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

Twentieth Meeting
Montreal, 16-18 October 1996

REPORT ON THE FIRST MEETING OF THE EXECUTIVE COMMITTEE'S SUBGROUP ON THE PRODUCTION SECTOR

Introduction

1. At its Nineteenth Meeting, the Executive Committee decided to appoint a subgroup composed of representatives of Australia, Chile, India, Philippines, the United Kingdom and the United States to consider the parts of its report not approved at that Meeting (Decision 19/36). The meeting of the Subgroup was held in Geneva on 25 August 1996. The list of participants is attached as Annex I.

2. The Subgroup had before it a briefing note prepared by the Fund Secretariat, the report of the second meeting of the Expert Group on the Production of Substitutes for Ozone-Depleting Substances (UNEP/OzL.Pro/ExCom/19/59) and the report of the Nineteenth Meeting of the Executive Committee. (UNEP/OzL.Pro/ExCom/19/64).

3. The Executive Committee had approved recommendations 1 to 5 and 7 and 8 transmitted to it by the Expert Group but had not considered points 1 to 5 submitted by the Expert Group for guidance. The Subgroup therefore took up the outstanding issues.

4. It was emphasized that any recommendation made by the Subgroup formed part of a package and could not be definitive until the package as a whole was agreed. Accordingly, the actions noted below are contingent on the development of a complete package that would be acceptable to all.

Recommendation 6

For ODS plant shut-down, the calculation of production capacity eligible for financing should be based on the average of actual production levels of a three-year period, subject to guidance from the Executive Committee on the appropriate three-year period to be used.

There was a consensus in the Subgroup that:

- a three-year period should be used, as recommended by the Expert Group on the production sector;

- While no specific three-year period has yet been agreed, there was consensus that the three-year period must be chosen in such a way so as to preclude the possibility of enterprises increasing production beyond normal growth in demand in those three years in order to obtain greater compensation from the Fund.

<u>**Guidance required from the Executive Committee**</u>

1. Should the implementing agencies be involved in the conducting of the technical audits? Who should supervise the audit team?

5. The Subgroup discussed whether or not implementing agencies should be involved in the technical audit. The view was expressed that the selection of an implementing agency at an early date should be encouraged, but that if no agency was appointed it was not necessary to select one for the audit. Another view was that agencies had a lot to offer in terms of experience so countries should be asked to select one.

6. The Ozone Operations Resource Group (OORG) could play a role in the review of projects if the World Bank was involved. If that was not the case, it was unlikely that the OORG would have a role.

7. It was pointed out that if an implementing agency became involved in a project after the technical audit had been completed, the agency might be compelled to replicate some of the work done during the audit.

8. The Subgroup recommended that:

- Implementing agencies already selected should be involved in the conducting of technical audits but if no implementing agency had been selected it was not necessary to appoint one;

- The Expert Group in its current composition, but without the members of the Executive Committee belonging to the Group, may be consulted in the review of the curriculum vitae of experts for the technical audit on the basis of the Terms of Reference for the technical audits adopted by the Executive Committee at its 18th and 19th Meetings, and make recommendations to the Chief Officer; and

- Since the terms of reference for the technical audit (Annex III to document UNEP/OzL.Pro/ExCom/19/59) specified that the field audit team should report to the Chief Officer, the audit team should be under the direct supervision of the Multilateral Fund Secretariat.

2. Should the capacity verification be covered by the technical audits or should it be conducted separately on a more urgent basis to satisfy Decision VII/9(8b) of the Parties? Who should pay for the capacity verification?

9. The Subgroup discussed whether capacity verification should be carried out at the same time as the technical audit or separately. It was proposed that countries should prepare preliminary capacity estimates as soon as possible and transmit them to the Fund. The estimates could then be verified at the time of the technical audit.

10. The Subgroup noted that the amount of work involved in capacity verification, and consequently the cost, depended on whether capacity meant theoretical capacity ("nameplate" capacity), potential capacity or actual production and on whether all plants would be audited, or only those with a large capacity. The issue of "swing" plants was also raised because verifying capacity in factories that could produce both CFCs and non-CFC products was much more complicated.

11. It was also discussed that while verifying capacity, a distinction could be made between large and other plants. The capacity verification in large plants should be carried out as soon as possible. In other plants, capacity verification should take place at the time of the technical audit, provided that the audit will take place in the next three years. The aim should be to carry out all capacity verifications within three years. All capacity verifications will be subject to the concurrence of the concerned Article 5 Party. It was felt that the Executive Committee may wish to visit this issue after the report of the Expert Group on capacity verification was available.

12. The Subgroup recommended that the Expert Group:

- define which capacity should be verified (nameplate, potential or actual);
- estimate the cost of verifying capacity;
- define "larger" plants which could be subject to near-term capacity verification;
- consider what information was required in order to verify capacity and report to the Twenty-First Meeting of the Executive Committee;

13. The Subgroup also recommended that capacity verification should be paid for by the Fund.

3. On closure projects:

(i) Of the two approaches to the calculation of shut-down costs, which approach should be followed?

14. The Subgroup noted that approach 1, as defined in Annex V to document UNEP/OzL.Pro/ExCom/19/59, was essentially based on an estimate of the future potential of a business, whereas approach 2, as defined in Annex VI to the same document, was based on historical verifiable data.

15. It was felt that Approach 2 was preferable, subject to determination of the life of the plant, the discount rate and prices to be used.

16. The Subgroup recommended:

- that an extensive presentation should be given to the Executive Committee at its Twentieth Meeting on Approach 2, with explanations of the implications of the various components of that approach.

(ii) Should the checklist provided in Annex IV serve as the basis for developing guidelines for the calculation of shut-down projects?

17. The Subgroup noted that the checklist did not mention the discount rate for determining net present value, and was informed that a 10% discount rate, which was first used by the World Bank, had historically been used for Multilateral Fund projects. Therefore, the Subgroup decided:

- to request the World Bank to inform the Executive Committee of the standard discount rate in other projects and the basis thereof, so that this could be understood by the Executive Committee.

With this exception, the Subgroup did not recommend any other changes to the checklist.

(iii) For the calculation of production capacity eligible for financing, which three years should be used for the calculation of the average; the average of three years immediately preceding the submission of a shut-down project, the average of the three highest productive years, or a different approach?

18. It was pointed out that using the three most productive years could lead to over-compensation by the Fund. It was also pointed out by one member that the approach of using three years could reduce significantly the eligible compensation as it ignores future growth. It was also noted that calculation of incremental costs should exclude CFCs stockpiled over and above normal inventories, as manufacturers should not be encouraged to increase production.

19. The Subgroup noted the options for selection of the three-year period:

- three years immediately preceding the submission of the shut-down project;
- three individual years with the highest volume of production, whether historical or future years;
- three consecutive years of highest production, whether historical or future years;
- three years of highest production, taking into account the GDP growth rate multiplied by a factor to relate it to the ODS production rate;
- future years to have normal inventories.

(iv) What pricings and standards should be used, local vs. international, historical or future, in the calculation of shut-down costs?

20. A view was expressed that the price should be the historical price in the absence of the Protocol and the relevant internationally-tradable price for ODS. A view was also expressed that if international historical prices were to be used, these should take into account appropriate mix of bulk and small packing, appropriate profit yielding prices in the free markets and adjustment of historical prices for inflation till current time. In this context it was also expressed that prices of products in free markets of developed countries in pre-Protocol period were generally low reflecting maturity and fully depreciated plants.

21. In the context of determining appropriate shut-down costs, the Subgroup recommended that the Expert Group:

- consider whether a methodology could be proposed to reflect the rate of return on capital and prices that could be substantiated;
- to consider for producing plants *[the maximum economic life]* or *[the remaining useful life]* or *[the remaining useful life (maximum economic life less the number of years the plant has been operating)]*, noting that the basis for overall compensation was clearly related to the rate of return and that a default figure could possibly be chosen unless special circumstances warranted otherwise.

22. The Subgroup requested:

- the Expert Group, the implementing agencies and the United States Environmental Protection Agency to investigate whether they had accurate CFC costs and rate of return data for CFC production during the mid-1980s;
- the representatives of Australia, India, the United Kingdom and the United States to contact manufacturers in their respective countries in order to ascertain what a reasonable rate of return might be for ODS and to report to the next meeting of the Subgroup;
- China and India to provide details on typical redundancy schemes so as to assist in determining what the local labour cost of shut-down might be.

4. Should guidelines for conversion projects and erecting ODS substitute production projects be developed now?

23. The Subgroup noted that non-closure projects raised a number of extremely sensitive issues and the Expert Group would require further guidance from the Executive Committee before it could consider guidelines. Furthermore, priorities would need to be fixed regarding the substitutes for which guidelines were required more urgently.

24. Different views were expressed regarding whether or not it was urgent to consider guidelines for conversion projects immediately after outstanding issues related to closure projects had been resolved.

25. The Subgroup recommended:

- that guidelines for conversion projects not be elaborated until outstanding issues on closure projects had been resolved.

5. What guidance, especially with regard to the definition, would the Executive Committee give the Expert Group on the issue of enforced idleness?

26. The Subgroup noted that it was the view of one member that compensation should be due for the declining utilization of a plant and that this would be less costly than compensating for closure.

27. The Subgroup:

- requested the representative of India to present to the Twentieth Meeting of the Executive Committee further information on its concept of enforced idleness, giving some concrete examples.

Other issues

28. The view was expressed by one representative that, in his country's experience, technology related to the production of ODS substitutes was not available on terms acceptable to it. He also considered that R & D costs should be funded by the Fund at its own risk and, if the effort was successful, the result should be made available to others, free of charge. That was particularly important as difficulties were encountered in obtaining the technology.

ANNEX I

List of participants

AUSTRALIA	Mr. James Shevlin
CHILE	Mr. Sergio Vives
INDIA	Mr. Anil Agarwal Mr. R.K. Sinha
PHILIPPINES	Mr. Delfin J. Ganapin Ms. Elvira I. Salvani
UNITED KINGDOM	Mr. David Clare Department of the Environment
	Mr. Chris Whaley Department of the Environment
	Mr. Rob Shooter Overseas Development Administration
UNITED STATES OF AMERICA	Mr. Bradford Johnson Department of State
	Mr. Paul Horwitz Environmental Protection Agency
EXPERT GROUP ON THE PRODUCTION OF ODS SUBSTITUTES	Mr. Mike Harris
UNITED NATIONS DEVELOPMENT PROGRAMME	Mr. Frank Pinto
WORLD BANK	Mr. Bill Rahill Ms. Jessica Poppele
MULTILATERAL FUND FOR FOR THE IMPLEMENTATION OF THE MONTREAL PROTOCOL	Dr. Omar El Arini Chief Officer
	Mr. Sheng Shuo Leng Deputy Chief Officer