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EXECUTIVE COMMITTEE OF
THE MULTILATERAL FUND FOR THE
IMPLEMENTATION OF THE MONTREAL PROTOCOL
Fifty-eighth Meeting
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**SPECIAL FUNDING FACILITY FOR ADDITIONAL INCOME FROM LOANS AND OTHER
SOURCES (DECISION 57/37)**

Executive Summary

1. The Executive Committee requested the Fund Secretariat to continue to explore possible uses for a special Facility to house additional income and loans, potentially to address climate and environmental benefits beyond those required for HCFC phase-out and possibly also ODS destruction. In particular, the Secretariat was asked to consider legal, structural and administrative issues related to such a facility.
2. The objectives of the Montreal Protocol and subsequent decisions of the Parties appear to provide a solid legal basis for the Facility. The Multilateral Fund is not precluded from funding other activities (such as non-agreed incremental costs) provided they are related to ODS phase-out required for control measure purposes.
3. Structurally, there do not appear to be any issues associated with housing a separate structure within the Multilateral Fund that would be governed by the Executive Committee. The potential for the receipt of transferred funds through expedited approval processes is being examined further by the Secretariat and this effort will continue until the next meeting of the Executive Committee. Issues related to the ownership of credits warrant further study, in particular with respect to potential proprietary rights that could accrue, at least in part, to the Multilateral Fund in a form to be determined at a later stage.
4. From an administrative perspective the Facility would require a separate account within the Multilateral Fund, but there does not appear to be a problem with respect to accounting for additional contributions or for accounting for approvals from a Facility and the Multilateral Fund separately. Nevertheless, in light of the UN financial rules, the ability of the Fund to accrue carbon credits along with their associated risk, merits further study by the Secretariat and the Treasurer.
5. The Secretariat is recommending that the Executive Committee establishes the Facility, including the funds that have already been allocated to it, on an interim basis. It also recommends that the Executive Committee considers funding resource mobilization efforts employing existing energy efficiency methodologies and that methodologies, which could be used to secure additional funding through carbon markets, be developed. To help realize carbon benefits in the long term, this paper suggests that the Secretariat seeks additional voluntary contributions to pursue a limited number of pilot projects that could contribute to establishing internal mechanisms for the Facility. Finally, the Secretariat suggests seeking the assistance of carbon funding experts to address potential issues that could arise with respect to accruing carbon credits over the longer term.

Introduction

6. At its 57th Meeting, the Executive Committee decided to request the Secretariat:
 - To prepare a paper on a special funding facility within the Multilateral Fund, together with an executive summary. The paper should take into account the views that had been expressed at the 57th Meeting as compiled by the Secretariat, and would be posted on its intranet, together with any views received by the Secretariat during the intercessional period; and
 - To submit the revised paper to the Executive Committee at its 58th Meeting (decision 57/37).
7. Comments were posted on the Fund Secretariat's intranet from Sweden, UNEP and USA. Implementing agencies, the Ozone Secretariat and the Treasurer have also been consulted.
8. Members felt that the paper should consider the legal issues, describe the structural arrangements and address matters of timing and cash flow, in particular with respect to the voluntary fund, co-financing and the market mechanism. It was also suggested that issues of risk to the Fund and ownership of credits would need to be considered with respect to market mechanism options. Members further suggested that

collaboration with the GEF Secretariat could be undertaken to explore further timing and cash flow issues associated with the option of co-financing.

9. This paper is also prepared in the context of the following decisions:

- Considering possible additional climate benefits from the HCFC phase-out (decision XIX/6, paragraph 11(b) of the 19th MOP);
- Encouraging countries and agencies to explore potential financial incentives and opportunities for additional resources to maximize the environmental benefits from HPMPs when developing the HCFC phase-out management plans (HPMPs) (decision 54/39(h));
- Requesting the Secretariat to approach other institutions with the objective of identifying individual, regional or multilateral funding mechanisms that might be suitable and compatible as sources for timely co-financing to top up Multilateral Fund ozone funding in order to achieve additional climate benefits (decision 55/43(i)).

10. The types of innovative financing being proposed in association with the Facility present an opportunity for leveraging further funding to achieve additional climate and environmental benefits from the implementation of HPMPs. The Facility is not envisioned to change the existing system within which pledged contributions are paid into the Multilateral Fund to meet the agreed incremental costs of activities to enable compliance with the Montreal Protocol. In the short term, activity under the Facility could begin with a series of small measures for funding that could be built upon to create a self-sustaining fund. If, during the implementation of initial measures, the Committee were to choose not to pursue additional funding under the Facility, an exit strategy would be invoked whereby any funds already earmarked for carbon co-financing could be employed until depleted and any other contributions could either be returned or moved into the Multilateral Fund. Accordingly, the risk associated with attempting to provide a self-sustaining fund for maximizing climate benefits is minimal

General legal considerations

11. Some of the comments raised by members of the Executive Committee concerned general legal considerations. This section provides a brief assessment of legal issues related to the Facility, including its coherence with Article 10 of the Montreal Protocol.

12. While it is up to the Parties to the Protocol to interpret its terms, it appears that the legal basis for the proposed Facility could be found within the objectives of the Montreal Protocol and subsequent decisions of the Parties. Specifically, the tenth preambular paragraph of the Protocol itself refers to climate change and decision XIX/6 directs the Executive Committee to give priority to *inter alia* low global warming potential (GWP) substitutes, if cost effective and when available, and also seeks to include energy-related factors. These, and other decisions, suggest the Parties' interest in continuing the climate protective history of the Montreal Protocol.

13. The existing Financial Mechanism set out in the Montreal Protocol consists of the Multilateral Fund as well as "other means of multilateral, regional and bilateral co-operation".¹ The Facility could fall within the latter category. Also, under its clearing-house functions the provision that the Multilateral Fund shall, "facilitate and monitor other multilateral, regional and bilateral co-operation available to Parties that are developing countries"² seems to imply that the Fund and Secretariat's resources could be used for managing the Facility.

14. The Multilateral Fund does not appear to be precluded from funding other activities (such as non-agreed incremental costs) as long as they relate to ODS phase-out required for control measure purposes. Indeed, the Fund's Terms of Reference allow it to pay for non-agreed incremental costs such as

¹ Article 10(2). According to a literal interpretation also those other means of cooperation were meant to enable compliance with the Protocol's control measures.

² Article 10(3)(b)(iv).

clearing-house functions and the costs associated with the Secretariat. Therefore, the Executive Committee might wish to establish the Facility by decision of the Committee and inform the Parties through its annual report.

Structural Considerations

15. The Executive Committee was established to manage the Multilateral Fund.³ As long as the Facility remains within the organizational and legal structure of the Fund it would be managed and governed by the same bodies and fall within the structure of the current Financial Mechanism under Article 10 of the Protocol. Were this the case, Article 5 countries would be eligible to request funding from the Facility. In the light of the decisions taken by the Parties and the Executive Committee, it appears that the Facility could be accommodated within the Fund.

16. Although the funds in the Facility would not come from pledged contributions, they would still be used for activities associated with the objectives of the Montreal Protocol, subject to the guidelines of the Multilateral Fund, and could therefore be managed within the existing framework. All decisions on matters related to voluntary contributions are in the hands of the Executive Committee. Nevertheless, it appears that additional voluntary contributions would be consistent with the Protocol, if defined for a specific purpose consistent with the objectives of the Montreal Protocol.

17. In terms of structure, it is useful to consider the manner in which any voluntary funds have been accepted by the Secretariat in the past. Both the Multilateral Fund and Ozone Secretariats have accepted funds from Parties for specific purposes (such as operating an Ozone Monitoring trust fund, facilitating workshops, assisting developing country participation, or supporting ozone celebrations). While, under the Multilateral Fund, a specific trust fund and terms of reference for spending have been established, in the case of the Ozone Secretariat related funding has been accepted by and used within the existing budgetary framework in a manner consistent with terms requested by the donor.

Administrative Considerations

18. From an administrative perspective, the Facility would require that a separate account be established within the Multilateral Fund.⁴ This is straightforward, and income from the Facility would be separated from that received from pledged contributions and reflected in an “other income” category. This is already the practice for the funds received from the host Government of Canada in the form of cost differential payments (for holding meetings of the Executive Committee outside Montreal). The funds associated with the Facility would be allocated to specific projects with climate benefits.⁵ If necessary, a Multilateral Fund sub-account with a separate code could also be established to separate additional earmarked contributions from pledged contributions and to accommodate any reporting requirements of

³ Specifically the Executive Committee was mandated primarily to “develop and monitor the implementation of specific operational policies, guidelines and administrative arrangements, including the disbursement of resources, for the purpose of achieving the objectives of the Multilateral Fund.” The terms of reference of the Executive Committee were established at the Fourth Meeting of the Parties, modified and annexed to the Report of the Ninth Meeting of the Parties, see Annex V of document UNEP/OzL.Pro.9/12, and slightly modified at the Sixteenth Meeting of the Parties (decision XVI/38) and at the Nineteenth Meeting of the Parties (decision XIX/11).

⁴ According to a strict interpretation of the Protocol, these other means of cooperation would exist parallel to the Fund, rather than within it, as one of two components of the present Financial Mechanism. An alternative route would involve requesting the Parties to establish the Facility as a separate legal entity under the Montreal Protocol – in addition to the present Financial Mechanism. This relates to the provision that the Financial Mechanism “is without prejudice to any future arrangements that may be developed with respect to other environmental issues” (Article 10(11) as amended by decision II/8). However, as long as the Facility falls within “other means of multilateral, regional and bilateral co-operation” this does not seem necessary.

⁵ The funds would therefore be accounted for separately at the aggregate level under the “allocations” component the same way as the Secretariat budget or the Monitoring and Evaluation budget. It could be shown separately under allocation for specific projects. Separate schedules could be produced to account for these funds.

donors.⁶ Such voluntary contributions for the Facility could be recorded as counterpart contributions outside the trust fund.

19. The use of voluntary funds could be accounted for according to existing procedures established by the Multilateral Fund. In most cases voluntary contributions should also be accounted for vis-à-vis donors. This implies that the Treasurer and the Secretariat would need to track and record funds from multiple sources and prepare financial reports accordingly. Donor contributions might also be earmarked for specific activities or countries. In either event, specific uses for voluntary contributions (as specified at the outset between the donor and the MLF/Facility) could result in an additional administrative burden for the implementing agency, the Treasurer, and/or the Secretariat, and might limit both the flexibility and availability of funds for allocation by the Executive Committee.

20. If, in the longer term, the Facility or the implementing agencies were to accrue carbon credits (either from compliance or voluntary carbon markets) an element of risk would be associated with the funding, as there could be gains and losses associated with holding such credits. From an accounting perspective, such gains and losses could be accommodated in the same manner as the gains and losses from the Fixed Exchange Rate Mechanism that are recorded in the Status of Contributions document submitted to each Executive Committee meeting. However, the extent to which UN financial rules allow risk requires further study by the Secretariat and the Treasurer.

Potential uses of the Facility

21. This section delineates in more detail some potential uses of the Facility. It should be emphasized that any specific use of the Facility would depend on decisions yet to be made on the reach of agreed incremental costs to fund HCFC activities that have a climate benefit.

A. Resource mobilization

22. Any funds required to prepare co-financing packages for resource mobilization (including pilot projects) could theoretically come from either the Multilateral Fund or the Facility depending on whether the Executive Committee decides that these fall within defined incremental costs or not. In decision 55/2, the Executive Committee decided that the Facility would initially be supported by the US \$1.2 million that had been returned to the Fund from the Thai chiller project. The Executive Committee has already approved resource mobilization activities associated with a study on ODS disposal funding options. To maintain the limited amount of funds that currently exist within the Facility, the Executive Committee might wish to use regular funds for a limited number of resource mobilization activities.

B. Voluntary contributions

23. Document UNEP/OzL.Pro/ExCom/57/64 suggested the possibility that the US \$1.2 million returned from the Thai chiller project could be replenished and/or supplemented through additional voluntary contributions, and used to enhance potential climate benefits in the context of HPMPs. The rationale for soliciting voluntary funds is to maximize the climate benefits related to the phase out of HCFCs. For example, if countries choose available alternatives based on cost effectiveness of the technology to solely achieve ozone benefits, the Multilateral Fund could be replacing an ozone depleting substance with a global warming gas, or an alternative that, due to its efficiency, yields a net climate

⁶ For example, QOL is the Source of Fund for the Trust Fund set up by the Ozone Secretariat to account for earmarked funds which they receive from donors. The “Q” is the first letter being used to identify all such earmarked trust funds. The “O” is used link it with the Ozone Secretariat and the “L” stands for Nairobi. Another factor to consider is the size of the expected contributions. If it is going to be material, the QOL approach might be more suitable since it facilitates reporting back to donors.

detriment. To avoid this outcome, the Executive Committee could establish the Facility as a self-sustaining fund capitalised through voluntary contributions.

24. An initial phase could be undertaken that involved seeking voluntary contributions to pursue a small member of pilot projects to maximize climate and other environmental benefits that could be linked to and associated with the HPMPs, which should be submitted starting in 2010. This would enable the Secretariat, agencies and the Treasurer to establish the internal mechanisms necessary for any future expanded use of the Facility as the Parties deal with issues such as HFCs, climate change and energy efficiency.

C. Expedited approval processes for co-financing and fund transfer

25. The objective of seeking such co-financing would be to enable implementation of HPMPs containing climate co-benefits that may not be eligible for Multilateral Fund support, and possibly to fund ODS destruction. This is consistent with the objective of the Facility, as currently envisioned. In the first instance, contacts would be limited to those institutions that have expressed interest.

26. The Multilateral Fund's experience with co-financing through its chiller projects shows that the involvement of multiple funding institutions tends to slow down approvals and delay project implementation. The notion of expedited approval for co-financing and fund transfers could facilitate this process and is also key to addressing concerns of Article 5 countries. It should be noted, that efforts already made by the GEF to expedite their approval process resulted in a rapid two-week approval for the Philippines chiller replacement project. As more experience is gained with co-funding arrangements, the time required for approvals could be shortened.

27. Co-financing may be available for HPMP projects as it was for the chiller projects. The initial objective of the Facility would be to attempt to arrange co-funding to enhance the climate benefits derived from the initial HPMPs. It is likely that such proposals would be presented by implementing agencies as part of the initial HPMPs once the Executive Committee has ascertained the extent to which it would fund climate benefits and energy efficiency. Until such time as the levels of required co-financing to achieve these benefits are determined, it is difficult to approach co-funding institutions beyond a conceptual basis. The length of time that it takes to resolve these issues will have a bearing on the extent to which the implementing agencies would be able to present the appropriate proposals to secure co-financing along with the initial HPMPs. The first HPMPs are expected at the end of 2009 or early in 2010 and project preparation for all HPMPs is expected to be approved by the end of 2010.

28. As already requested, the Secretariat has begun to approach other institutions with respect to facilitating co-financing, and it will continue to do so. These efforts are administrative in nature, except where such agreements involve the transfer of funds for co-financing in advance of the approval. In this regard, the Facility could serve to store those funds for additional climate benefits until they are approved through any expedited or simultaneous approval process.

D. Engaging in the international markets for carbon credits

29. Ultimately, resource mobilization under the Facility could lead the Fund or its agencies to seek carbon credits for climate and other environmental benefits either from compliance markets (CDM) or voluntary markets.

30. The Executive Committee has already approved a special funding window for a Global Chiller Initiative to mobilize external resources and co-funding. The World Bank's India chiller project obtained co-funding from other entities (such as the GEF) for climate benefits and the Bank has developed and received approval for a CDM methodology to receive credits for energy efficiency from the CDM. This, and other refrigeration and air conditioning methodologies, may be used in association with HCFC phase-out, although the HCFC phase-out itself could not benefit from the CDM. Methodologies associated with energy efficiency could be used in compliance markets.

31. The possibility that the MLF/Facility could participate in projects under the CDM (possibly with a co-funder) and receive some or all of the credits merits additional consideration. Ownership of credits, a concern that has been raised by Members, is a contractual issue between project participants. In the India chiller project building owners signed over their carbon credit rights to the project developer in India, and the proposed arrangement was approved by the Designated National Authority. The reasons that the building owners agreed to transfer their rights were as follows: (a) credits that would have been generated by each individual chiller owner were too small and not financially viable to become a CDM project on its own; and, (b) the value of the upfront financing and the value of the potential revenue from carbon credits were about the same. Consequently, the beneficiary saw a means of receiving a guaranteed upfront payment in exchange for a future payback of similar value. The legal issues associated with respect to potential proprietary rights might warrant further study, similarly the financial aspects of a return on the upfront investment might also warrant additional study.

32. One Member raised the issue of encashment of credits. The CER system is designed so that verified emission reductions are issued and forwarded to the registry accounts of the project participants. These credits can be then be sold to countries or companies seeking to offset emissions that are higher than their allocated allowance, to a carbon neutrality company or to a broker or a potential co-funder/carbon fund trustee (such as the World Bank). Credits would be transferred accordingly and could in theory be cashed at any stage in the process.⁷ Unless carbon credits are sold immediately upon certification, it can take several years before they are encashed and the funds are realized.

33. As CO₂ and certain other greenhouse gas emissions are capped by governments (and in some cases through voluntary commitments) a voluntary carbon trading market has developed whereby, for example, if a company wants to emit CO₂ in excess of its quota, it can buy the credits of a company that is emitting CO₂ below its allowable levels. Therefore, if a company develops a project that will result in net reductions in emissions, that project can attract carbon credits that can be sold to a high-emitting company. Under this system companies that emit high levels of CO₂ bid for the credits. Once companies have reduced their emissions, the reduction is verified by an auditing firm with a fiduciary responsibility to ensure the reduction is made. The price of carbon credits is negotiated between the buyers and the sellers.

34. The proposal presented by UNDP at the 57th Meeting of the Executive Committee regarding a new ODS Carbon Facility/Mechanism is relevant to this discussion. UNDP proposed institutional strengthening through methodologies and registries (for example, validation methodologies and a registry to track ODS levels) that would occur before engaging in soliciting finance from the voluntary markets. It noted that a useful model might be for voluntary contributions from donors to fund the early pilot stages, and that initial interaction with the markets should be limited to establishing project eligibility and ultimate value to the market.—Voluntary carbon markets may be a viable option for ODS disposal since CDM is prevented from funding the climate benefits from ODS phase-out. There is still much uncertainty with respect to carbon markets. The Executive Committee may wish to seek the advice of external carbon market specialists on how the carbon market might ultimately be best engaged ahead of the next commitment period of the Kyoto Protocol.

Conclusion

35. With respect to potential funding from additional voluntary contributions and carbon markets, opportunities exist to maximize both ozone and climate benefits. While there remains uncertainty in this context, the risk of exploring these measures further is minimal and returns could be substantial.

⁷ This would be subject to a contractual agreement between the Fund/Facility and the buyer. It is not uncommon that one part of the credits is paid for at the signing of the Emissions Reduction Purchase Agreement and the other part after issuance. A few years ago, when prices were lower, it was not unusual to pay all up-front (i.e., for project development). The choice may depend on the character of the project.

36. The Secretariat is recommending only that the Executive Committee establishes the Facility on an interim basis at this stage, subject to any future guidelines it may choose to adopt within the context of the rules and procedures of the Multilateral Fund. If the Executive Committee acts in the near term it could maximise the opportunities to leverage co-financing to achieve additional benefits through the HPMPs and put in place mechanisms for capitalising on future climate benefits that might be accrued through qualifying Multilateral Fund projects. In the short term this would involve resource mobilization to coincide with stage 1 of the HPMPs and the establishment of a mechanism for the receipt of voluntary contributions. With respect to the goal of the receipt of carbon credits to provide an ongoing source for covering climate and environmental benefits, the Secretariat could, in cooperation with the Treasurer, continue to explore this matter within the context of UN financial rules and practices and retain the advice of external carbon market specialists on how the carbon market might be best employed in the longer term.

RECOMMENDATIONS

37. The Executive Committee may wish to consider:

- (a) Noting the report on the Facility for additional income from loans and other sources as contained in UNEP/OzL.Pro/ExCom/58/49.
- (b) Establishing the Facility on an interim basis to provide additional climate and environmental benefits associated with ODS phase-out projects and that could initially house additional income from voluntary contributions over and above pledged contributions to the Multilateral Fund;
- (c) Approving:
 - (i) Resource mobilization activities with a view to piloting the Facility and establishing the internal mechanisms that could be used to develop the Facility further from Fund resources conditional on criteria specified in (c) (ii) below;
 - (ii) Criteria for requests from implementing agencies for resource mobilization to provide climate and environmental benefits beyond those provided through agreed incremental costs requiring that:
 - a) The results of the resource mobilization efforts should be associated with one or more HPMPs to be submitted by the agency;
 - b) Such proposals should result in projects (including monitoring and verification) that will make them eligible for carbon credits, the financial benefit of which would accrue, at least in part, to the Multilateral Fund in exchange for the advance of the capital required for the enhanced climate and environment benefit;
- (d) Mandating the Secretariat, with the assistance of the Chairman, to seek additional funds from interested donors to support a limited number of pilot projects through voluntary contributions for the Interim Facility to augment those currently available from the return of the Thai chiller project and report to the 59th Meeting on progress;
- (e) Requesting the Secretariat:
 - (i) And the Treasurer to study and report to the 60th Meeting on the implications of optimally managing credits for climate change and other environmental benefits from the global carbon markets with a view toward operationalising this

component of the Facility; and

- (ii) To seek the advice of external carbon market specialists on how the carbon market might be best employed in the longer term in the context of the Facility for input into the report foreseen for the 60th Meeting.
