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Item 7(b) of the provisional agenda[1]

REPORTS ON PROJECTS WITH SPECIFIC REPORTING REQUIREMENTS WITH OUTSTANDING ISSUES FOR INDIVIDUAL CONSIDERATION

China: Report on the difference between the remaining balance reported in United States dollars and that reported in renminbi in the financial audit report, and on the balances to be returned in stage I of the industrial and commercial refrigeration and air-conditioning (ICR) sector plan (UNDP)

Background

1. The ICR sector plan of stage I of the HCFC phase-out management plan (HPMP) was approved at the 64th meeting at a total cost of US $61,000,000 to contribute to the 10 per cent reduction from HCFC baseline consumption by 2015. The ICR sector plan was operationally completed in December 2019, with the disbursement of committed incremental operating costs (IOCs) planned for completion by December 2020. The project completion report was submitted to the 85th meeting in 2020. However, due to the outbreak of the COVID-19 pandemic, economic activities slowed down, leading to delays in IOC disbursement. At its 86th meeting, the Executive Committee allowed the continued manufacture and sale of products from converted manufacturing enterprises and the disbursement of IOCs until the end of 2021; and the financial completion of the sector plan was further extended to 31 December 2022. The Executive Committee *inter alia* requested the Government of China and UNDP to submit, at the 92nd meeting, a report on IOC disbursement under stage I of the ICR sector plan (decision 90/27(c)).

2. At the 92nd meeting, UNDP, on behalf of the Government of China, submitted the report in line with decision 90/27(c). The Executive Committee noted that the remaining balance of the IOCs of US $1,163,094, plus agency support costs of US $81,417 for UNDP, would be returned to the Multilateral Fund after the approval of the financial audit report at the 93rd meeting (decision 92/11).

3. In line with decision 92/11, UNDP submitted the China Audit Report on the Grant and Disbursement of HPMP (financial audit report) of 2022 to the 93rd meeting. The financial audit report presents the balances

[1] UNEP/OzL.Pro/ExCom/94/1

of stage I of the ICR sector plan in two currencies: United States dollar (US $1,893,426.36) and RMB (RMB131,974.59), which do not correspond to each other. Due to the limited time, the Secretariat was unable to conclude its review of balances to be returned at the 93rd meeting. Accordingly, the Executive Committee decided to request the Secretariat, with the support of UNDP and the Government of China, to prepare a report, for consideration at the 94th meeting, on the difference between the remaining balance reported in United States dollars and that reported in RMB in the financial audit report and on the balances to be returned in stage I of the ICR sector plan (decision 93/51(b)).

4. To prepare for the report, the Secretariat, UNDP and UNIDO[2] discussed the matter during the recent Inter-Agency Coordination meeting,[3] including the reasons for the difference in the remaining balance reported in US dollars and RMB, possible mechanisms to more clearly report disbursements to the Executive Committee, and the measures to mitigate the risk of future exchange rate losses during implementation of the sector plans. Based in part on those discussions, UNDP, in consultation with the Government of China, provided a report containing an analysis of the difference between the remaining balances reported in the two currencies, and proposed mitigation measures for more transparent reporting on balances and for reducing the difference in future implementation.

Analysis on the difference in remaining balance reported in two currencies

5. The project accounts at the Foreign Economic Cooperation Office (FECO) of the Ministry of Ecology and Environment (MEE) for stage I of the HPMP were maintained in RMB for all sectors except for polyurethane (PU) foam and the production sector implemented by the World Bank. After the project approval by the Executive Committee, funds were transferred from UNDP to FECO and converted from US dollar to RMB upon receipt.[4] Subsequent disbursements to beneficiaries, as well as balances and accrued interests, were recorded in RMB. Therefore, the balance in RMB reflects the actual status of funds in the ICR sector account.

6. Before 2014, conversion contracts in the ICR sector plan were signed in US dollars. Payments to beneficiaries for those contracts were made in RMB based on the agreed payment schedule in the contract in US dollars, and the exchange rate at the time of disbursement. After 2014, all conversion contracts were signed in RMB, and payments for these contracts were based on the agreed schedule in RMB amounts.

7. The financial audits on the HCFC phase-out plans were conducted annually by an independent firm (WUYIGE Certified Public Accountant LLP), covering all projects for the phase-out of controlled substances on a sector basis. These audits provide information on grants received, funds disbursed, account balances, and interests accrued from the funds held by FECO. The audits were conducted in RMB and the results were converted to US dollars.

8. Each audit period covers numerous disbursements occurring at different times during implementation, with the exchange rate constantly changing. The audit report applied the average rates at the beginning and end of the audit year for calculating interest, and the rate at the beginning of the month for payments.

<u>Understanding the reasons for the difference between the remaining balance reported in the two currencies in the 2022 financial audit report for the ICR sector</u>

[2] Implementing agency for stage I of the room air-conditioning (RAC) sector plan. A similar case on the difference between the balance of stage I of the RAC sector plan in United States dollars and RMB was reported in the 2022 financial audit report. The implementation of stage I of all other sectors have been completed and balances returned to the Multilateral Fund.

[3] Montreal, 12-13 March 2024

[4] At the exchange rate given by the commercial bank used by FECO for the ICR sector.

9. Based on the information provided by UNDP on behalf of the Government of China and the audit report, the difference between the two currencies is attributed to fluctuations in the currency exchange rate between the time when the funds were received by FECO from UNDP and when they were disbursed from FECO to the final beneficiaries. These differences arise due to the different exchange rates used for calculating amounts in the account at the time of receipt, disbursement, and audit, resulting in variations between the reported balances in the two currencies.

10. The following hypothetical example can illustrate the issue: FECO received a transfer of US $1,000,000 in August 2015. With the exchange rate of 6.21 which is the UN exchange rate in August 2015, FECO received RMB6,210,000. After receiving the funds, contracts were signed between FECO and enterprises for the total amount of RMB6,210,000. Assuming the projects were completed in December 2015, and all RMB6,210,000 were disbursed to beneficiary enterprises in February 2016, the progress report should show a zero balance. However, the disbursement of RMB6,210,000 would be recorded as US $944,343 due to the exchange rate of 6.576 which is the UN exchange rate at the month of February 2016 used in the audit report, resulting in a difference between the reported and actual disbursement of US $55,657. In this hypothetical example, there would be no remaining balances as all RMB6,210,000 were disbursed; however, the financial audit report would show a balance of US $55,657.

11. Conversion projects could take several years to complete and stage I of the ICR sector plan spanned over 10 years. Throughout this period, the exchange rate between the US dollar and RMB fluctuated significantly, leading to differences between the two currencies in the audit report. Similarly, the difference in the remaining balance in two currencies for the room air-conditioning (RAC) sector can be attributed to the same reasons.

12. Based on the records of funds transfers from UNDP to FECO, stage I consisted of five tranches, and funds were transferred to FECO in 10 batches (an average of 2 batches per tranche). A significant portion of each tranche was transferred to FECO upon approval. For instance, the entire first tranche of US $16 million was transferred at once. According to the Agreement between the Country and the Executive Committee, a tranche can be requested once 20 per cent of the previous tranche was disbursed. Consequently, funding balances from multiple tranches accumulated in FECO's account after the initial 20 per cent disbursement. The difference in remaining balances between the two currencies in the audit report grew larger with time, as the RMB depreciated while held in FECO's account and converted back to US dollar when the audit took place.

13. Funds associated with IOCs were transferred to FECO together with the incremental capital costs (ICCs) as a part of the project costs. While the funds were fully converted to RMB at the time of receipt, disbursements for IOCs were only made based on a certain number of units sold to the market. Therefore, funds associated with IOCs remained in FECO's account for an extended period, exacerbating the difference between the value of funds in RMB versus the value of those funds in US dollars.

14. Another reason for the difference between the remaining balance reported in the two currencies in the financial audit report for the ICR sector was that before 2014, contracts were signed in US dollars, but FECO paid the beneficiaries in RMB based on the exchange rate at the time of those disbursements. As the RMB had devalued from the time contracts were signed, this resulted in a loss. To avoid this situation, all contracts were signed and paid in RMB after 2014.

The reporting of balances in the tranche progress report

15. The reporting of balances in the tranche progress reports used a different approach than the financial audit. The project management team at FECO maintained records of contract amounts in RMB. These contracts' values were converted to US dollars using the exchange rates at the time of signing. Subsequent disbursements of these contracts were reported in US dollars using the same exchange rate, without considering fluctuations in exchange rates over the past ten years. The different exchange rate used is the

primary reason for the difference between the calculated amount in the progress report and the actual amount in the financial audit.

Discussions between the Secretariat and UNDP regarding the proposed mitigation measures

16. The Secretariat noted that there are two distinct but related issues. The first is to ensure clear and transparent report to the Executive Committee so that the Committee understands the actual level of disbursement and the level of remaining balances at the time when those are reported. The second is to identify measures to mitigate the risk of future currency exchange rate losses.

17. The Secretariat noted that the reporting of disbursements and remaining balances would be clear, and there would be no risk of future currency exchange rate losses, if FECO were to establish a US dollar account as is done for the PU foam and production sectors implemented by the World Bank, and therefore urged the Government to consider setting up US dollar accounts for all the sector plans. UNDP clarified that, in accordance with the Ministry of Finance requirements, FECO/MEE opened a dedicated US dollar account for the World Bank's projects only. This was due to an overarching policy on the special authorization for the World Bank, which also provides non-grant instruments to the Government of China. However, such a policy may not be applicable to other UN agencies that only handle grant instruments. Additionally, FECO must adhere to the requirements of the national audit, which mandates that funds from UNDP and UNIDO should be managed in the local currency. Accordingly, FECO was not in a position to open a US dollar account for the ICR, XPS foam, RAC and servicing sector plans.

18. The Secretariat also proposed the application of hedged exchange rates as a financial tool to avoid currency exchange loss. This approach was not agreed upon due to the complexity of implementation, the required flexibility of using the funds for project implementation and the financial capability required to manage such an arrangement with a commercial bank. However, the Government agreed that disbursements and balances would be reported in the tranche progress reports in both US dollar and RMB, using the exchange rates at the time of the initial transfer from the implementing agencies to FECO. In cases involving multiple transfers, a weighted average exchange rate will be used to reflect expenditures in US dollars. UNDP will coordinate with the auditor to ensure that the same methodology is used in the audit report.

19. Extensive discussions were held on measures to improve the funds transfer schedule to prevent large amounts of funds from accumulating in FECO's account. The objective was to avoid the accumulation of funds in FECO's account without imposing restrictions that would slow implementation. In this context, the concept of a limit for each funds transfer was proposed, which would determine the maximum amount of funds that could be kept at FECO's account before a new funds transfer could be made. UNDP suggested that this maximum amount could be set at 25 per cent of the tranche for the ICR sector.

20. In addition, due to the variation in the size of tranches both within and across sectors, it was agreed that a percentage of the tranche could be used as the limit for each transfer of funds from the implementing agency to FECO. UNDP suggested that up to 25 per cent of the tranche could be transferred to the ICR sector plan on a trial basis.

21. The Secretariat and UNDP also discussed mechanisms to minimize the time between when funds were transferred from the implementing agency to FECO and from FECO to the final beneficiaries. To implement this, the lead implementing agency and FECO will agree upon fund disbursement plans to cover payments in future months. Fund transfers will then be made based on these disbursement plans, subject to the limits described in paragraphs 19 and 20 above. For the ICR sector, a disbursement plan could cover future payments over a period of 3 to 6 months.

22. The Secretariat noted that the conditions specified above, including the maximum amount that could be held by FECO before a new transfer from the implementing agency to FECO was made, the limit for each transfer of funds from the implementing agency to FECO, and the number of months used to determine the

funds needed to cover the disbursement plan, may vary by sector and suggested that, UNDP, as the lead implementing agency for the HPMP for China, coordinate with sector lead implementing agencies and, in consultation with the Government, develop similar conditions for RAC, XPS foam, solvent and servicing sectors, and submit a report to the 95th meeting on how the overarching principles will be applied including the proposed limits for other sectors.

23. To ensure the return of balances upon project completion, UNDP also suggested holding a portion of the funds in the last tranche to cover the balance of returns once the project is operationally completed.

24. Based on the above analysis and discussions, the Government of China through UNDP proposed overarching principles, contained in annex I of the present document, to govern the transfer of funds from the relevant implementing agencies to FECO for projects supported by the Multilateral Fund. These principles focus on better management of funds transfer from the implementing agencies to FECO to prevent funds from accumulating in FECO's account; clearer recording of the disbursement and balances using the same exchange rate when the funds were first converted from US dollars to RMB; and holding a certain amount of the last tranche at the implementing agencies' account to facilitate the return of balances.

Conclusion

<u>The balances to be returned in stage I of the ICR sector plan</u>

25. In light of the information provided by UNDP and the analysis on the reasons for the difference in the remaining balance reported in US dollars and that in RMB, the Secretariat considered that UNDP and FECO had followed the agreed financial procedures in funds transfer and disbursement, and that the balance shown in RMB in the financial audit report, amounting to RMB131,974.59, is the balance to be returned to the Multilateral Fund. Consequently, the Secretariat recommends requesting UNDP to return US $18,337, calculated using the exchange rate on 13 May 2024, plus the associated agency support costs. The Secretariat noted that in line with decisions 69/24(b)(ii) and 77/49(b)(iii), UNDP would continue to report the interest accrued from the funds held by FECO, including, *inter alia*, the remaining balances of stage I of the ICR sector plan, and to return the interest to the Multilateral Fund.

<u>Application of overarching principles for funds transfers to sector plans in future implementation</u>

26. The Secretariat considers that the mitigation measures proposed by the Government in the overarching principles as contained in annex I of the present document are meaningful. Their implementation should help alleviate the difference in remaining balances reported in two currencies. Applying these principles, while taking into account lessons learned from stage I implementation, will lead to improved fund management and optimize the efficiency in using project funds. Therefore, the Secretariat recommends applying these overarching principles to the ICR, RAC, XPS foam, solvent and servicing sector plans under stage II of the HPMP. The Secretariat further recommends requesting UNDP, in coordination with the lead implementing agency of each sector, to submit a report to the 95th meeting providing further details on how the overarching principles will be applied to those sectors, including by specifying the number of months to be considered for the disbursement plans, the conditions for funds transfer, and the proportion of the last tranche to be held by the implementing agency or other comparable measures to ensure the return of balance, as discussed in paragraphs 19, 20, and 21 above.

27. While expecting that the application of the overarching principles would alleviate the difference in remaining balances reported in the two currencies, the Secretariat notes that some difference between the reported value in the two currencies cannot be eliminated.

Recommendation

28. The Executive Committee may wish:

(a) To note the report on the difference between the remaining balance reported in United States dollars and that reported in renminbi in the financial audit report, and on the balances to be returned in stage I of the Industrial and Commercial Refrigeration and Air-conditioning (ICR) sector plan, as contained in document UNEP/OzL.Pro/ExCom/94/10;

(b) To note the overarching principles for managing funds transferred from implementing agencies to the Foreign Economic Cooperation Office (FECO) for stage II of the HCFC phase-out management plan (HPMP) of China described in annex I of document UNEP/OzL.Pro/ExCom/94/10;

(c) To request UNDP to apply to stage II of the ICR sector plan for China, on a trial basis, the overarching principles referred to in subparagraph (b) above and the conditions for their application as described in paragraphs 19, 20 and 21 of document UNEP/OzL.Pro/ExCom/94/10;

(d) To request UNDP, as the lead implementing agency for stage II of the HPMP for China, to coordinate with other implementing agencies and submit a report to the 95th meeting on how to implement the overarching principles referred to in subparagraph (b) above to the solvent sector, the extruded polystyrene foam sector, the room air-conditioning manufacturing and heat-pump water heater sector, and the refrigeration and air-conditioning servicing sector plan and the national enabling programme; and

(e) To note that UNDP would return to the 94th meeting US $18,337, which was calculated on an exceptional basis using the exchange rate on 13 May 2024, representing the remaining balances of the funds from the implementation of stage I of the ICR sector plan, plus agency support costs of US $1,322 for UNDP.

Annex I

OVERARCHING PRINCIPLES FOR THE IMPLEMENTATION MODALITY OF MULTILATERAL FUND PROJECTS IN CHINA

Submitted by the Government of China through UNDP, as lead implementing agency for stage II of the HPMP

General principles

(a) The implementation procedures established for Multilateral Fund projects are governed by the relevant implementing agencies' rules and procedures. According to these rules, each implementing agency maintains oversight responsibilities for project execution performance ensuring the proper allocation of funds (as per Multilateral Fund policies), and compliance with the Agreement with the Executive Committee.

(b) In addition, specific administrative, financial, and operational procedures must follow national regulations governing technical cooperation projects, as mandated by the Ministry of Finance of China, along with other relevant policies, rules, and regulations within the country.

Funds management

(c) With the exception of the World Bank, all other sector plans funded by the Multilateral Fund for China are managed by FECO/MEE using a national account in RMB, therefore RMB will be used as the bookkeeping currency.

(d) The funding approval schedule for sector plans in the Agreement with the Executive Committee is in US dollar amounts. Funds transferred from the relevant implementing agencies to FECO/MEE will be converted into RMB and transferred to FECO's bank account based on the actual conversion exchange rate provided by the bank.

Reporting of disbursements and balances

(e) Unlike the previous reporting practice where only estimated balances in US dollar amounts were reported in tranche progress reports, FECO will now provide disbursement figures (expenditures) in both RMB and US dollar in future progress reports and tranche requests. The disbursements in US dollars will be calculated using the exchange rate at the time when the funds were transferred from the implementing agency to FECO.

(f) In the case where there were multiple transfers, a weighted average exchange rate of the multiple transfers will be used to reflect expenditures in US dollars. UNDP will coordinate with the auditor to ensure the same methodology is used in the audit report, aiming to minimize discrepancies between the audit report and the progress report.

Improving the funds transfer schedule from implementing agencies to FECO

(g) Implementing agencies will collaborate with FECO to improve the current funds transfer schedule, aiming to prevent the accumulation of large balances in FECO's RMB account and thereby mitigate exchange rate risk. The respective implementing agencies and FECO will agree upon a limit for a maximum amount of each transfer based on the implementation plan of the specific sector. For the ICR sector, the proposed limit is set at 5 to 25 per cent of the tranche for each payment.

(h) In addition to the milestones set in the current implementation agreement established between implementing agencies and FECO, an estimated disbursement plan will also be agreed upon for a specific number of months based on the enterprise conversions and disbursement plans. This aims to optimize the payment schedule based on the best estimates against the conversion milestones of the enterprises. For the ICR sector, the proposed period is set at 3 to 6 months.

(i) In principle, implementing agencies will withhold payments if there are sufficient funds in FECO's account for the committed payments in the upcoming number of months. Each payment from an implementing agency to FECO should not exceed an agreed percentage of the tranche (which will, in turn, be commensurate with the Conversion Plan and Disbursements Plan from FECO to the enterprises).

Last payment of the funding from implementing agencies to FECO

(j) To facilitate the potential return of balances unspent by the end of the implementation, implementing agencies will withhold the last payment until there is a clear report from FECO on the amount of funds that will be disbursed in the agreed time frame and estimated balance of the entire project. The final payment from an implementing agency to FECO should cover the committed amounts and will be disbursed accordingly. Any final remaining balances should stay in the implementing agencies' account for return to the Multilateral Fund.