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EXECUTIVE COMMITTEE OF  
THE MULTILATERAL FUND FOR THE  
IMPLEMENTATION OF THE MONTREAL PROTOCOL  
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**FURTHER CONCEPT PAPER FOR A SPECIAL FUNDING FACILITY FOR ADDITIONAL  
INCOME FROM LOANS AND OTHER SOURCES (DECISION 58/37)**

## **Introduction**

1. The issue of a Facility for additional income and loans was first addressed at the 55<sup>th</sup> Meeting in the context of a suggestion that a separate allocation should be established for the funds returned from the Thai chiller concessional loan project as additional income. This suggestion led to the decision that the potential uses of this facility should be considered at the 57<sup>th</sup> Meeting of the Executive Committee (decision 55/2). The Fund Secretariat prepared a concept paper that was considered at the 57<sup>th</sup> Meeting (UNEP/OzL.Pro/ExCom/57/64) and a request was made for further work on the issues raised based on the comments at the Meeting (decision 57/37).

2. A further concept paper (UNEP/OzL.Pro/ExCom/58/49) was considered at the 58<sup>th</sup> Meeting with a request to provide a detailed account of the discussion in the Committee's report to the Twenty-first Meeting of the Parties and a request to the Secretariat to prepare a further concept paper for the 59<sup>th</sup> Meeting, expanding on the papers presented to date with respect to the elements raised at the meeting, in particular on a definition and added value of a facility. The Secretariat was also requested to address, with the assistance of the Treasurer, how the Treasurer would manage credits for climate change to make that component of a facility operational. It also requested the Secretariat to seek advice on carbon markets and accepted the offer of the World Bank to give a presentation at the 59<sup>th</sup> Meeting on mechanisms for dealing with additional financing and blending Fund resources with carbon financing (decision 58/37).

3. This paper expands on the papers presented to-date with respect to the elements raised at the 58<sup>th</sup> Meeting, addressing in turn the various elements set out in paragraph 2 above. It also provides a summary of documents before the Executive Committee and the Meeting of the Parties with respect to carbon markets, followed by a brief discussion on legal matters and juridical personalities; co-financing and resource mobilization proposals; and additional burden of the Facility to the work of the Secretariat.

## **Definition of the Facility and criteria for receiving funding**

4. The initial idea of a facility was the return of funds from a loan that might be allocated for a different use given that the resources of the Multilateral Fund were intended to assist developing countries to achieve compliance with the control measures of the Montreal Protocol. A possible use of the Facility was further articulated in the papers to the 57<sup>th</sup> and 58<sup>th</sup> Meetings. These papers suggested that the Facility might be used to maximize climate and other environmental benefits, as suggested in decision XIX/6 of the Nineteenth Meeting of the Parties, that would not be required to meet the accelerated HCFC phase-out schedule agreed in that decision of the Parties. It was also suggested that the Facility could be used to finance other activities related to the Montreal Protocol but not funded by the Executive Committee, for example for ODS disposal, given that the Committee has to-date only funded a limited number of demonstration projects for ODS disposal. On this basis, the definition of the Facility, and the activities that would be eligible for the Facility, would be firstly to maximize climate and other environmental benefits associated with Montreal Protocol activities but not required to achieve compliance with the control measures of the Protocol.

5. A second component of the definition of the Facility would be to receive income from additional sources and loans, recalling that the amount set aside to-date (about US \$1.2 million) for the Facility is from the return of funds from a concessional loan. Additional sources of income could include voluntary contributions or funds transferred for co-financing as well as any credits that might accrue as a basis for activities financed by the Multilateral Fund that could include Certified Emissions Reduction (CERs) and carbon credits. Therefore, the definition of the Facility put forward to-date is to be both a source of funding for the costs of additional environmental benefits and a store of funding received from additional sources.

6. The criteria for receiving funding from the Facility would be the same as that required for ODS projects, namely, incremental costs and the existing guidelines of the Executive Committee as applied to projects to maximize the climate and other environmental benefits. For example, rules such as limiting capacity expansion to only that which is unavoidable and reductions for proportions of transnational ownership would continue to also be applied to these projects. Project components and their incrementality would continue to be assessed in respect of the costs associated with maximizing the non-ODS benefits.

**Added value of the Facility versus using the existing Fund structure to fund climate and other environmental benefits**

7. Another initial idea associated with the Facility was the fact that it might receive more funds than the initial capital investment. This is because the chiller projects under implementation by the implementing agencies had originally indicated the ability to generate additional income two times the amount of the initial investment by the Multilateral Fund; subsequently, the income turned out to be, on average, twelve times the amount of the initial investment. Under the existing Fund structure, such benefits would normally result in net incremental savings that would not be funded by the Multilateral Fund.

8. A review of the status of the chiller projects is found in document “Report on implementation projects with specific reporting requirements” (UNEP/OzL.Pro/ExCom/59/10). The chiller projects would use the additional resources from carbon credits and energy savings for future activities in the countries where the benefit is accrued. An added value of the Facility would be to capture part of that benefit that could be more than the initial capital investment from the Fund. Although future carbon credits might remain in the country for future activities, if those benefits are accrued to the Fund they could be used to provide greater incentives in low-volume-consuming countries instead of such benefits accruing to the largest consumers. The Facility provides a means of capturing some of those benefits. This redistribution of benefits from large to low-volume-consuming countries is a characteristic of the CFC phase-out supported by the Fund and could also be a characteristic of the Facility.

9. One of the added values of the Facility would be to provide additional environmental benefits beyond that required for compliance. The Fund has done this on a limited basis with respect to additional funding for hydrocarbon alternatives; however, the Fund is limited to facilitating compliance with the control measures of the Montreal Protocol. Should the Multilateral Fund finance the maximum climate and other possible environmental benefits, then the Facility might still be used to cover additional climate and environmental benefits for future phases of HPMPs or ODS destruction that could not be funded at the present time due to technological difficulties. Funds from the Facility might be used to finance more expensive non-HFC technologies, to secure higher climate change benefits.

10. Another added value of the Facility arising from the definition would be to use it as a store for additional sources of income and loans. It should be recalled that the incremental costs of a project are based on both the capital costs and operational costs or savings for a given project. If there are operational cost savings, they are deducted from the capital costs to determine the value of the grant. Similarly, if an investment in a project generates additional income from a loan programme or through carbon credits, an amount up to the level of the grant might be expected to be returned to the Fund to offset the capital investment. In this respect, the grant for HCFC or ODS disposal activities might be repaid, not from the beneficiaries as was the case with the Thai chiller project, but from carbon credits that are generated from the Fund’s investment at no expense to the beneficiary.

11. However, the value of the credits is not known until after the project is implemented. Since the value is market-driven, the amount that would be returned to the Fund may either not account for all of the capital investment or more than the capital investment. Those countries that have enterprises that have received CERs, for example, have shared the risk and benefit of CERs and therefore they may not be

willing to provide more returns than the upfront costs. Also, if co-financing is provided by another entity, the benefits from the co-financing might also need to be shared.

### **Resources for the Facility**

12. The initial capitalization of the Facility consists of the US \$1.2 million returned from the loan project mentioned above. It has been suggested that additional voluntary contributions and co-financing might be sought and housed as necessary in the Facility. Additional voluntary contributions might be provided by Governments or other funding entities to cover those climate and environmental benefits that are not covered by the Fund. The role of extra-budgetary contributors would have to be determined by any conditions associated with their contributions including reporting requirements. However, such contributions would probably be made to meet the requirements of the definition of the Facility.

13. Some funds could come into the Facility as soon as the submission of the first HPMP that obtained resources for the purpose of the Facility. However, unless there is a large effort to capitalize the Facility with additional voluntary contributions not associated with specific requests for HPMPs (or ODS disposal projects), it is unlikely such funds would be available for the initial HPMPs. The time frame for funds from any carbon credit accrued to the Facility would be longer since the funding is likely to be available only after the project has been implemented. Since the Committee has only approved a limited number of ODS disposal demonstration projects to-date, it is not clear at this time the extent to which the Committee will fund ODS disposal investment projects in the near future. Therefore, any credits encashed from ODS disposal might take some time before they are available through the Facility.

### **How UNEP as Treasurer would manage additional income and carbon credits in the Facility**

14. The Treasurer provided the information on this subject on the basis of an outline prepared by the Fund Secretariat. This section addresses the Treasurer's ability to receive additional cash income and flexibility to accommodate Executive Committee decisions and the following aspects of managing carbon credits: UN financial regulations for investment, experience with carbon credits at UNEP, the need for an additional trust fund, the additional burden to the operation of the Treasurer, and additional study needs.

#### Ability of the Treasurer to receive additional cash income and flexibility in accommodating Executive Committee decisions

15. The Treasurer confirmed UNEP's ability to receive additional income. There is sufficient room for accommodating receipt of and accounting for additional income within UNEP and also specifically within the Multilateral Fund. However, it is important to ensure there is an adequate definition of the relationship of the additional funds with any on-going arrangement so that it would be explicit, the risks understood, agreed and approved by the holders of those funds. Additional cash contributions pose the least of the challenges as UNEP has already established a mechanism.

16. The Multilateral Fund has been established as a trust fund within UNEP and it abides to all the UN and UNEP regulations and rules in respect of trust funds. The Multilateral Fund Treasurer has, over time, managed to review the decisions of the Parties, guided them on what would be needed to accommodate the various needs for managing the fixed-exchange-rate mechanism, promissory notes, and other features such as the bilateral cooperation programme that contributing member states can opt for. There is ample room within the UN system to deal with additional income as long as a little flexibility is allowed. There has always been a dedicated staff deployed for the management of the functions of Treasurer for the Multilateral Fund that has also been responsible for the maintenance of all the appropriate records and systems supporting these functions.

17. In response to the special needs of the Multilateral Fund, UNEP has had to seek from the UN Controllers special facilities for the management of promissory notes so that these would be recognized as

assets in the financial statements. With respect to other special requirements of the Multilateral Fund like the management of the fixed-exchange-rate mechanism, projects as bilateral contributions and capturing the reports of the implementing agencies, there were ample facilities within the UN and UNEP system to structure these within the financial system allowing for their sound management, including reporting.

18. The fixed-exchange-rate mechanism of the Multilateral Fund is the only one institutionalized in the UN where, based on the historical inflation rates in contributing member states, those meeting the threshold rate are allowed to fix their pledges and payments for the entire replenishment period. Naturally during the replenishment period these rates fluctuate relative to the US dollar and thus their payments attract gains or losses. The Meeting of the Parties to the Montreal Protocol reviewed the functioning of the fixed-exchange-rate mechanism and agreed to its use and to absorb the gains and losses. In the mechanism's cumulative existence to the 58<sup>th</sup> Meeting of the Executive Committee, the net experience was a gain amounting to US \$35 million. It should be noted that the fixed-exchange-rate mechanism's exposure is limited to the currency fluctuations rather than the total market forces and the limit is further set within the historical inflation rate established as an acceptance threshold.

#### Managing carbon credits

19. While the Treasurer for the Multilateral Fund had come up with ways of accounting for the gains and losses in the fixed-exchange-rate mechanism, which the Meeting of the Parties to the Montreal Protocol had approved, it is yet to be determined whether a similar mechanism could be established for carbon credits. Carbon credits have a higher volatility in the market forces that could easily render such a system inoperable if there are no checks, which would have been reviewed and appropriate compensatory mechanism worked out and approved.

#### *UN financial regulations for investments*

20. The UN financial regulations and rules are designed on a conservative platform that avoids overexposure to risks on the resources. It is for this reason that the system is cash-based and the investments are limited to time deposits. Investment policy of the UN guarantees the preservation of the principal amounts, and the manner in which the time deposits are managed is to pool the resources for a higher, and sometimes negotiated, rate of return.

21. The value of carbon credits, on the other hand, fluctuates with the market forces – and because of this they would not be preferable for the UN, unless special allowances and approvals were secured to this end. There would likely be investment gains and losses due to the encashment process depending on the direction of the market from their acquisition to encashment, as there are inevitably gains or losses on the value of carbon credits.

22. Even with the considerably enhanced skills, aided with computerization, of management of stocks there is nobody who would guarantee timing for positive gains. The UN, because of its policy of avoiding losses to its capital, would not engage in such speculation without any special clearances and specific guidelines and approvals of how the losses would be covered. And this would not be because of approval processes *per se* but rather the level of risks exposed to. Also due to the inflexibility of the UN system, the operation could experience cash flow problems because encashment would not necessarily respond to the needs of the operation as encashment might not be as fast as required on the ground.

#### *Experience with carbon credits at UNEP*

23. The experience of UNEP in the management of its carbon offsets is very limited and hardly of use for the Facility envisaged. It is a simple system of establishing the carbon offsets needed for all the official travels so that the same account used for official travel would be charged to the offset costs. These funds collected would then be used to purchase the offsets from projects which are deemed to be

most effective in contributing towards climate change. These credits are immediately retired upon purchase in order to avoid holding with them as assets whose value would have needed to be tracked and accounted for until they would be retired.

24. The immediate retirement of the carbon credit offsets purchased is aimed at avoiding to keep them and embarking on the work of constant valuation and the accompanied booking of the gains and losses. Thus there is no gain or loss to record as such in the way the system is being managed by UNEP. The procurement process would never be the best tool for dealing with volatile conditions such as those experienced by the markets.

*Need for additional trust fund*

25. It might not be prudent to co-mingle the resources of the Multilateral Fund and those of the carbon offsets. The Multilateral Fund has had a track record of stable funding arrangements with the established procedures and processes while those of carbon credits might need to be preceded by a piloting phase to concretize the details of the envisaged management required. It will be ideal if the carbon credits would be managed as a separate trust fund so that the Multilateral Fund would proceed with its operations without being overexposed by possible risks from the volatile carbon credits markets.

26. UNEP would not have any problems establishing a separate trust fund for the management of carbon credits as long as there will be concise guidelines from the Meeting of the Parties to the Montreal Protocol and approved by UN headquarters.

*Additional burden to the operation of the Treasurer*

27. The management of the carbon credits will come with its own differentiated challenges from those of UNEP being Treasurer to the Multilateral Fund. If UNEP were to be asked to undertake the functions of managing the carbon credits then this would call for a review of those functions alongside those of the Multilateral Fund and the fee would have to be adjusted to take into account the need for additional resources.

*Additional study needs*

28. The Facility under consideration would need a more market-oriented approach in the management of the carbon credits. The Treasurer is of the view that the issue of carbon credits may require additional study by carbon credit experts. A comprehensive study may be needed to consider all of the parameters of the various risks and quantified for the purposes of guiding how a mechanism of managing the gains and losses – with emphasis on minimizing the losses – would be operated. Carbon credit experts should review the systems of the UN for UNEP's management aimed at making recommendations that would be appropriate to adopt. These suggestions could then be reviewed by UNEP in consultation with the UN Controller on operating such a system.

**How the carbon market might best be employed in the longer term in the context of a facility per decision 58/37 paragraph (e)**

29. The Executive Committee requested the Secretariat to seek advice from external carbon market specialists on how the market might best be employed in the longer term in the context of the Facility. To meet this request, the Secretariat first considered the fact that there is information from a workshop, a presentation and documents before the Executive Committee in this respect, all of which would become available at the time of the 59<sup>th</sup> Meeting.

30. For example, the Executive Committee accepted the offer of the World Bank to make a representative from its Treasury Department available to the 59<sup>th</sup> Meeting of the Executive Committee to

present mechanisms, such as advance commitments, for dealing with additional financing and blending Multilateral Fund funds with carbon financing (decision 58/37(f)).

31. The World Bank has also submitted a paper entitled “Study on Financing the Destruction of Unwanted Ozone-Depleting Substances through the Voluntary Carbon Market” (UNEP/OzL.Pro/ExCom/59/Inf.2) that addresses *inter alia*: ODS destruction, understanding the carbon market, accessing voluntary markets, the financial feasibility of financing through the voluntary market, the availability of resources from the voluntary carbon markets, methodologies for ODS destruction in the voluntary market, challenges and potential solutions, and case studies.

32. The Ozone Secretariat has prepared an information document submitted to the Twenty-first Meeting of the Parties entitled “Further information from the Ozone Secretariat on issues related to funding opportunities for the destruction of ODS” (UNEP/OzL.Pro.21/INF/6). This document organizes more than 20 funding opportunities according to: funding opportunities falling under the purview of the Montreal Protocol itself; funding opportunities involving cooperation between the Montreal Protocol and other institutions, including co-financing; funding opportunities that could be acted upon by individual Parties; and funding opportunities that could be acted upon independently by other institutions. It also addresses the Ozone Secretariat’s effort with respect to the Global Environment Facility (GEF) and other Multilateral Environmental Agreements (MEAs), information on producer or manufacturer responsibility/take-back programmes, and legal issues associated with financing by the Multilateral Fund for the destruction of ODS. The document also includes an annex referencing information provided by UNIDO on producer responsibility programmes defined as “an environmental policy approach in which a producer’s responsibility, physical and/or financial, for a product is extended to the post-consumer stage of a product’s life cycle”. It cites examples of countries that have such programmes. It also demonstrates how ODS disposal activities could be designed to include legislation requiring buy back programmes that do not exist currently in Article 5 countries.

33. UNDP has already presented to the Executive Committee at its 57<sup>th</sup> Meeting its concept for a Facility within the Multilateral Fund. The Secretariat requested UNDP to provide information on the role of carbon markets as a financing source for the Facility. A copy of UNDP’s paper is provided as Annex I. The paper provides key considerations for the Facility with regard to the carbon markets as well as a summary of UNDP’s proposal for accessing the carbon markets through an ODS Climate Facility.

34. After reviewing this information, the Executive Committee may wish to recommend areas of additional interest for which the Secretariat might seek additional advice from external carbon market specialists.

### **Legal matters and juridical personalities**

35. The Secretariat included a detailed account of the Facility discussion in its report to the Twenty-first Meeting of the Parties (UNEP/OzL.Pro.21/6). The Secretariat consulted legal experts for the paper that was presented to the 58<sup>th</sup> Meeting that includes a detailed assessment of legal issues. As indicated in the previous documents on the Facility, it appears that the Multilateral Fund could accommodate a Facility within its existing structure as long as it is associated with the phase-out of controlled substances. Ultimate however, the authority on legal matters with respect to this issue is the Parties to the Montreal Protocol themselves. The document prepared by the Ozone Secretariat mentioned above (UNEP/OzL.Pro.21/INF/6) also addresses legal issues and comes to a similar conclusion.

36. By presenting this detailed account of the Facility discussion to the Meeting of the Parties, the Parties have been given an opportunity to opine on the actions taken by the Executive Committee to-date as well as provide any additional guidance on further development of the Facility in the light of Article 10 of the Protocol. Based on the previous analyses, there was no need for a separate juridical personality for the Facility as it is envisioned that the Facility would operate under the Multilateral Fund, the Executive

Committee and the Meeting of the Parties. However, issues such as juridical personality are also ultimately a question for the Parties. Another issue raised at the 58<sup>th</sup> Meeting was whether the Facility would be a new funding entity by itself. The Secretariat understood that the intent was instead to use the Facility as an expansion of funding sources to achieve additional environmental objectives beyond those required by the ODS control measures, rather than to establish a new funding entity.

### **Co-financing and resource mobilization proposals**

37. During the discussion of the Facility at the 58<sup>th</sup> Meeting, one member suggested that the Secretariat prepares a paper, in consultation with the GEF Secretariat, to examine opportunities for co-financing with particular emphasis on available funding resources and modalities for bringing projects forward for consideration. The Secretariat discussed this matter with a representative of the GEF Secretariat. It was felt that there should be funds available in the next GEF replenishment that could be used for co-financing to maximize climate benefits through GEF. However, the GEF replenishment is currently under discussion. Moreover, the extent to which the Executive Committee would cover climate and other environmental benefits depends upon the Committee's ongoing discussion on HCFC cost guidelines that are before the 59<sup>th</sup> Meeting. Once guidelines have been developed, the Secretariat will continue its discussions with the GEF with respect to expediting the approval by the GEF of projects to be co-financed with the Multilateral Fund.

38. The absence of an agreement *a priori* with the GEF does not prevent implementing agencies from pursuing co-financing with the GEF for the initial HPMPs as envisioned in the guidelines for HPMP preparation. In fact, the World Bank has indicated that it is pursuing resource mobilization for its HPMP projects. UNDP, UNIDO and the World Bank have again submitted their requests for resource mobilization efforts to facilitate obtaining co-financing (and possibly carbon credits) for HPMP activities. The Executive Committee may wish to consider the requests addressed in the Work Programme Amendments of UNDP, UNIDO and the World Bank (UNEP/OzL.Pro/ExCom/59/13, 15, and 16) to facilitate the inclusion of these potential other sources of income for HPMPs and ODS destruction projects.

### **Additional burden of the Facility to the work of the Secretariat**

39. As mentioned above with respect to the additional burden of the Facility on the Treasurer, if the Executive Committee establishes the Facility there would be a need to assess the needs of the Secretariat in meeting the requirements of the Facility. As mentioned in the two previous papers prepared by the Fund Secretariat, the initial pilot phase of a Facility could likely be accommodated within the existing structure and complement of the Fund Secretariat without significant additional burden. However, if the Facility becomes a substantive source of supporting the Fund's activities, the burden on the Secretariat might increase depending largely on the complexity of the Facility as it evolves.

### **RECOMMENDATION**

40. The Executive Committee may wish to
- (a) Note the document presented by the Secretariat entitled "Further concept paper for a special funding facility for additional income from loans and other sources" as contained in UNEP/OzL.Pro/ExCom/59/54; and
  - (b) Consider any further action with respect to the Facility and the requests by the implementing agencies for Resource Mobilization.

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ISSUES PAPER  
8 October 2009

THE FACILITY FOR ADDITIONAL INCOME  
UNDP INPUTS ON CARBON MARKETS AS A POTENTIAL FINANCING SOURCE

INTRODUCTION

At the request of the Executive Committee to the Multilateral Fund, the Fund Secretariat has been exploring the possibility of a Facility for Additional Income ('the Facility') to address the climate benefits related to the Montreal Protocol's activities. The Fund Secretariat has issued two papers on the subject, for the 57<sup>th</sup> and 58<sup>th</sup> Meeting, and is preparing a revised paper for the 59<sup>th</sup> Meeting.

At the request of the Fund Secretariat, UNDP has prepared this Issues Paper on the role of carbon markets as a financing source for the Facility. UNDP recognizes the broader ongoing discussions on other sources of co-financing, however, in order to be focused, this paper specifically concentrates on the carbon markets.

Overall, given their current size and growth potential, UNDP believes the exploration of the global carbon markets as a source of co-financing for climate benefits is interesting for the Montreal Protocol community. The comments provided in this Issues Paper are given with the objective of identifying what steps would be necessary to successfully achieve co-financing by the carbon markets.

This Issues Paper is organized as follows:

- In Section 1, some key considerations for the Facility with regard to the carbon markets are set out.
- In Section 2, UNDP's proposal for accessing the carbon markets, the ODS Climate Facility, is described.
- In the Annex, for ease of reference, certain key terms in the carbon markets are explained.

The current design of the Facility remains at a preliminary stage. If the specific goal of co-financing in the carbon markets is to be successfully achieved by the Facility, UNDP believes that it will be necessary to fully address the considerations set out in Section 1. As such, it is hoped that the detailed description of the ODS Climate Facility, which is expressly designed to access the carbon markets as a financing source, can be helpful as the design process moves forward.

## 1. KEY CONSIDERATIONS FOR THE FACILITY WITH REGARD TO THE CARBON MARKETS

This section identifies a number of key themes for the Facility related to accessing the carbon markets to finance climate benefits.

### 1.1 Addressing the full scope of climate benefits through the carbon markets

There are potentially 3 forms of interactions with the carbon markets:

- Energy efficiency gains from HCFC phase-out (CDM)
- Direct emission avoidance from HCFC phase-out (voluntary carbon markets)
- Direct emission avoidance from ODS destruction (voluntary carbon markets)

A current objective of the Facility is to address the climate benefits from energy efficiency under the Kyoto Protocol's CDM. This is understandable, as the CDM is a well-established carbon mechanism and is underpinned by a defined oversight framework. At the same time, the contribution of energy efficiency climate benefits may be relatively minor in the key sectors in which HCFC phase-out will take place. This will likely result in small financial flows and make transactions costs a sensitive issue.

With these facts in mind, UNDP suggests that consideration is given to expanding the Facility's carbon market interactions to include direct emissions from both HCFC phase-out and ODS destruction activities (collectively, 'ODS Direct Emissions'). UNDP is aware that the inclusion of ODS destruction activities may depart from the mandate given by the Executive Committee to focus the current work of the Facility on HCFC phase-out (Decision XIX/6). However, targeting ODS Direct Emissions in their entirety will address the full range of climate benefits, with the largest greenhouse gas (GHG) impacts, and will maximize the possible financial flows from the carbon markets.

It can be noted that the inclusion of ODS destruction activities can often be organized in association with early retirement programmes which provide major energy efficiency benefits, and where currently organizations such as GEF are taking the lead.

### 1.2 The need for further development of the nascent carbon markets for ODS Direct Emissions

Currently, ODS Direct Emissions are not recognized by the oversight frameworks which create and drive the compliance carbon markets. Rather, they are new and innovative areas of the voluntary carbon markets.

The fact that ODS Direct Emissions are a nascent part of the voluntary carbon markets raises a number of issues. The necessary oversight framework to ensure high quality, robust credits for ODS Direct Emissions is only now beginning to be developed by certain voluntary carbon market standards, and the quality of these standards is not yet assured. Equally importantly, demand for credits from ODS Direct Emissions under the voluntary market is uncertain and is likely to be low. This is because buyers in the voluntary market are often more discerning than those in the compliance market, requiring that the project type has a good story-line and track record. UNDP has some concern that ODS credits in the voluntary market may not be seen as attractive by many voluntary buyers who will not share the insights of the Montreal Protocol community itself.

To the extent that ODS Direct Emissions are included, a considerable risk for the design of the Facility would be to assume that mature voluntary markets for ODS credits exist. The required level of market maturity may never materialize.

UNDP suggests that consideration is given to a design for the Facility that specifically assists in the development of the currently immature carbon markets for ODS Direct Emissions. In the long term,

UNDP believes that the goal should be for ODS Direct Emissions to be part of the compliance markets. Such an approach is set out in Section 2, where one of the main purposes of UNDP's proposal for the ODS Climate Facility is to achieve this objective.

### 1.3 Form of investment by the Facility and alignment with carbon market practice

The carbon markets, such as the CDM, are market mechanisms with particular characteristics and practices. If the Facility is to effectively develop and harness the carbon markets to finance climate benefits in the short term, it is important that the Facility engages carbon market norms and is simply structured, thereby incentivizing private sector participation and earning widespread credibility.

With a view to maximizing the smooth integration of the Facility to the carbon markets, UNDP suggests that consideration is given to the following:

- First, that the Facility conforms to market practice and provides its carbon-based co-financing to projects through an Emission Reduction Purchase Agreement ('ERPA'). An ERPA is the established contractual approach for purchase of credits between buyer and seller.
- Secondly, that the Facility - at least in its initial form - does not seek to be self-financing through claiming a share of a project's credits in return for its co-financing investment. Such an approach can insert additional complexity, with the considerable risk of turning away private sector involvement.

UNDP recognizes that the direction of the above suggested approaches may introduce apprehensions in governments that are not comfortable with a carbon market objective, and who would prefer the Facility as a vehicle for other sources of co-financing, such as direct grants. However, it needs to be recognized that structures that are optimal for interaction with the carbon market may not be optimal for other forms of co-financing. Grant based co-financing will likely undermine any concurrent ERPA-based approach in the eyes of the carbon markets. A key challenge in the design of the Facility is in reconciling the interests of a number of disparate stakeholders simultaneously.

### 1.4 Near term delinking from HPMPs for practical purposes

With the advent of HPMPs, there is theoretically the possibility to link ozone and climate financing for all HPMPs through the Facility and the Multilateral Fund's existing activities, creating a one-stop-shop financing solution for Article 5 countries.

In the long term, UNDP would welcome the exploration of such a linkage. In the immediate term, for practical reasons, UNDP recommends that there is no obligation for the Facility to finance the climate benefits of HPMPs themselves, as this will avoid unnecessarily delaying HPMPs which are about to launch.

### 1.5 The possible impact on the carbon markets of the current proposal to amend the Montreal Protocol to include HFCs

It is worth noting that the current proposal for inclusion of HFCs under the Montreal Protocol, if adopted, will limit the scope of the carbon markets to provide co-financing for climate benefits related to HCFC phase-out.

Decision XIX/6 provides the opportunity to make strides in reducing greenhouse gas emissions of HCFCs which themselves have significant global warming potentials (e.g. HCFC-22 with a GWP of 2270). However, as there is currently no obligation to adopt the most climate beneficial solution, the cost of adopting technologies with lower climate impact is considered 'additional' in the carbon markets, hence qualifying for appropriate carbon credits.

The introduction of an HFC phase-down, depending on its specific timing, could drive a much stronger presumption against HFC-based projects and would make it more difficult to establish the “additionality” threshold. If so, HCFC-phase out could largely be ruled out of carbon markets co-financing, although early avoidance of HCFCs (i.e. ahead of the HCFC phase-out schedule) could be counted as an acceleration and still qualify if high GWP alternatives remain an option at project level.

#### 1.6 Summary

As set out above, a key challenge with respect to carbon markets will be the currently immature nature of these markets for ODS destruction, and the need to assist in their development. Another key challenge arises from reconciling the design needs of housing multiple sources of co-financing within the Facility.

If co-financing from the carbon markets is to be successfully achieved, UNDP suggests an approach focused on developing and exploring carbon markets, delinked initially from the Montreal Protocol compliance, and which would conform in its practices with standard carbon market norms. This approach is taken with the ODS Climate Facility and is set out in the next section.

## 2. UNDP’S PROPOSAL TO ESTABLISH CARBON MARKETS AS A SOURCE OF CO-FINANCING FOR CLIMATE BENEFITS.

At a side-event at the 57th Meeting, UNDP put forward a proposal on carbon markets, including an ODS Climate Facility. This proposal has now been further refined. This section sets out key components of the proposal.

### 2.1. Objectives of UNDP’s proposal

The objective behind UNDP’s proposal is to explore a pathway to establishing the carbon markets as the source of financing for climate benefits. This objective can be split into 2 phases.

- Phase I: Setting up an interim ODS Climate Facility, which would consist of a donor-led fund and an accompanying oversight framework to facilitate the purchase of credits from ODS Direct Emissions (HCFC phase-out and ODS destruction) projects. The purpose of the ODS Climate Facility would be to gain experiences across project types and to set an example, thereby helping establish credibility and develop the carbon markets. It is important to note that the ODS Climate Facility would not represent an irrevocable commitment by the Montreal Protocol community to the carbon markets, but is instead an exploratory and preparatory initial step, which may be terminated or followed by a subsequent Phase II.
- Phase II: Linkage of ODS Direct Emissions to the compliance carbon markets. Should the ODS Climate Facility be regarded as successful, the objective can be to build on its experiences and to include the category of ODS Direct Emissions in a future compliance carbon markets regime – for example, a post 2020 international agreement. Once linked to the compliance carbon markets, the ODS Climate Facility’s fund component would no longer be necessary to ensure demand for ODS credits, as this demand could come from the compliance market. The ODS Climate Facility’s oversight framework would remain in place and be further developed as the oversight instrument for any compliance markets mechanism.

Overall, if the carbon markets are to be a source of financing for climate benefits, UNDP believes that the long term objective should be the compliance markets, with the voluntary markets only as an interim step. The ODS Climate Facility effectively acts as a ‘controlled’ or ‘contained’ instrument in the voluntary market, prior to the real objective of inclusion of ODS Direct Emissions in the compliance markets.

## 2.2 ODS Climate Facility: possible structure

Structurally, the ODS Climate Facility can be seen to have two key functional components: a fund and an oversight framework. These components could either be established within the Montreal Protocol Bodies (including the Multilateral Fund) or at the Implementing Agency level (for example UNDP, the World Bank).

Three possible structural configurations for the ODS Climate Facility can be envisaged:

Configuration	Fund	Oversight Framework
#1	Multilateral Fund	Montreal Protocol Bodies
#2	Implementing Agencies	Montreal Protocol Bodies
#3	Implementing Agencies	Implementing Agencies

The selection of an appropriate configuration can be a function of a number of factors. Considerations may include:

- The need for the Executive Committee, and/or the parties to the Montreal Protocol, to get involved with carbon market mechanisms directly.
- In respect of the management of the fund, the existing experience of the Implementing Agencies with the carbon markets may be a relative strength, for instance in contractual aspects such as entry into ERPAs to acquire credits.
- For the oversight framework, the Montreal Protocol bodies are particularly well suited, given their long-standing technical expertise with ODS banks and transition technologies, accounting of ODS trends and ODS project validation capabilities.

## 2.3 ODS Climate Facility: fund component

Within the ODS Climate Facility, the objective of the fund component is to provide financing for climate benefits, by purchasing and ensuring demand for ODS credits generated by projects under the ODS Climate Facility's oversight framework. The fund is necessary because in the current absence of compliance markets, demand in the voluntary market for ODS credits is uncertain and likely to be low.

### 2.3.1 Fund sponsors

The ODS Climate Facility's fund, or funds (if an Implementing Agency based funding model is taken), can be capitalized by sponsors, whether governments or private sector, that support the ODS Climate Facility's objective.

As a result of its purchases, the fund(s) would acquire ODS credits whose ownership would be pro-rated to sponsors according to their contribution to the fund(s). These ODS credits could either be held in the fund(s) or retired on behalf of donors.

### 2.3.2. Fund investment approach

#### ERPA Modality

The fund(s) would make financing investments in projects for the climate benefits, utilizing the standard carbon market contractual modality of an ERPA, where the unit of account is a credit representing 1 tonne of CO<sub>2</sub>e. The Fund would enter into an ERPA with each ODS Direct Emission project at the beginning of its project cycle, according to which the Fund will agree to pay a set price per ODS credit, for an agreed volume of ODS credits to be delivered over an agreed period of time.

## Pricing Mechanism under ERPA

A key aspect of the fund(s)' ERPAs would be to take a 'cost-plus' approach to pricing the ODS Credits under the ERPA. This 'cost-plus' pricing would mean that the purchase price being offered will differ from one category of project to another, so that a more costly technology type for addressing ODS Direct Emissions, for example ODS recovery from foams, would receive a higher price per ODS credit.

This 'cost-plus' pricing will have a number of benefits:

- It will maximize the number of projects financed under the fund, as the fund will not overpay
- The fund(s) will not pay a high price per ODS credit for so called 'low-hanging fruit' project types which have a very low cost. In this way, this will avoid a re-occurrence under the ODS Climate Facility of the HFC-23 scenario under the CDM.

A further valuable role of the ODS Climate Facility would be to gather and publicly disseminate information on costs and pricing of different technology types. It is possible that there will be a certain level of other voluntary carbon market activity on ODS Direct Emissions outside the ODS Climate Facility. Information on pricing and real costs disseminated by the ODS Climate Facility can moderate any external prices being paid, again acting against a 'low-hanging fruit' scenario.

## Advance Payment under ERPA

Some ODS Direct Emissions project types may have substantial up-front costs, and projects may have difficulty accessing financing to cover these up-front costs. Typically, carbon credit buyers make their payments under an ERPA on an annual basis during the lifetime of the project, when the project delivers its annual credits to the buyer. However, for these projects types with substantial up-front costs, it can be possible for advance payments to be made under the ODS Climate Facility's ERPAs at the beginning of the project cycle, thereby addressing this issue.

### 2.4 ODS Climate Facility: oversight framework

Within the ODS Climate Facility, the objective of the oversight framework would be to ensure that the ODS credits generated by its projects, and purchased by its fund(s), are high quality and robust. The oversight framework will ensure high and uniform standards in quantifying the GHG benefits of ODS Direct Emissions, and tracking the use of ODS credits generated by these projects under appropriate registries. With the aim of developing the carbon markets, and in the absence of monitoring from the oversight bodies of compliance markets, the ODS Climate Facility's oversight framework can be key to raising the profile and credibility of ODS credits.

#### 2.4.1 Approach to Oversight Framework.

There has recently been substantial activity in developing of protocols and methodologies for ODS destruction projects under two voluntary carbon market programmes, namely the Climate Action Reserve (CAR) and the Voluntary Carbon Standard (VCS). Both have the potential to be rigorous ODS protocols, with the CAR programme having slightly higher reputational value (and hence carbon price) while the VCS has the potential for wider geographic applicability than CAR – at least in the short-term.

The preferred oversight framework for the ODS Climate Facility is envisaged to combine complementary roles for the Montreal Protocol bodies and selected voluntary carbon market standards, maximizing existing expertise and sharing responsibilities. As such, it might be possible to see the content of the respective protocols reviewed by an Assessment Panel (most likely the TEAP) and the application of the protocol be addressed by the Fund Secretariat in a validation role at project level. This same oversight could also extend to the specific methodologies.

Similarly under the preferred oversight framework, since both voluntary carbon market programmes either already have, or are in the process of developing, registries that could be relied upon for tracking ODS Direct Emission projects, there appears to be no need to recreate these at Montreal Protocol level. However, it could be proposed that the Ozone Secretariat either directly, or via Parties, acts as a repository for ODS Direct Emission credit reports from the voluntary carbon market actors such as VCS and CAR. If such a reporting requirement could be enforced in some way, the Montreal Protocol community could keep an appropriate track on the credits being claimed.

As an alternative to the preferred oversight framework, it is possible that the Montreal Protocol community decides that it is not appropriate at this stage to be directly involved in the ODS Climate Facility, but rather that the ODS Climate Facility should be an Implementing Agency-led activity. In this scenario, the Implementing Agencies could establish an oversight framework in conjunction with selected reputable voluntary carbon market programmes.

## 2.5 ODS Climate Facility: projects and co-financing

### 2.5.1 Overview of projects

A key role of the Implementing Agencies, such as UNDP, would be to source and facilitate projects under the ODS Climate Facility. This role can involve identifying projects, assisting in preparation of project documentation, and assisting and overseeing the operation of the project activity.

Projects would be selected with the over-riding objective of the ODS Climate Facility acting to develop the carbon markets. The aim will be to gain a broad range of experiences, to understand the benefits and challenges of carbon markets as a financing source across different project types.

The project portfolio for the ODS Climate Facility would target the following general characteristics:

- It would be limited to (i) HCFC phase-out and (ii) ODS bank management
- It would encompass a range of geographies
- It would encompass a range of technology types, including refrigerants and foams, but needing to make case-by-case decisions on halon and CTC destruction
- It would include a range of project sizes, in order to better understand the impact of transaction costs
- The number of projects would be a function of the funding made available by sponsors and the size of the projects that are targeted

### 2.5.2 Co-financing of projects

The ODS Climate Facility, as envisaged, would have the specific focus of developing financing from carbon markets to address ODS Direct Emissions.

Where there are other sources of financing in addition to the carbon markets, either ozone (for instance, with a HCFC phase-out project), or climate (for instance, through energy efficiency either through the GEF or CDM), the Multilateral Fund and Implementing Agencies can act as one-stop-shop for projects, combining these financing sources.

As a practical matter in terms of co-financing, the ODS Climate Facility would not be automatically linked to HPMPs. This is because the Facility – with its objective of developing the carbon markets - is intentionally, at this stage, not exhaustive in its scope and will only address a subset of HPMPs. In the longer term, assuming ODS Direct Emissions are included in a compliance mechanism, full linkage with HPMPs can be pursued.

## 2.6 ODS Climate Facility: timing

### 2.6.1 Establishment and term of ODS Climate Facility

Should there be support for the ODS Climate Facility, there are benefits to an immediate launch. Although still in the early stages, activities in the voluntary carbon market for ODS Direct Emissions are progressing, and there is a closing window for the Montreal Protocol community to influence the carbon markets development in a positive manner. The risk of not moving quickly would be that the voluntary markets would take on the ODS Direct Emission projects in an uncontrolled way and that reputational damage could be done.

As to the lifetime of the ODS Climate Facility, this would be a function of a number of factors including:

- Sufficient experience and data on ODS Direct Emissions projects having been gained. This information will be necessary to design a well-functioning compliance approach.
- The timing of negotiations and the establishment of substantive compliance mechanisms which may include ODS Direct Emissions.

It may also be prudent for the design of the ODS Climate Facility to include a pre-defined term, should subsequent linkage to a compliance mechanism not be desired/possible.

### 2.6.2 Timing considerations related to HCFC phase-out and emissions from ODS bank management

There is clear evidence from the work of TEAP in response to Decision XX/7 that the opportunities for ODS Bank Management are at their greatest at this point in time because of the significant element of CFCs in the products currently entering their respective waste streams. This proportion will decline over the next fifteen years and it will be important that an optimal credit value is established during that period to support the maximization of bank management opportunities. That said, current TEAP estimates suggest that the opportunity for annual refrigerant recovery and destruction alone is likely to be above 200 Mt tonnes CO<sub>2</sub>-eq in 2025 and 150 Mt tonnes CO<sub>2</sub>-eq in 2030, based on the vast quantities of HCFC-22 still reaching the waste stream over that period.

In the case of technology transition projects related to the HCFC phase-out objectives of Decision XIX/6, the timescales for individual transitions will be spread across the overall phase-out period. However, since the HPMPs need to identify and ideally maximize the climate benefits of their respective project portfolios at the start of the overall project cycle (i.e. during 2010), an early awareness of the likely climate incentives will be essential.



## ANNEX: KEY CONCEPTS IN CARBON MARKETS

For ease of reference, this annex sets out some common concepts in the carbon markets.

“Carbon Credit” refers to a right, interest, benefit or allowance for the holder to emit greenhouse gases. The standard unit of measure of a Carbon Credit is one ton of carbon dioxide equivalent (CO<sub>2</sub>e). There are two broad types of Carbon Credits:

- an “offset” is a carbon credit which is created in recognition of a reduction in greenhouse gas emissions below an accepted business-as-usual baseline.
- an “allowance” is a right or permit to emit greenhouse gas and is granted under a regulatory regime, like the EU ETS.

“Compliance Market” refers to Carbon Credit trading activities which are conducted by entities who are subject to regulatory requirements to limit or cap on their greenhouse gas emissions. The most common Compliance Markets are created by the Kyoto Protocol and the EU Emissions Trading Scheme. The value of trading in the Compliance Market in 2008 was US\$125 billion (1).

“Clean Development Mechanism” or “CDM” is a flexibility mechanism created under the Kyoto Protocol under which emission reduction activities which occur in developing countries may be registered to create Carbon Credits. These CDM Carbon Credits can be acquired and utilized by developed nations, where the cost of reducing emissions is higher, to contribute to meeting their Kyoto Protocol compliance obligations. In 2008, the total value of CDM Carbon Credits transactions was US\$32.8 billion (1).

“Emission Reduction Purchase Agreement” or “ERPA” means a legal contract between a buyer and a seller for the sale of Carbon Credits. An ERPA is often signed to secure a “forward sale” of Carbon Credits, meaning that the terms of the contract are agreed at the date of signing for future dates of delivery of carbon credits.

“Methodology” is an approach to calculate either (i) the baseline, or business-as-usual, emissions that are forecast to occur if a particular project idea is not implemented, or (ii) the actual emission reductions that have occurred due to implementing a project idea. A methodology is an essential tool towards crediting a project’s emission reductions (whether in the compliance or voluntary market).

“Protocol” means a governing framework for compliance or voluntary market carbon projects which is designed to ensure the environmental integrity and quality of Carbon Credits from those projects. A Protocol will generally set out a specific project cycle for accreditation of projects under the Protocol, including validation against a prescribed standard.

“Registry” is a central depository of accounts for the holding and trading of Carbon Credits. Each of the major Protocols has established a registry system for Carbon Credits which are created and verified pursuant to its protocol. The Voluntary Carbon Standard and Climate Action Reserve each have their own registry. In addition to holding and transferring, a registry can be used to cancel or “retire” a Carbon Credit. Once a Carbon Credit is cancelled or retired, it will cease to exist and thus cannot be traded or utilized for any future offsetting purposes.

“Voluntary Market” refers to trading in Carbon Credits which is conducted for any reason other than to meet a regulatory compliance obligation. Carbon Credits traded in the Voluntary Market are generally called “VERs”, meaning “Verified Emission Reductions”. Purchasers may buy VERs on the voluntary market for a number of reasons, including: (i) as a means to hedge against future compliance obligations, (ii) branding or public relations purposes, (iii) as an investment or asset to trade, or (iv) out of a sense of

moral or ethical duty to offset one's emissions. In 2008, the value of transactions in the voluntary market was US\$397 million.<sup>1</sup>

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<sup>1</sup> Source: State of the Carbon Markets, 2009.