

# **An Arctic Council Project Support Fund (PSF)**

## **Discussion paper**

### **1. Introduction**

At their meeting in Svartsengi in October, 2003 the Senior Arctic Officials continued to discuss the possible establishment of a fund to facilitate the financing of Arctic Council projects. As a basis for the discussion, the Chair, with the assistance of NEFCO, had prepared an informal background paper on various aspects of a fund mechanism. The SAOs raised a number of questions and concerns in respect to the fund concept and requested further clarification on a number of issues. This paper seeks, in a concise form, to address those issues, providing clarification about the nature and role of a project support fund (PSF) and explaining how a fund mechanism could provide benefits and “value added” to the Arctic Council.

### **2. Main questions**

The main questions that have been raised can be summarized as follows:

- There is a concern that the introduction of a fund mechanism could change the present structure of the Arctic Council;
- The delimitation of the scope of activities of a fund in relation to the different actors and activities in the Arctic Council has not been sufficiently clarified;
- It is unclear how a fund mechanism operates, including the decision-making procedures;
- The procedure of establishing a fund should be defined;
- There is a need for better understanding the role of the fund manager.

### **3. Scope**

The proposed PSF does not include the full range of activities, ongoing or planned, in the Arctic Council. The financing of research and monitoring programs, participatory activities, administrative cost etc. should, initially at least, be dealt with as a separate matter. The purpose of the fund would be to enhance the process of mobilizing resources for projects that involve concrete program actions, because these constitute a particular type of activities with their own common features and well-established, generally adopted practices. As fundamental as this delimitation is in this context, it is, however, not always easy to draw a precise demarcation line, as there exists no precise definition of a “project” or a “program action”. In an abstract sense, a project or program action can be described as a concrete action or series of actions, limited in time and scope, with a determined cost estimate and a defined, measurable result. Typically, but not always, a project will involve some level of investment, i.e. procurement of equipment, installation and/or construction. Furthermore, various preparatory activities, such as feasibility studies, conceptual and detailed design and development of business plans, form part of the project cycle. The scope of an Arctic Council PSF would embrace these preparation and implementation phases of projects. In practical terms, projects would be related to concrete measures in order to mitigate environmental threats, identified and prioritised in the various Arctic Council programs. As all projects, in order to become eligible for the fund, would follow the normal approval procedure of the Arctic Council, actual problems should not be expected in respect of the proposed scope of activities.

### **4. Current practise and its weaknesses**

What would be the “value added” that a fund mechanism would bring to the work of the Arctic Council? The establishment of a PSF can be justified only if there is shared

recognition that it would bring concrete benefits. In addressing this question one has to review present practice and evaluate the experience so far.

The motivation for launching the idea of a fund mechanism is the realization that the current modalities for mobilization of financial resources for project preparation and implementation may not be working in an optimal way. This applies *inter alia* within ACAP, where the interface to project financing is most frequent. As the importance of concrete action oriented projects grows, the weaknesses of the present *ad hoc* approach are becoming more pronounced. Project-by-project or step-by-step funding may retain its validity. Nevertheless, such an approach may not be the best way to handle a growing number of investment-focused projects in practise.

All financing of Arctic Council projects and activities is voluntary. At present, funding is a country-driven process where a lead country or countries take the initiative in raising funds necessary for a project to be completed. Mandates, provided to the working groups by Ministers and in some cases SAOs, contain considerable flexibility as to how to initiate new projects and organize their work schedules.

Funding sources for Arctic Council projects stem from member states themselves, particularly the lead country concerned, international organizations, as well as private foundations and enterprises. Thus, significant responsibility lies with the lead countries, member states hosting working groups secretariats, as well as the Chair of the Council.

Once a working group has agreed on a project to be presented to the SAOs, a lead country or countries take charge of securing finances and organizing the work schedule. As a general rule, members of the working group are responsible for approaching public and private funding sources in their respective countries.

In many instances, the working group secretariat assumes the task of outlining the work schedule and financial scenario. In cases where a work schedule calls for a clear division of labor, such as in writing individual chapters of a report, the member country responsible for the chapter in question, is also charged with its financing. The working groups' secretariat have generally taken on the task of approaching international organizations for funding, as well as securing funding for common cost, such as printing etc.

All Arctic Council projects are subject to prioritizing by individual member states. Upon the adoption of a project, a working group or individual member states will set their own pace or decline participation altogether.

The main drawbacks, particularly for investment projects, of the above approach are threefold:

- The mobilization of resources is frequently unpredictable and time-consuming, delaying, and in the worst case, blocking the implementation of projects (In addition, the anticipated difficulties to mobilize financing may already at the approval stage lead to sub-optimal decisions in respect of project scope or time-table);
- The *ad hoc* procedure makes it difficult to draw upon (or develop) project financing competence; and
- The step-by-step arrangements make interaction with other potential financiers of projects difficult and diminish the possibilities to mobilize co-financing, which in turn restricts the implementation of larger projects.

Setting up of an Arctic Council PSF would be one way of alleviating these problems without changing the mechanisms of project prioritisation and approval. Arctic Council projects would still be subject to the approval procedures that apply today. Once a project has been approved, however, the fund would come into play and, as it is in essence a pool of financial resources that have been previously set aside and earmarked for Arctic Council projects, would provide for:

- Faster project implementation involving a comprehensive planning horizon, which in the best case comprises the entire project cycle;
- Access to project financing competence through the services of an experienced fund manager; and
- Improved possibilities to develop financing packages for projects, bringing in other financiers, including non-grant sources. This may give a substantial leveraging effect, multiplying the resources of an Arctic Council PSF.

## **5. Maintaining Arctic Council structures**

The decision-making process up to and including project approval would thus be left as before. Moreover, the process thereafter would also remain in place. In the present ACAP system, for instance, once a group of willing financiers has been identified, they will set up a steering group or committee to coordinate their input and actions in respect of the particular project. It is within this group of donors that any decisions affecting the financing, and henceforth the implementation, of the project will be taken, whereas parties that are not contributing would not participate. With a fund structure it is the contributors to the fund that maintain this same role. Rather than weakening the possibilities of Council bodies to oversee and steer the project implementation phase, a joint PSF would establish a stronger role for the Arctic Council in this respect. The establishment of such a fund would not transfer decision-making power to a different body. The fund would be seen as a lever and the fund manager would provide a service function without assuming decision-making authority himself. A fund structure would, furthermore, guarantee transparency and consistency in the procedures, as these would be set down in operating guidelines to be agreed upon.

In order to function effectively a fund should function both proactively, identifying good project opportunities alongside other actors and bringing them up for approval by the Arctic Council, and reactively, in providing financing for projects once they have been approved as Arctic Council projects.

## **6. Flexibility**

As indicated above, it would be desirable for an Arctic Council PSF to participate throughout the project cycle, including financial support for project preparation (pre-feasibility studies, feasibility studies, preparation of business plans, tendering procedures), as well as the actual project implementation (investment) phase and adequate supervision and monitoring activities.

In order to provide maximum cost efficiency, it is also proposed to work with instruments that give a possibility for revolving, to the extent possible, the capital of the fund. Clear benefits can be gained from non-grant mechanisms such as concessional (soft) loans or contingent grants (which have to be repaid if the project achieves its goals). Projects that may generate future revenues, which enable the project entity to repay all or part of the investment, but where uncertainties at the time of investment preclude them from mobilizing debt and/or equity financing, would be suitable targets for such a modality. A non-grant financial mechanism would bring efficiency gains to the available fund resources (by multiplying in the best case the effect of a given amount of financing).

By capturing the future revenue upside of projects, such mechanisms would contribute to appropriate resource management and set good examples for other projects. Important policy considerations, such as the introduction in practice of the polluter pays principle as a basis for sound and sustainable development would also be enhanced.

While stressing the benefits of revolving mechanisms, it must, nevertheless, be recognized that there will remain a substantive portion of project activities, which can only be financed through conventional grants. Therefore, it is important that a fund has the option to decide case-by-case what the appropriate financial instrument would be.

## **7. Ownership**

Would a fund mechanism lead to a lower level of commitment and project ownership among those who would benefit from the fund's support? Again, in comparison with present practices, it is hard to see why financial assistance from a PSF would differ in this respect from the financial assistance provided individually by various donors. A fund would not assume a role different from other external financiers. A fund would not under any circumstances become a project owner. It is not the fund that undertakes to execute projects - this responsibility remains, and should remain, with the project owner - but it may in the same way as other financiers agree to provide financing for a project. Also, the fund would not be an all-encompassing solution to the demand for project financing. It is neither realistic nor advisable to advocate a solution where a fund would obtain resources on a scale to cover all needs. External financial assistance is a scarce resource and should be applied only to the minimum extent needed to overcome constraints for project implementation. In some cases, based on the specific circumstances of the project in concern, the external portion may be proportionately high. Still, the line would never be crossed where the financier/s end up as project owners. The financing provided through an Arctic Council PSF should be leveraged to the extent possible by project owners' funds and external capital resources, including loans.

## **8. Liability**

To what extent would the establishment of a fund expose the Arctic Council or its subsidiary bodies to possible liabilities or increased risks? As the fund would not get involved in the respective projects in any other way than what is common practice among external financiers, the risks and liabilities for the fund would not be different from those regularly accepted in the field and, in fact, accepted today by the parties involved in ongoing Arctic Council projects (One specific area where the liability aspect has caused concern among financiers is nuclear liability. This, however, is not a relevant field of activity for an Arctic Council PSF).

On the other hand, to the extent such potential risks would materialize for the fund, they would not be absorbed by the Arctic Council or its bodies. As explained in the next section, the setting up of a fund, in line with the basic approach of not substituting the existing modalities of Arctic Council project financing, would be a matter for the contributors and the fund manager. Therefore, any risks or liabilities would also be carried by those parties, not by the Council.

## **9. Set up procedure**

The procedure for setting up a PSF of the proposed type would be straightforward. The proposed procedure is one that has frequently been used in other similar contexts. The arrangement involves collaboration with an institution that takes on the role as fund manager. For this kind of intergovernmental cooperation it would be natural to involve an IFI. The IFI, through a decision by its board, sets up a fund and opens it for contributions by interested parties. These contributors are the owners of the fund, the capital of which is held in trust by the IFI. The operating guidelines are negotiated and agreed between the

founding contributors and the fund manager and would clearly earmark the financing to be provided from the fund to Arctic Council projects. The role of the fund manager would be to administer the fund according to the instructions given by the contributors. In practice the contributors' representatives convene in an assembly when discussing and deciding on matters related to the fund.

At the same time, it would be important to establish an Arctic Council identity for a PSF, through, for example, an official endorsement of the fund concept by the Arctic Council, welcoming the establishment of the fund and approving the purpose and general principles of the fund's operations.

It should also be noted that a PSF would not necessarily require participation by each and every member of the Arctic Council. Just as the present *ad hoc* procedure does not involve participation by each member for a project to be implemented, it would be possible for a group of interested Arctic Council members to set up a fund. Participation would then be a voluntary undertaking.

How broad the participation would have to be for a fund to be meaningful is a political issue to be decided by the interested parties.

#### **10. The fund manager**

The role of the fund manager would be of a managerial nature only. An IFI as fund manager provides competence and experience of all aspects of project financing, including project appraisal and financial engineering, and brings wider access to the financing community facilitating mobilization of other resources for projects.

The rights and obligations of the fund manager would be regulated in the operating guidelines agreed with the contributors. These guidelines would also define the compensation that the fund manager is entitled to receive for services rewarded.

#### **11. Conclusion**

In conclusion, the establishment of a joint PSF need not be a major departure from current practices in the Arctic Council. The fund would neither change the way decisions are made nor the organizational structure of the Arctic Council. Instead, it should be designed to enhance the existing *modus operandi*.