing demand.
- (ii) Where the ODS is used in manufacturing as an intermediate good or has end use, incremental cost to establish new facilities with ODS substitutes equivalent to capacity lost when plants are converted or scrapped.

Provision needs to be made to rectify these deficiencies.

These are explained below:

8. Incremental cost to meet future demand:

- (i) Future demand refers to the demand of goods, currently produced with ODS, which is likely to arise up to 1999 i.e., the date when the actual consumption should be brought down to the level of 1996, but cannot be met with the existing production facilities. In respect of 'end use', it may include:
 - Quantity of user equipment required during the phase out period or likely to exist at the end of the phase out period.
 - Quantity of ODS to be collected, managed, recycled or destroyed during the phase out period.
 - and requirement of technical assistance to reduce consumption and unintended emission of ODS during the phase out period.
- (ii) Though under the Protocol, for Article 5 countries the production and consumption of ODS is to freeze at the level of 1996 (for CFCs and Halons), and a phase out schedule has been prescribed, these countries are being asked not to increase consumption till 1996 and to accelerate the phase out. But in Article 5 countries, the demand for products using

ODS has been growing very rapidly and this is expected to continue for some time. The capacity of existing facilities will not be able to meet the rapidly growing demand till the end of the phase out period.

- (iii) If there was no Montreal Protocol either expansion of existing facilities would have taken place or, new facilities using ODS would have been established to meet the growing demand. If this is to happen with ODS free technologies without the support of the Multilateral Fund it would cause unbearable burden on the enterprises of the developing countries and hence the proposed amendment is necessary.
- (iv) Secondly, to get the benefit of the Fund under the present list expansion or new investment in facilities will, per force, have to be with ODS technologies first, so that these become an existing facility to satisfy the current eligibility condition. Only then these enterprises can come to the Fund for claiming the benefit of the incremental costs for switching over to ODS free technologies. This will be an extremely inefficient way of adopting ODS free technologies.
- (v) In case, this amendment is not adopted phasing out of ODS will not only be inefficient but also have forces discouraging it. If future demand is to be met either by expansion of capacity or by setting up new facilities and if the incremental capital cost for such investment is not available to the enterprise, it will discourage the enterprise to go for such investment. The products from such investment will not be able to compete with the existing facilities that have secured incremental costs from the Fund. The entrepreneurs may find it more competitive to either expand or establish new facilities with ODS technologies which will defeat the phase out efforts. The Protocol has recognized the difficulties of developing countries and provided for a grace period of 10 years to adopt non ODS technologies. The longer an enterprise takes to adopt ODS free technology, greater will be the damage to the Ozone Layer and higher will be the cost to the Fund than compared to the situation in which substitution to ODS free technologies takes place now and enterprises are compensated for only the incremental cost of extra capacity to meet the future demand. Delay will mean additional burden on the Fund due to inflation also.

Note: The terms new production facilities, intermediate good, end use and existing capacity used in this paper will have the same meaning as in the indicative list of categories of incremental costs. No new base year is contemplated.

- (vi) In order to ensure that the Article 5 countries are able to adhere to the date of schedule as provided in the Montreal Protocol, it is necessary to provide funds for them to meet incremental costs for meeting the future demand as defined above.
- (vii) Even the present indicative list of categories of incremental costs does not provide answers to all the questions. The Executive Committee has been taking policy decisions amplifying the present list. Once the amendments have been adopted in principle, further discussion can take place for its implementation. To mention a few specific points agreement should not be difficult on issues such as growth of import, export, domestic demand, operational costs etc. For instance the growth could be taken as provided in the country programme and reviewed every 3-5 years. Till the base year, 1996 the demand will have to include export, import and the domestic demand for calculating the capacity of the facilities required. The Protocol does not provide any restriction on use of ODS in Article 5 countries till 1996. Efforts by these countries to phase out ODS before 1996 should be encouraged by way of not putting any restriction on the base line. However, after the base year, projects for meeting future demand may take into account only increase in domestic demand over the base year.

9. Admissibility of existing capacity for computing incremental cost:

The Indicative list of categories of Incremental costs, in the case of supply of substitutes, provides for the inclusion of the existing capacities for the purpose of computing incremental costs. This provision is not so clear in the case of manufacturing where ODS is used as an intermediate good or where ODS has end use. It is necessary to clarify that while calculating incremental costs, the existing capacities will be considered in all the three categories i.e.

- supply of substitutes,
- use in manufacturing as an intermediate good, and
- end use.

10. In view of the above, the following modifications are proposed in the Indicative List of Categories of Incremental Costs:

- (i) At the end of para 2 (b) (i) the semicolon may be deleted and the words, "so as to achieve the existing capacity", may be added. Thus the new para 2 (b) (i) may read as follows:

"Cost of conversion of existing equipment and product manufacturing facilities so as to achieve the existing capacity."

- (ii) At the end of paragraph 2, an explanatory note should be added specifying that "while computing the incremental capital costs the existing capacity of the facilities will be taken into account."
- (iii) Add the following as para. 3 to the List "The incremental capital cost for establishing facilities to meet the future demand during the phase out period for all the three purposes covered under paras 2(a), 2(b) and 2(c) above will be eligible for funding along with Incremental Operational Costs which will be assessed suitably and adjusted on actuals."

INDICATIVE LIST OF CATEGORIES OF INCREMENTAL COSTS

1. The evaluation of requests for financing incremental costs of a given project shall take into account the following general principles:

(a) The most cost-effective and efficient option should be chosen, taking into account the national industrial strategy of the recipient party. It should be considered carefully to what extent the infrastructure at present used for production of the controlled substances could be put to alternative uses, thus resulting in decreased capital abandonment, and how to avoid deindustrialization and loss of export revenues;

(b) Consideration of project proposals for funding should involve the careful scrutiny of cost items listed in an effort to ensure that there is no double counting;

(c) Savings or benefits that will be gained at both the strategic and project levels during the transition process should be taken into account, on a case by case basis, according to criteria decided by the Parties and as elaborated in the guidelines of the Executive Committee;

(d) The funding of incremental costs is intended as an incentive for early adoption of ozone protecting technologies. In this respect the Executive Committee shall agree which time scales for payment of incremental costs are appropriate in each sector.

2. Incremental costs that once agreed are to be met by the financial mechanism include those listed below. If incremental costs other than those mentioned below are identified and quantified, a decision as to whether they are to be met by the financial mechanism shall be taken by the Executive Committee consistent with any criteria decided by the Parties and elaborated in the guidelines of the Executive Committee. The incremental recurring costs apply only for a transition period to be defined. The following list is indicated:

(a) Supply of substitutes

(i) Cost of conversion of existing production facilities:

- cost of patents and designs and incremental cost of royalties;
- capital cost of conversion;
- cost of retraining of personnel, as well as the cost of research to adapt technology to local circumstances;

(ii) Cost arising from premature retirement or enforced idleness, taking into account any guidance of the Executive Committee on appropriate cut-off dates:

- of productive capacity previously used to produce substances controlled by existing and/or amended or adjusted Protocol provisions; and
- where such capacity is not replaced by converted or new capacity to produce alternatives;

- (iii) Cost of establishing new production facilities for substitutes of capacity equivalent to capacity lost when plants are converted or scrapped, including:
 - cost of patents and designs and incremental cost of royalties;
 - capital cost;
 - cost of training, as well as the cost of research to adapt technology to local circumstances;
- (iv) Net operational cost, including the cost of raw materials;
- (v) Cost of import of substitutes;
- (b) Use in manufacturing as an intermediate good.
 - (i) Cost of conversion of existing equipment and product manufacturing facilities;
 - (ii) Cost of patents and designs and incremental cost of royalties;
 - (iii) Capital cost;
 - (iv) Cost of retraining;
 - (v) Cost of research and development;
 - (vi) Operational cost, including the cost of raw materials except where otherwise provided for;
- (c) End use
 - (i) Cost of premature modification or replacement of user equipment;
 - (ii) Cost of collection, management, recycling, and, if cost effective, destruction of ozone depleting substances;
 - (iii) Cost of providing technical assistance to reduce consumption and unintended emission of ozone-depleting substances.