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EXECUTIVE COMMITTEE OF
THE MULTILATERAL FUND FOR THE
IMPLEMENTATION OF THE MONTREAL PROTOCOL
Twenty-fourth Meeting
Montreal, 25-27 March 1998

**REPORT OF THE EXECUTIVE COMMITTEE'S SUBGROUP
ON THE PRODUCTION SECTOR**

1. In accordance with decision 23/50 of the 23rd meeting of the Executive Committee, the Production Sector Subgroup held its 5th meeting February 17-19 in Washington, DC. The Subgroup was attended by representatives of the following countries members of the Executive Committee: Canada, China, Costa Rica, India, Italy, and the United States.

2. As a result of its three-day meeting, the Subgroup prepared the following short note for submission to the Executive Committee.

3. The meeting spent considerable time discussing the advantages of a sectoral approach in eliminating ODS production but acknowledged the inherent difficulties in proceeding with such an approach. Deliberations continued with a discussion of the broad principles on which funding for production sector projects would be based. Subgroup members reviewed past decisions of the Executive Committee. In that regard, the Subgroup noted the decisions of the 19th Meeting of the Executive Committee which called for countries to submit preliminary data on the production sector by December 31, 1996. The Subgroup was informed that only one country had made such a preliminary submission. It also noted the input report submitted by India in response to paras 10, 14 and 17 of the report of the 4th meeting of the subgroup. The Indian representative stated that he would welcome written comments from members on the said input report. The Subgroup recommended that the Secretariat send out letters to all producing countries reminding them of the need to submit such data. In the context of the past Committee decisions, the Subgroup also discussed the desirability of having countries prepare sector plans. In that regard, it was agreed that the letter from the Secretariat should note the Executive Committee's decision that there was funding available for the preparation of such plans.

4. Following a discussion of these broad issues, the Subgroup moved on to a discussion of the draft methodology that they had been working on for the last four meetings. It was understood that the expert group had initially discussed two methodologies (buy out and lost profits). It was also understood that the methodology under consideration was designed to provide compensation to producers based on an analysis of lost profits using a no-Protocol scenario. Finally, it was also recognized that the feasibility of using such an approach may have to be considered. On that basis, the Subgroup prepared and began discussing an initial list of outstanding issues associated with the methodology. The initial list developed, which was not exhaustive, had the following items on it:

- Eligibility
 - cut off dates
 - production capacity eligible
- Profit Margin/lost profit
- Growth Rate
- Inflation Rate
- Discount rate and sunk costs
- Swing plants
- Years of compensation
- Residual infrastructure

- Cost effectiveness thresholds
- Worker compensation
- Grants or concessional loans

5. On the issue of eligibility, the Subgroup held a long discussion. In general, some members believed that no compensation should be forthcoming for any plant that began production after the London Amendment was negotiated. Others believed that the cut off date could be the date the country ratified the Montreal Protocol. Finally, others believed that the cut off date should be 1995, consistent with the Executive Committee cut off decision on the consumption sector. Regarding production capacity eligible, some members thought that the level eligible for compensation should be limited to the average level of the highest consecutive 36 month-period of operation of the plants, and that no growth rate beyond that should be assumed. Others thought that the level eligible for compensation should be allowed to grow at 14.5% growth rate per year until the full capacity of the plant was reached.

6. On the issue of profit margins, some felt that the profit margin should be in the 6-10% range with no inflation for the cost of CFCs from 1986, while others felt it should be in the 50-75% range, considering possible inflation in the price of CFCs from 86. However, no conclusion was reached on how to treat inflation in the calculation of compensation. There was also no conclusion on the use of financial vs. economic analysis.

7. The Subgroup then discussed the issue of worker compensation. Several members expressed the need for more information on the application of any related local laws, and for an estimate on what kinds of costs, if any, the Fund may face in this regard.

8. On the issue of grants or concessional loans, members felt that because we were contemplating paying on the basis of lost profits, grants would be most appropriate. However, the potential for using concessional loans, particularly in swing plants, was mentioned by one member. A view was expressed that in calculating compensation for swing plants, compensation should be based on the cost of conversion taking into account any changes in operational costs. One member felt it was possible that swing plants may not make any difference in the amount of compensation.

9. After a discussion of the above listed items, the Subgroup decided to try to place some of the main parameters into a spread sheet, and then derive the costs associated with several different funding scenarios. Parameters included in the spread sheet were:

- Baseline production
- growth rate per year
- date of start of commercial production
- date of project approval by the Committee
- discount rate
- price of CFC 11 and 12
- profit margin

10. The wide divergence of opinion on input numbers resulted in a very wide rate of potential costs. Depending on the parameters selected, the net present value cost for closure of, as an example, 22,000 tonnes of current production volume with a total capacity of 63,000 could range from \$16m to \$460m (see annex 1).

11. Each member of the group was provided with an Excel spread sheet on a disk so that they could examine a range of scenarios and apply sensitivity analyses to the model. This would enable members to gain a better understanding of the impact of the various parameters on the funding level of the production sector and allow members to pursue their consideration of the issues at their next meeting. Those favoring consideration of inflation believed that any future iteration of the methodology should include a separate factor for inflation. One member also believed that any future spread sheet should take as a separate factor additional profit margins in respect of integrated plants.

12. After discussing these issues, the Subgroup expressed a belief that they could benefit from seeing some draft project proposals. As a consequence, they decided to recommend to the Executive Committee that they authorize the development of draft project proposals to be reviewed by the Subgroup. This would assist the Subgroup in reaching agreement on the fair value of key parameters for compensation or at least reduce the range of the values. It would also advance the preparation of projects that would, in the end, be considered by the Executive Committee. It was recognized that draft project proposals should be formulated based on the understanding of the expert group report and discussions of the Subgroup and consistent with a country's sector plan, (in an effort to ensure approvable projects). It was also understood that the Project Review Subcommittee is the appropriate body to make recommendations to the Executive Committee on any formal project submission. It was also understood that until guidelines were finalized, it would be best if initial proposals could fall within categories for which there was general agreement. For example, while noting that no decisions had yet been taken on eligibility, some members suggested that initial proposals should be for plants that began production prior to 1990, and that such projects should not preclude future decisions by a country to swing their CFC 11/12 plants to HCFC 22. One participant believed that no projects should come forward in the absence of agreed guidelines. With a view to facilitate the completion of the guidelines, this participant offered to prepare a theoretical project for the sector as a whole based on as close to real life information as possible. Outstanding issues, if any, related to technical audits will be dealt with informally on the margins of the Executive Committee and raised to that body if necessary.

13. In accordance with Decision 23/50 of the 23rd Meeting, the group agreed that it would be useful to hold another meeting after March 1998 to consider any new information, and to see if it would be possible to reach agreement on how to deal with the range within the specific parameters included in the spread sheet. It was agreed that if the Subgroup could not resolve the outstanding issues at its next meeting, it might be necessary to refer them to the Executive Committee.

Compensation for Closure of an ODS Producing Facility(A hypothetical project)									
<u>Assumptions</u>									
Baseline capacity*(ton/yr.)		22,000							
Growth rate per annum**(percentage)		14%							
Date of start of commercial production		1985							
Date of project approval by ExCom.		1998							
Discount rate**(percentage)		7.00%							
Price of CFC 11 (\$/kg.)**		1.32							
Price of CFC 12 (\$/kg.)**		1.56							
Profit margin of sales**(percentage)		50%							
<u>Residual life of plant*** (No. of yrs.)</u>									
Method (a)		16							
Method (b)		8							
<u>Average profit CFC11&12(\$/kg)****</u>		0.72							
Year	1	2	3	4	5	6	7	8	Total
Production	22,000	25,080	28,591	32,594	37,157	42,359	48,289	55,050	291,121
Total profit(\$)	\$ 15,840,000	\$ 18,057,600	\$ 20,585,664	\$ 23,467,657	\$ 26,753,129	\$ 30,498,567	\$ 34,768,366	\$ 39,635,938	\$ 209,606,921
NPV(\$)									\$149,400,904.35
*Verified through technical audit.									
**Refer to Report of 3rd & 4th Meetings of Expert Group									
***Method (a): 25-(1998-1985)=12		Method (a) is favourable to new plants.							
Method (b): (2010-1998)*8months=8		Method (b) is favourable to old plants.							
****Average profit for CFC11&12(\$/kg.)									
(\$1.56 for CFC12*0.2+\$1.32 for CFC11*0.2)/2=0.29									

Compensation for Closure of an ODS Producing Facility(A hypothetical project)																	
Assumptions																	
Baseline capacity**(ton/yr.)	22,000																
Growth rate per annum**(percentage)	14%																
Date of start of commercial production	1985																
Date of project approval by ExCom.	1998																
Discount rate**(percentage)	7.00%																
Price of CFC 11 (\$/kg)**	1.32																
Price of CFC 12 (\$/kg)**	1.56																
Profit margin of sales**(percentage)	50%																
Residual life of plant*** (No. of yrs.)																	
Method (a)	16																
Method (b)	8																
Average profit CFC11&12(\$/kg)****	0.72																
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	Total
Production	22,000	25,080	28,591	32,594	37,157	42,359	48,289	55,050	62,757	63,000	63,000	63,000	63,000	63,000	63,000	63,000	731,878
Total profit(\$)	\$ 15,840,000	\$ 18,037,600	\$ 20,585,664	\$ 23,467,657	\$ 26,753,129	\$ 30,498,567	\$ 34,768,366	\$ 39,635,938	\$ 45,184,969	\$ 45,360,000	\$ 45,360,000	\$ 45,360,000	\$ 45,360,000	\$ 45,360,000	\$ 45,360,000	\$ 45,360,000	\$72,311,890
NPV(\$)																	\$306,947,579.42
**Verified through technical audit.																	
***Refer to Report of 3rd & 4th Meetings of Expert Group																	
****Method (a): 25-(1998-1985)=12		Method (a) is favourable to new plants															
Method (b): (2010-1998)/3months=8		Method (b) is favourable to old plants.															
****Average profit for CFC11&12(\$/kg.)																	
(\$1.56 for CFC12*0.2+\$1.32 for CFC11*0.2)/2=0.29																	

Compensation for Closure of an ODS Producing Facility(A hypothetical project)									
<u>Assumptions</u>									
Baseline capacity*(ton/yr.)			22,000						
Growth rate per annum**(percentage)			14%						
Date of start of commercial production			1985						
Date of project approval by ExCom.			1998						
Discount rate**(percentage)			7.00%						
Price of CFC 11 (\$/kg.)**			1.32						
Price of CFC 12 (\$/kg.)**			1.56						
Profit margin of sales**(percentage)			75%						
<u>Residual life of plant*** (No. of yrs.)</u>									
Method (a)			16						
Method (b)			8						
<u>Average profit CFC11&12(\$/kg)****</u>			1.08						
Year	1	2	3	4	5	6	7	8	Total
Production	22,000	25,080	28,591	32,594	37,157	42,359	48,289	55,050	291,121
Total profit(\$)	\$ 23,760,000	\$ 27,086,400	\$ 30,878,496	\$ 35,201,485	\$ 40,129,693	\$ 45,747,850	\$ 52,152,550	\$ 59,453,906	\$ 314,410,381
NPV(\$)									\$224,101,356.52
*Verified through technical audit.									
**Refer to Report of 3rd & 4th Meetings of Expert Group									
***Method (a): 25-(1998-1985)=12									
Method (a) is favourable to new plants.									
Method (b): (2010-1998)*8months=8									
Method (b) is favourable to old plants.									
****Average profit for CFC11&12(\$/kg.)									
(\$1.56 for CFC12*0.2+\$1.32 for CFC11*0.2)/2=0.29									

Compensation for Closure of an ODS Producing Facility(A hypothetical project)									
<u>Assumptions</u>									
Baseline capacity*(ton/yr.)			22,000						
Growth rate per annum**(percentage)			0%						
Date of start of commercial production			1985						
Date of project approval by ExCom.			1998						
Discount rate**(percentage)			10.00%						
Price of CFC 11 (\$/kg.)**			1.32						
Price of CFC 12 (\$/kg.)**			1.56						
Profit margin of sales**(percentage)			10%						
<u>Residual life of plant*** (No. of yrs.)</u>									
Method (a)			16						
Method (b)			8						
<u>Average profit CFC11&12(\$/kg)****</u>									
			0.14						
Year	1	2	3	4	5	6	7	8	Total
Production	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	176,000
Total profit(\$)	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	25,344,000
NPV(\$)									\$16,901,046
*Verified through technical audit.									
**Refer to Report of 3rd & 4th Meetings of Expert Group									
***Method (a): 25-(1998-1985)=12									
Method (a) is favourable to new plants.									
Method (b): (2010-1998)*8months=8									
Method (b) is favourable to old plants.									
****Average profit for CFC11&12(\$/kg.)									
(\$1.56 for CFC12*0.2+\$1.32 for CFC11*0.2)/2=0.29									

Compensation for Closure of an ODS Producing Facility(A hypothetical project)																	
Assumptions																	
Baseline capacity*(ton/yr)	22,000																
Growth rate per annum**(percentage)	0%																
Date of start of commercial production	1985																
Date of project approval by ExCom	1998																
Discount rate**(percentage)	12.00%																
Price of CFC 11 (\$/kg)**	1.32																
Price of CFC 12 (\$/kg)**	1.56																
Profit margin of sales** (percentage)	6%																
Residual life of plant*** (No. of yrs.)																	
Method (a)	16																
Method (b)	8																
Average profit CFC11&12(\$/kg)****																	
	0.09																
Year																	
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	Total
Production	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	352,000
Total profit(\$)	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	\$ 1,900,800	30,412,800
NPV(\$)																	\$30,412,800
*Verified through technical audit																	
**Refer to Report of 3rd & 4th Meetings of Expert Group																	
***Method (a): 25-(1998-1985)=12 Method (b): (2010-1998)*8months=8 Method (b) is favourable to old plants.																	
****Average profit for CFC11&12(\$/kg.) (\$1.56 for CFC12*0.2+\$1.32 for CFC11)*0.2)/2=0.29																	

Compensation for Closure of an ODS Producing Facility(A hypothetical project)																	
Assumptions																	
Baseline capacity*(ton/yr.)	22,000																
Growth rate per annum**(percentage)	0%																
Date of start of commercial production	1985																
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Price of CFC 12 (\$/kg)**	1.56																
Profit margin of sales**(percentage)	10%																
Residual life of plant*** (No. of yrs.)																	
Method (a)	16																
Method (b)	8																
Average profit CFC11&12(\$/kg)****	0.14																
Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	Total
Production	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	330,000
Total profit(\$)	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	50,688,000
NPV(\$)																	\$24,785,508.98
*Verified through technical audit.																	
**Refer to Report of 3rd & 4th Meetings of Expert Group																	
***Method (a): 25-(1998-1985)=12 Method (a) is favourable to new plants.																	
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****Average profit for CFC11&12(\$/kg.)																	
(\$1.56 for CFC12*0.2+\$1.32 for CFC11*0.2)/2=0.29																	

Compensation for Closure of an GDS Producing Facility(A hypothetical project)																		
Assumptions																		
Baseline capacity*(ton/yr.)				22,000														
Growth rate per annum**(percentage)				0%														
Date of start of commercial production				1985														
Date of project approval by ExCom.				1998														
Discount rate**(percentage)				12.00%														
Price of CFC 11 (\$/kg.)**				1.32														
Price of CFC 12 (\$/kg.)**				1.56														
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Residual life of plant*** (No. of yrs.)																		
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Average profit CFC11 & 12 (\$/kg.)****				0.14														
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Production		22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	22,000	330,000
Total profit(\$)		\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	\$ 3,168,000	50,688,000
NPV(\$)																		\$22,093,588.13
**Verified through technical audit																		
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**Draft Report of the 5th Meeting of the Executive
Committees Subgroup on the Production Sector**

In accordance with decision 23/50 of the 23rd meeting of the Executive Committee, the production Sector subgroup held its 5th meeting February 17-19 in Washington DC. The subgroup was attended by representatives of the following countries members of the Executive Committee: Canada, China, Costa Rica, India, Italy, and the United States.

As a result of its three day meeting, the subgroup prepared the following short note for submission to the Executive Committee.

The meeting spent considerable time discussing the advantages of a sectoral approach in eliminating ODS production but acknowledged the inherent difficulties in proceeding with such an approach. Deliberations continued with a discussion of the broad principles on which funding for production sector projects would be based. Subgroup members reviewed past decisions of the Executive Committee. In that regard, the Subgroup noted the decisions of the 19th Meeting of the Executive Committee which called for countries to submit preliminary data on the production sector by December 31, 1996. The Subgroup was informed that only one country had made such a preliminary submission. It also noted the input report submitted by India in response to paras 10, 14 and 17 of the report of the 4th meeting of the subgroup. India welcomed the views of the members on the report. The subgroup recommended that the Secretariat send out letters to all producing countries reminding them of the need to submit such data. In the context of the past Committee decisions, the subgroup also discussed the desirability of having countries prepare sector plans. In that regard, it was agreed that the letter from the Secretariat should note the ECs decision that there was funding available for the preparation of such plans.

Following a discussion of these broad issues, the subgroup moved on to a discussion of the draft methodology that they had been working on for the last four meetings. It was understood that the expert group had initially discussed two methodologies (buy out and lost profits). It was also understood that the methodology under consideration was designed to provide compensation to producers based on an analysis of lost profits using a no-Protocol scenario. Finally, it was also recognized that the feasibility of using such an approach depended on the ability to come to agreement on a number of key parameters, and that failing such agreement, another approach may have to be considered. On that basis, the subgroup prepared and began discussing an initial list of outstanding issues associated with the methodology. The initial list developed, which was not exhaustive, had the following items on it:

Eligibility

- cut off dates
- production capacity eligible

Profit Margin/lost profit

Growth Rate
Inflation Rate
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Swing plants
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On the issue of eligibility, the subgroup held a long discussion. In general, some members believed that no compensation should be forthcoming for any plant that began production after the London Amendment was negotiated. Others believed that the cut off date could be the date the country ratified the Montreal Protocol. Finally, others believed that the cut off date should be 1995, consistent with the Executive Committee cut off decision on the consumption sector. Regarding production capacity eligible, some members thought that the level eligible for compensation should be limited to the average level of the highest consecutive 36 month period of operation of the plants, and that no growth rate beyond that should be assumed. Others thought that the level eligible for compensation should be allowed to grow at a 14.5% growth rate per year until the full capacity of the plant was reached.

On the issue of profit margins, some felt that the profit margin should be in the 6-10% range with no inflation for the cost of CFCs from 1986, while others felt it should be in the 50-75% range, considering possible inflation in the price of CFCs from 86. However, no conclusion was reached on how to treat inflation in the calculation of compensation. There was also no conclusion on the use of financial vs economic analysis.

The subgroup then discussed the issue of worker compensation. Several members expressed the need for more information on the application of any related local laws, and for an estimate on what kinds of costs, if any, the Fund may face in this regard.

On the issue of grants or concessional loans, members felt that because we were contemplating paying on the basis of lost profits, grants would be most appropriate. However, the potential for using concessional loans, particularly in swing plants, was mentioned by one member. A view was expressed that in calculating compensation for swing plants, compensation should be based on the cost of conversion taking into account any changes in operational costs. One member felt it was possible that swing plants may not make any difference in the amount of compensation.

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The wide divergence of opinion on input numbers resulted in a very wide range of potential costs. Depending on the parameters selected, the net present value cost for closure of, as an example, 22,000 tonnes of current production volume with a total capacity of 63,000 could range from \$16m to \$460m (see annex 1).

Each member of the group was provided with an Excel spread sheet on a disk so that they could examine a range of scenarios and apply sensitivity analyses to the model. This would enable members to gain a better understanding of the impact of the various parameters on the funding level of the production sector and allow members to pursue their consideration of the issues at their next meeting. Those favoring consideration of inflation believed that any future iteration of the methodology should include a separate factor for inflation. One member also believed that any future spread sheet should take as a separate factor additional profit margins in respect of integrated plants.

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