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SHOULD THE MULTILATERAL FUND FINANCE THE CONVERSION EFFORTS OF ENTERPRISES IN ARTICLE 5 COUNTRIES WHICH EXPORT TO NON-ARTICLE 5 COUNTRIES

(Draft)

Part 1. Introduction

1. At its 13th Meeting held from 25-27 July 1994, the Executive Committee, in the context of reviewing the project from Brazil (System for storage and charging of ester oils used in manufacture of HFC-134a refrigerant refrigerator compressors at Empresa Brasileira de Compressors (EMBRACO)), was presented with the issue of how to deal with the export component of the concerned project. The issue was debated at the meeting as to whether the financing should be made available to the export share of the project, and views both for and against funding were expressed. Since the issue raised has policy implications beyond the specific projects, the Executive Committee:

> "approved the project, ... in the amount of US $221,200, which represented 79 per cent of the requested funding and reflected the share of EMBRACO's production which is utilized in Article 5 countries." (UNEP/OzL.Pro/ExCom/13/47, para. 85).
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> And decided:
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> "... that no new projects could be presented to the Executive Committee until the policy issues raised by the EMBRACO project had been studied and decided upon by the Executive Committee. In that light, the Secretariat would prepare a document." (UNEP/OzL.Pro/ExCom/13/47, para. 82).

2. It is realized from the outset that this is a very complicated issue. The paper tries to present in a balanced manner the arguments both in favour and opposed to financing by the Multilateral Fund of the conversion efforts of enterprises in Article 5 countries which export all or part of their products to non-Article 5 countries, with the aim of assisting the Executive Committee in its deliberations on this issue.

3. Export products used in this paper refer to products made with, or containing, ODSs, including intermediate goods.

4. As the title of this paper suggests, the discussion in the paper relates only to exports of Article 5 countries to non-Article 5 countries. The exports to other Article 5 countries are not covered in this paper, with the understanding that all Article 5 countries are eligible for financing by the Fund of incremental costs, provided they meet the criteria and policy guidelines established so far by the Meeting of the Parties and the Executive Committee and, therefore, the concern over equity between producers among Article 5 countries does not apply here.

Part 2. Arguments for financing

1. <u>ODS phase-out</u>

> Except for such intermediate goods like compressors which do not phase out ODS directly until they are installed in the final products, export products covered in the paper eliminate a certain number of tonnes of ODSs when they are produced with ODS-free

technologies. This tonnage also forms part of the national calculated consumption figure in the country programme. In the final analysis, the whole business of the Montreal Protocol and the Multilateral Fund is the phase out of ODS and the restoration of the ozone layer. Since ODS does not recognize national borders, it should be eliminated wherever it is, within or without the borders. Therefore, there exists the need for a global commitment rather than hemispheric commitment either by the North or by the South. Denying funding to export production, especially to exports to non-Article 5 countries, could be misinterpreted as dividing the responsibilities along hemispheric lines, while that division is scientifically impossible.

2. Net incremental costs

Like similar enterprises which produce entirely for domestic markets, the enterprises which export also face net incremental costs in converting their production. If these exporting enterprises receive only partial financing or no financing as compared to other enterprises in the same country, they will be put in an unfair position, because they would most probably have to finance their entire conversion or part of their conversion either from their own source or by external loan financing, while others will be receiving grants to cover all agreed incremental costs.

This is a different situation from the case of denying funding to shares owned by Transnational Corporations (TNC), because:

> "...In such a case, funding could be provided as a percentage of project incremental costs proportionate to the local share ownership of the enterprise with the transnational corporation responsible for the rest". (UNEP/OzL.Pro/ExCom/7/30, para. 88).

3. Volatile market

The market, including the export market, is a fluid and dynamic place. What is true today may not be true tomorrow. What is reported in the project requests as share of export of the enterprise only relates to the status-quo before the conversion takes place. As for the market structure in the post-conversion, it can be anyone's guess. Therefore, decisions made on the basis of current market share may not hold for the future.

4. Common but differentiated responsibilities

The new international co-operation to address global environmental issues is based on the principle of common and differentiated responsibility. This principle is best illustrated in the implementation of the Montreal Protocol.

Under the "polluter pays" principle, the developed countries, because of their dominant role in ozone depletion, agreed to assist the developing countries in covering the incremental costs in complying with the provisions of the Montreal Protocol. Otherwise, the ozone layer cannot be adequately protected if the developing countries use the same ODSs in their development paths that the developed countries have used.

5. Unfair Competition

The price disparities between products produced with assistance of the Multilateral Fund and exported to non-Article 5 countries and those produced in non-Article 5 countries themselves might be perceived to introduce unfair competition. This unfair competition may happen not only in the domestic market of non-Article 5 countries as a result of the exports from Article 5 countries, it may also occur in the domestic market in Article 5 countries where the non-Article 5 countries have been exporting their products before the conversion takes place. If funding is denied to production of exports to non-Article 5 countries on account of unfair competition, the argument could also be extended to deny funding to enterprises producing for the domestic market, because the exports from non-Article 5 countries may also be threatened by the local producers subsidized by the Fund.

Part 3. Arguments against financing

1. Competition on level ground

In many sectors, conversion from ODS-based technologies to ODS-free technologies still incurs costs extra to the current business-as-usual situation. These extra costs are faced, however, by producers from both Article 5 and non-Article 5 countries. The difference comes in the forms these extra costs are met. In the case of the producers from Article 5 countries, these costs, especially the up-front investment costs, are financed by grants from the Multilateral Fund in the form of incremental capital and operational costs. For the producers in non-Article 5 countries, these up-front costs have either to be met by their own source or most likely by external loan financing first and then, partly at least, will be transferred to the customers in the form of higher prices.

The difference in the form these extra costs are met will eventually be reflected in the future production costs of these producers. For the producer from the non-Article 5 country, these up-front investment costs in equipment and other production infrastructure to accommodate the non-ODS technology have to be recouped in the annual depreciation which goes into the production costs, while this is not necessary in the case of the producer from the Article 5 country since these up-front costs are met by the grants.

At the end of the production process, all these costs will determine the pricing of the products to be put on the market. In the case of the two producers, one from the Article 5 and one from the non-Article 5 country, all other things being equal, the grant financing from the Multilateral Fund might create a different pricing policy in favour of the producer from the Article 5 country. In other words, the producer from the Article 5 country can afford to charge a lower price than the non-Article 5 country producer, if both are operating under the same market conditions such as government regulations and taxes.

Implications of the exports from the Article 5 country producer to the non-Article 5 countries:

If this difference in financing conversion is translated into lower price of the exports into the non-Article 5 countries, it could create a disadvantageous position for the producer in the non-Article 5 country.

The above implications work against financing the exports production from Article 5 countries to non-Article 5 countries.

2. <u>Incentive for early phase-out</u>

The anticipation of the trade ban on imports of CFCs and commodities containing CFCs has already forced many exporting enterprises in Article 5 countries to go ahead with the conversion way ahead of the national phase-out schedule without the assistance of the Fund. The motivation behind such efforts was, in many cases, the consideration of the export market. Therefore, the desire to have continued access to these markets proved to be an incentive to early phase-out. Although the incentive here was not provided by the Multilateral Fund, it, however, served the purpose of inducing early phase-out.

This being the case, the Fund should not finance these export-oriented conversion efforts since they could occur of their own accord; and should, instead, concentrate on those areas where an incentive is lacking. This could be an important consideration when the demand for resources exceeds the supply.

3. <u>No ODS phase-out: the case of compressors</u>

The manufacturer of ODS-free compressors does not phase-out ozone-depleting substances directly. It happens only when non-CFC compressors are installed in the refrigerator at the refrigerator manufacturing facility and the refrigerator system is filled with non-CFC refrigerant. When ODS-free compressors produced in Article 5 countries are exported to non-Article 5 countries, they do not affect ODS phase-out in Article 5 countries. Rather, they contributed to the phase-out in non-Article 5 countries.