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

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PROJECTS THAT MIGHT REALIZE NET INCREMENTAL SAVINGS
(Draft)

1. The Multilateral Fund was established to support developing country efforts to phase out ozone depleting substances (ODS) through the financing of agreed incremental costs associated with such efforts. Incremental costs of project proposals submitted to the Executive Committee for consideration are calculated on the basis of capital and operational (recurrent) costs. Operational costs occur when a new technology results in higher operational costs than the old technology. Such costs are added to the capital costs in determining eligible grants.

2. Operational savings occur when a new technology results in less operational costs than the old technology. Such savings are netted out in determining eligible project grants. Net operational savings occur when operational savings are greater than operational costs. Net incremental savings (the absence of incremental costs) occur when net operational savings are greater than a project's capital costs.

3. At its Eleventh Meeting, the Executive Committee requested the Fund Secretariat to prepare a policy paper on potential funding options for projects that realize net incremental savings and could realize significant ODS reductions (UNEP/OzL.Pro/ExCom/11/36, para. 70) but nonetheless might not be undertaken due to the inability of the companies involved to obtain financing. The Fund Secretariat submitted a draft paper on "Projects that Might Realize Net Incremental Savings" to the Twelfth Meeting of the Executive Committee. At that meeting, the

Executive Committee requested the Fund Secretariat to prepare, in collaboration with the implementing agencies and taking into account the views expressed during the meeting discussion, a revised paper for submission to the next Executive Committee meeting (UNEP/OzL.Pro/ExCom/12/37, para. 154).

4. The World Bank submitted a note on World Bank Lending for ODS Phase-out Activities which was incorporated into the text. UNIDO contributed comments on the paper which addressed the main modifications to this revision of the paper. UNDP submitted a document on the Operational Procedures and Administrative Arrangements of the UN Revolving Fund for Natural Resource Exploration.

Impact of the calculation of operational savings

5. The original request to consider this issue was the result of a recommendation to defer action on two foam projects in Egypt due to the significant negative impact of potential operational savings (UNEP/OzL.Pro/ExCom/11/36, para. 66). Although these projects would result in ozone depleting substance (ODS) phase-out and they are similar to other foam projects already funded in Egypt and elsewhere, the impact of potential operational savings from these projects would result in a reduced grant amount which will not be sufficient to purchase the capital equipment necessary for conversion and ODS phase-out. The two Egyptian enterprises informed UNDP that they could not start converting to non-ODS substitutes without having the capital cost made available to them.

6. The Executive Committee has approved several project proposals that have had a positive incremental cost despite having net operational savings. Net operational savings may occur in projects where the substituting chemical or conversion technology results in lower operational costs. Thus far, net operational savings have occurred in some aerosol, foam and solvent projects. This is because the first two convert to much less expensive hydrocarbons and the other converts to aqueous solutions.

7. For the projects with net operational savings, the calculation of operational savings is determined on the basis of current prices of the controlled substance; the prices of substitute alternatives; other operating costs such as utilities and labour; amount of ODS phased out; and, the period of calculating operational costs. Prices of ODS and alternatives can vary significantly from country to country and future costs may also vary significantly.

8. The two projects, referred to in paragraph 5 above, were originally presented with the support of the implementing agency with the same estimated cost of hydrocarbon as was used in a similar project approved for Malaysia. Upon review by the Secretariat, it was determined that the current price for hydrocarbons in Egypt was US $1 per kilogram lower than that used in Malaysia's project. The recalculation of incremental costs resulting from the use of local cost estimates resulted in significant operational savings which reduced the grant amount to below zero, in one case, and an amount insufficient to cover enough capital costs to proceed with the project without additional assistance in the other case.

9. It thus transpires from paragraphs 7-8 above that the calculation of operational savings is sensitive to small variations in the price of substitutes and to the quantity of controlled substances to be phased out. Further, lack of available funds may mean that projects that would phase out larger amounts of ODS in the most cost-effective manner possible would not receive funding and be implemented, while those with smaller amounts of ODS to be phased out and lower levels of cost-effectiveness would be funded. Thus, by providing funding to the lower-ODS consuming companies, the Fund may indirectly provide a competitive advantage vis-a-vis other companies that do not receive the grant.

10. Eligible project costs are also dependent on the transition period of calculating incremental operational costs. The issue of a transition period has been discussed by the Executive Committee before and it was decided that:

> "Given the uncertainty associated with projecting future cash flows, recurrent (operational) costs would be considered for a transitional period as defined in the document (UNEP/OzL.Pro/ExCom/10/39) and its Annexes. In cases where recurrent costs were not considered as defined in the document and its Annexes, a justification for that approach must be given to the Executive Committee by the implementing agency" (UNEP/OzL.Pro/ExCom/10/40, para. 171.b.).

11. The Annexes in document ExCom/10/39 specify the transition period for operational costs for up to four years. If the transition period were reduced, less savings would have been deducted from the capital costs which might provide sufficient funds to meet the cost of capital equipment.

12. Some of the cases and conditions for funding projects with net incremental savings were discussed at previous meetings of the Executive Committee. Concern was expressed that companies whose conversion projects had net incremental benefits might decline to undertake projects without support from the Fund, thereby delaying phase-out. This is especially the case where, as discussed above, the market is not competitive or there is a lack of access to capital.

Pertinent decisions of the Parties and the Executive Committee

13. Both the Parties and the Executive Committee have addressed the issue of savings in the determination of incremental costs. The Indicative List of Categories of Incremental Costs (UNEP/OzL.Pro.2/3, Annex IV and UNEP/OzL.Pro.4/15, Annex VIII) states that savings and benefits that will be gained at both the strategic and project levels must be taken into consideration when assessing incremental costs. As a result, savings are deducted from incremental costs to determine the grant amount. Consequently, projects with net incremental savings are not eligible to receive grants.

14. The Executive Committee's Implementation Guidelines address the issue of projects with net incremental savings that have short payback periods:

> "Assistance for investment projects shall generally be provided in the form of grants. However, where the investment project has a short payback period (i.e., 1-2 years), financing may take the form of highly concessional loans. If an implementing agency believes that a highly concessional loan is appropriate for a particular project, it shall recommend this action at the next meeting of the Executive Committee. The Executive Committee shall make the final decision on the terms of assistance" (UNEP/OzL.Pro/ExCom/3/18/Rev.1, Annex III, Section V, para. 3).

15. Under these guidelines, projects with net incremental savings, although not eligible for grants, may be eligible for funding on the basis of concessional loans.[1] However, it should be noted that, to-date, this mode of financing has neither been requested nor recommended by any of the implementing agencies.

Types of loan programmes

16. During the discussion of the subject of net incremental savings at the last meeting of the Executive Committee, four types of loan programmes were mentioned: market loans, loans from Fund resources, on-lending as was utilized in the grant to Turkey, and financing with the regular resources of the implementing agencies.

<u>Market loans</u>

17. Theoretically, most projects that result in short term cost savings would be undertaken independently of Fund resources through a market (commercial) loan. Currently, where the incremental savings and/or benefits significantly reduce or eliminate incremental costs, the enterprise must put up capital from its own resources or borrow funds from commercial sources.

18. As part of the project preparation process, implementing agencies may calculate financial information such as the internal rate of return, credit worthiness of the company, capacity to pay back, and other information that might be required by a commercial lending institution. It sometimes happens that in the process of preparing a project's feasibility, the

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1 A concessional loan is a loan where the repayment terms (interest rate, maturity period, grace period) are more favourable than for usual commercial loans. The more favourable the repayment terms, the greater the degree of concessionality. The use of concessional loans versus grants was addressed in a paper prepared by the Fund Secretariat and presented to the Seventh Meeting of the Executive Committee (UNEP/OzL.Pro/ExCom/7/31). The paper defined concessional loans and addressed the consequences of funding through concessional loans instead of outright grants.

implementing agency demonstrates to the company, and commercial lending institutions, the financial viability of the conversion.

19. Nevertheless in some cases, the projected level of savings for the project may not necessarily serve as an adequate incentive for the enterprise to use its own capital. Further financing from other sources may be difficult to obtain or overly risky, given interest rate fluctuations in some countries.

20. The issue of lack of access to loan capital is a significant problem in developing countries. In some cases, companies with projects that will result in net savings may not be able to find a lending institution willing to support a loan request. For many companies, the average expected return on investment for capital is higher than the average case in developed countries. If companies did have access to capital, they might prefer to invest the funds in more highly profitable activities.

Loans from Fund Resources

21. As mentioned above, the Fund could, theoretically, transfer funds to an implementing agency which would then lend the funds, on behalf of the Multilateral Fund, to the recipient country. The World Bank and UNDP have indicated, however, that their respective Ozone Trust Fund rules prevented them from loaning funds transferred to their Trust Funds from the Multilateral Fund. Consequently and under the present circumstances, loans to governments from the Fund are effectively precluded. For example, the agreement between the World Bank and the Executive Committee states that "the World Bank will provide financing from the Ozone Trust Fund in the form of grants denominated in United States dollars". Therefore, the agreement between the Executive Committee and the World Bank would have to be modified to enable financing in the form of concessional loans.

On-lending

22. Another method for the use of loans is for the Executive Committee to approve funds for transfer as a grant to an Article 5 country which could then loan the transferred funds to the recipient enterprise. In this manner, the Fund could provide resources which could then be loaned, and to varying extent recovered and loaned again, for ODS phase-out purposes.

23. On the initiation of the Government of Turkey, the Turkish government decided to on-lend grant funds approved for the Arcelik project in the refrigeration sector. The Bank informed the Committee of this decision and entered into an agreement with Turkey which enabled the Turkish government to on-lend the grant funds under specific conditions that the recovered funds (loan repayments) would then be used for other ODS phase-out projects with any residual funds used for other environmental purposes.

24. In cases where the return on capital at risk is insufficient or where there is a serious shortage of capital funds (such as in an inflationary economy), on-lending can provide the appropriate incentive to initiate ODS phase-out efforts. On-lending is best managed at the country-level, where administrative cost are most likely to be lower. On-lending allows to

leverage limited resources to achieve greater environmental benefit, whether in cases of incremental or non-incremental costs.

Financing with the regular resources of the implementing agencies

25. A fourth method of providing loans would be for an implementing agency to use its own resources as a loan to Article 5 countries to cover project costs that lead to the phase-out of ODS but cannot be supported by the Multilateral Fund due to net incremental savings. In this case, the standard loan procedures of the implementing agencies would apply.

26. The World Bank has the ability to loan funds for ozone projects with internal funds unrelated to the Multilateral Fund. The other implementing agencies do not have this ability with the possible exception of UNDP through its Revolving Fund for Natural Resources Exploration which is intended primarily, if not uniquely, for natural resource exploration. Although not implementing agencies of the Fund, Regional Development Banks and the European Bank for Reconstruction and Development do have lending programmes for the environment.

27. The World Bank[2] generally lends funds only to governments or para-public organization under guarantee from the government. In most cases, World Bank loans for ODS phase-out efforts would therefore be to the government which would then presumably on-lend to the participating enterprises; however, one of the Bank's units, the International Finance Corporation does provide loans directly to companies in developing countries.

28. The World Bank generates its operating revenues on the basis of interest earned from loans which have favourable payback periods to its clients, but at commercial rates. Concessional lending is available only through the International Development Agency (IDA) to the poorest countries in the world, those with a per-capita income of less than $1,305, and focuses on the most pressing development needs of the country.

29. Lending programmes are discussed by the Bank (through Country Departments) and its clients on an annual basis. It is at such time that a country can express its interest in sector-specific Bank loans, including environment-sector loans. There are no additional criteria (except for project specific conditionalities) beyond the basic eligibility criteria and capacity to pay back upon which the Bank can extend loans to its clients for environmental protection activities, including projects for the phase-out of ozone-depleting substances. So far, only the Republic of Argentina has discussed borrowing from the Bank for financing the non-incremental portions of the project costs of ODS phase-out efforts.

30. It should be noted that the largest projects that have been presented to the Executive Committee are well below the average size of a World Bank loan which is well over

[2] The World Bank includes the International Bank for Reconstruction and Development, International Development Agency, Multilateral Investment Guarantee Agency and the International Finance Corporation.

US $100 million. Since the Bank processes about 200 large projects for a loan portfolio of over US $25 billion, ozone projects with net incremental savings might be only a small component of a much larger request that covers more than the ozone phase-out investments.

Rationale for strategic sectoral distribution of incremental costs

31. One of the primary reasons for assisting projects with net incremental savings is that they result in the elimination of ODS which is the main goal of the Fund. The Fund has already financed activities that facilitate ODS elimination but do not directly result in ODS phase-out as do projects with net incremental savings. Paragraph 1(a) of the Indicative List states that "the evaluation of requests for financing incremental costs . . . shall take into account the most cost-effective and efficient option . . . ." A project with operational savings deducted from the capital costs results in higher cost-effective measurements than the same project with no operational savings. Higher-consuming companies have a larger market and, due to economies of scale, are likely to be more efficient than smaller-consuming companies.

32. A significant possibility for addressing this issue is for projects to be considered within the context of a sectoral strategy for all sector enterprises which could address any possible unintentional distortions. The sector strategy could contain a request for funding and a plan for the distribution of the country's total sectoral incremental costs to achieve the goal of the phase-out of all ODS in the sector. The strategy could include funds for both projects with and without operational savings and the distribution of funds could be based on grants, concessional loans, on-lending or any combination thereof.

Recommendations

33. The Parties and the Executive Committee have addressed the issue of savings and determined that only incremental costs should be financed with grants and projects with net savings may be funded through concessional loans. Although Fund activities currently demonstrate that projects with incremental savings are feasible (through the financing of project preparation), such projects may be good candidates for concessional loans from resources provided by the Fund or from other funding sources.

34. It is, therefore, recommended that consideration of projects with net incremental savings might be provided through the consideration of sector strategies for each country. In such strategies, the impact of funding one company's project over another could be assessed and remedial action recommended as part of an overall sector plan that might include both grant and loan components.

35. Implementing agencies, Regional Development Banks and other lending institutions should be encouraged to provide loans for those projects in Article 5 countries that lead to the phase-out of ozone depleting substances but may not be eligible for grants from the Multilateral Fund. In this regard, feasibility studies and project proposals prepared by implementing agencies or bilateral donors should be made available to Regional Development Banks and other lending institutions.