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Agenda Item 18

OPERATIONAL GUIDELINES FOR THE APPLICATION OF THE INCREMENTAL COST PRINCIPLE

Recommended Council Decision

The Council, having reviewed document GEF/C.31/12, *Operational Guidelines for the Application of the Incremental Cost Principle*, approves the guidelines as a basis for a simplified demonstration of the "business-as-usual" scenario, incremental reasoning, fit with the focal area strategies and co-funding. The Council requests the Secretariat, the GEF agencies and the Evaluation Office to ensure that the guidelines and information requirements are followed in project design and implementation, monitoring and evaluation.

Executive Summary

1. The GEF Instrument states that “the GEF…shall operate for the purpose of providing new and additional grant and concessional funding to meet the agreed incremental costs of measures to achieve agreed global environmental benefits” in the GEF focal areas.

2. Its application has been recognized as complex and not always transparent by GEF Council, the Secretariat and agencies as well as project proponents, Governments and NGOs.

3. Recently, the GEF Evaluation Office conducted an evaluation of how incremental cost assessments have been undertaken in GEF projects and concluded that while the principle of incremental funding is alive and well in GEF, there remains weak understanding and much confusion about incremental cost concepts and procedures; most project documents register low quality and compliance when measured against GEF requirements for incremental cost assessment and reporting; and as currently applied, incremental cost assessment and reporting do not add value to project design, documentation and implementation.

4. To address the concerns presented in the *Evaluation of the Incremental Cost Assessment*, and Council’s request to address these issues, this document describes a **pragmatic, simplified, strategic and cost-effective approach** for determining incremental costs.

5. The proposed approach consists of five steps that simplify the process of negotiating incremental costs, clarifies definitions, and links incremental cost analysis to result based management and the GEF project cycle. The guidelines enhance the transparency of the determination of incremental costs of a project during the preparation period, as well as its implementation through:

(a) determination of the environmental problem, threat, or barrier, and the “**business-as-usual”** scenario (or: What would happen without the GEF?);

(b) identification of the **global environmental benefits (GEB)** and fit with GEF strategic programs and priorities linked to the GEF focal area;

(c) development of the **result framework** of the intervention;

(d) provision of the **incremental reasoning** and GEF’s role; and

(e) negotiation of the role of **co-financing**.

6. An annex summarizes the information requirements linked to each step at various GEF project cycle stages.

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Introduction

1. The GEF Instrument states that "the GEF…shall operate for the purpose of providing new and additional grant and concessional funding to meet the agreed incremental costs of measures to achieve agreed global environmental benefits" in the GEF focal areas.

2. Its application has been recognized as complex and not always transparent by GEF Council, the Secretariat and agencies as well as project proponents, Governments and NGOs.

3. The issue of incremental cost had been identified in several evaluations conducted by the GEF Evaluation Office as an issue that needs further clarification. More recently, the GEF Evaluation Office conducted an evaluation of how incremental cost assessments have been undertaken in GEF projects and what can be learned from the application of the methodology so far, building on findings from the focal area program studies, and the completed evaluation of the role of local benefits in global environmental programs (GEF/ME/C.30/2, *Evaluation of Incremental Cost Assessment*, December 2006).

4. The *Evaluation of Incremental Cost Assessment* had four conclusions reflecting the current practice of applying the incremental cost principle to GEF projects:

(a) **The principle of incremental funding is alive and well in GEF projects.** Although the evaluation found many doubts and concerns expressed about the process of incremental cost assessment as it is carried out, the evaluation found that incremental reasoning underpins the global environmental focus of the design of GEF projects.

(b) **There remains weak understanding and much confusion about incremental cost concepts and procedures**. Confusion still persists on whether incremental cost is a (primarily qualitative) form of logic or reasoning, or a quantitative, numerical calculation. Specific terms associated with incremental cost were also found to be poorly understood, most notably "incremental cost", "alternative," "system boundary" and "additionality".

(c) **Most project documents register low quality and compliance when measured against GEF requirements for incremental cost assessment and reporting**. The evaluation found that 64 % of projects only report on half of the six aspects of incremental cost that are required by policy and guidelines (broad development goals and baseline, alternative, and cost).

(d) **As currently applied, incremental cost assessment and reporting do not add value to project design, documentation and implementation.** The bulk of effort is expended on reporting on incremental cost as a required part of the project document rather than connecting it to the project design. The preparation of the annex is usually carried out ex post facto, at the end of project formulation, by experts. The annex serves merely to summarize or repeat the information contained in the main text of the project document.

5. The *Evaluation of Incremental Cost Assessment* also points out that "despite being based nominally on economic techniques for project appraisal, incremental cost assessment is not a process of economic analysis, even though it borrows widely from economic jargon. At a practical (and even pragmatic) level, the case for applying incremental cost assessment in the strict economic sense to GEF projects is problematic, probably unachievable, and largely unnecessary".

6. On the basis of this evaluation, the Council decided in December 2006[1] that:

(a) the incremental reasoning in project objectives and design should be explicitly addressed in appropriate documentation, particularly at the project concept stage, during implementation and at completion;

(b) the current incremental cost assessment and reporting requirements for GEF project proposals should be reformed so as to result in a simplified demonstration of the project baseline, incremental costs and co-funding;

(c) monitoring for progress towards achieving global environmental benefits and for achieving co-funding should be included in Project Information Reports and the Portfolio Performance Report;

(d) terminal evaluations should evaluate achievement of global environmental benefits and co-funding, followed by an independent assessment in the Annual Performance Reports of the GEF Evaluation Office; and

(e) the GEF Secretariat to incorporate in its paper on the revised project cycle to be presented to the Council in June 2007, new operational guidelines to implement the above sub-paragraphs.

7. The GEF Council request reflects the need for the GEF to shift to a more pragmatic approach with clear operational guidelines for determining the incremental costs associated with a GEF project engaging at various steps in the GEF project cycle, the focal area strategies, country-based information and the concept of managing towards results.

8. To address the concerns presented in the *Evaluation of the Incremental Cost Assessment*, and Council's request, this document describes a **pragmatic, simplified, strategic and cost-effective approach** for determining incremental costs in GEF projects. The guidelines are also consistent with and will help to inform the proposed results-based management system for the GEF (*Results-Based Management Framework*, GEF/C.31/11). The proposed approach is also in line with the shortened and more effective project cycle (*GEF Project Cycle*, GEF/C.31/7) with less formal requirements but more emphasis on the fundamental issues defining the mandate and effectiveness of the GEF.

9. The new Operational Guidelines for the Determination of Incremental Cost in GEF Projects meet the GEF Council's recommendations that incremental reasoning be addressed at the concept stage and all through the project cycle. The 5-step process proposed is a simplified

[1] *Joint Summary of the Chairs: GEF Council Meeting*, GEF/C.30/CRP.5, December 8, 2006.

demonstration of how the incremental costs can be qualitatively and quantitatively determined. Terminologies have been defined and refined, and some have been dropped. Guidance is provided on how progress towards achieving global environmental benefits, project outcomes and co-funding, can be monitored during implementation and evaluated after the completion of a project.

Operational Guidelines to Determining Incremental Costs of a GEF Project

10. The proposed approach consists of five steps that simplify the process of negotiating incremental costs, clarifies definitions, and links incremental cost analysis to result based management and the GEF project cycle. The guidelines enhance the transparency of the determination of incremental costs of a project during the preparation period, as well as its implementation through:

(a) determination of the environmental problem, threat, or barrier, and the "**business-as-usual"** scenario (or: What would happen without the GEF?)[2]

(b) identification of the **global environmental benefits (GEB)** and fit with GEF strategic programs and priorities linked to the GEF focal area (*Focal Area Strategies and Strategic Programming Framework for GEF-4*, GEF/C.31/10);

(c) development of the **result framework** of the intervention;

(d) provision of the **incremental reasoning** and GEF's role; and

(e) negotiation of the role of **co-financing**.

11. The following is a detailed explanation of the five-step process. Annex 1 provides a summary with the requested detail of information.

Step 1: Presentation of "Business-as-Usual" (or: What would happen without the GEF?)

12. **The "business-as-usual" describes the situation or context relevant to the proposed project intervention in a country or proposed project site as it would expectedly unfold without the GEF support.** It provides an assessment of ongoing and planned activities in the absence of the GEF and the expected/projected loss of GEBs if left unattended. It identifies any trade offs, such as those between short-term socio-economic gain and long-term socio-economic and environmental sustainability. It will identify how the different ongoing or planned interventions will contribute to achieving environmental and developmental goals. In order to identify the role for the GEF and to justify the requested GEF grant, the "business-as-usual" will be analyzed in terms of the objectives and outcomes that might be achieved, and the quantitative (e.g. budgets and planned expenditures) and qualitative (e.g. institutional capacity) inputs that would be forthcoming regardless of whether the GEF intervention occurs or not.

[2] The "business as usual" was previously called the "baseline". However, it has been changed in order to avoid the confusion that between "baseline scenario" and "baseline situation" (value of indicators prior to the start of the project).

13. At the PIF stage, the proposal needs to provide an overview of the "business-as-usual" in the country (-ies) or proposed project site. This includes information relevant to the proposed project on e.g. current national or regional programs, sector policies, bi- and multi-lateral donor activities, NGO and CBO activities.

14. At the stage of CEO endorsement, the fully prepared project will provide detailed information on the "business-as-usual", including quantification of the ongoing and planned costs of actions that either form the activities for addressing environmental problems (both global and national).

Step 2 : Global Environmental Benefits and Strategic Fit

15. Once the environmental problems, threats, barriers and the extent to which global environmental benefits (GEB) are being lost have been identified, the next step is to identify and agree on the GEB the project is going to address. **Each focal area of the GEF has determined the GEBs it is addressing, and all focal areas have or will have indicators and tracking tools for GEBs.** The determination of the GEBs then in turn defines the specific strategic program of the focal area that the potential project can fall under. The attainment of a GEB shall not undermine or result in the loss of another GEB.

16. The GEBs are determined in general terms at the PIF stage, and the appropriate focal area strategy is also identified. The documentation submitted for CEO endorsement has a more detailed description of the GEBs, as well as the underlying national and local benefits. The project document will contain relevant indicators and tracking tools for the GEB in question, and will articulate how the project will contribute to the focal area strategic program or priority.

17. During implementation of a project, it is rare that the GEB will change, however, this may occur because of changing external circumstances, and if this should occur, then the annual project implementation review (PIR) should record this change and the GEF Agency shall consult with the GEF Secretariat on how to address this change (project cancellation, or project redesign).

Step 3 : Incremental Reasoning and GEFs' Role

18. **Incremental reasoning defines the role for the GEF in the context of the expected agreed global environmental benefits from a proposed project. It is based on an assessment of the value added by involving the GEF**. The identification of GEF's role is of great importance for the design and implementation of a project, and therefore requires a recorded process of transparent dialogue and negotiation between key stakeholder groups such as the project proponent, the involved GEF Agency, the GEF Secretariat and the GEF Council.

19. The GEF Secretariat will be involved in the negotiation the moment a proposal is presented to the GEF for potential financing (i.e. at the PIF stage). At this stage, the GEF Secretariat validates the proposed role for the GEF based on the expected global environmental benefits of the future project and its general fit with the strategy of the focal area and the strategic program under which the project proposal has been submitted. Any request for GEF funding at PIF stage is indicative and will be approved by Council in form of a work program

and confirmed at the stage of CEO endorsement when details about the expected results of the project are defined.

20. Once the proposal is fully prepared and submitted for CEO endorsement, the section in the project document on incremental reasoning will describe the expected global environmental benefits in the context of the focal area under which the proposal has been submitted for GEF funding. The project's contribution to expected global environmental benefits will be reflected by appropriate impact indictors and targets in the project results-framework.

Step 4: Results Frameworks for Projects

21. Once the problem, "business-as-usual", and GEB have been defined, the next step is to identify and negotiate the vision, objective and expected outcomes of a project. These decisions are enshrined in the results framework (such as the logical framework). **The results framework describes both the GEF increment (i.e. achieving GEBs) and the underlying interventions related to the "business-as-usual" (achieving local and national benefits)**.

22. At the PIF stage, the results framework is defined in general terms only. The PIF will define the goal, objective and anticipated outcomes of the project. At the stage of CEO endorsement, a fully prepared project proposal is presented that has a results framework with indicators and targets that show the project's contribution to achieving the strategic objective and outcomes of the focal area for the GEF-4 replenishment period, as well as national sustainable development objectives. Impact and outcome indicators would show the expected global environmental and national benefits. Information from the "business-as-usual" analysis may also provide important information for the assumptions and risks for the proposed project.

23. The results framework should present appropriate baseline data for the proposed indicators. According to the *GEF M&E Policy*, this data should be collected during the preparation period of the project, and presented at the time of CEO endorsement. If major baseline indicators cannot be identified, the *GEF M&E Policy* allows the project to submit a plan for collecting this information within one year of implementation..

Step 5: Defining the role of cofinancing

24. Cofinancing is defined as the non-GEF project resources that are essential for meeting the GEF project objectives, and directly contribute to the outcomes of the future project. Finance for activities that are not essential for achieving the GEF objectives but are processed for transactional convenience in the same loan or technical assistance package are not considered as cofinance but as parallel finance (GEF/C.20/6/Rev.1 – April 2003). Cofinancing can be either part of the underlying project as on-going interventions or new and additional funding secured for the project. Cofunding can be considered as incremental if it achieves GEBs, thus allowing the GEF to share or (co-fund) the incremental costs of the future proposal with other partners.

25. At the PIF stage, the general level of co-financing should be provided. Each focal area may have its own targets for the ratio of co-financing to GEF financing. At the CEO endorsement stage, detailed information will be provided on co-financing, including source, amount, and status of identification/commitment. An outcome-based budget table will be

provided that will show the level of sharing of project resources between the GEF and co-financing for each project outcome.

26. During project implementation, GEF agencies will report through the PIR on the progress towards achieving the targets for cofinancing, both that was expected at project approval and presented in the project document endorsed by the CEO, and that which materializes over time. If benchmarks are not met, corrective measures have to be taken and agreed upon with the GEF Secretariat.

Annex 1: Operational Guidelines for Incremental Cost Analysis - Information Requirements at GEF Project Cycle Stages

5 Step Incremental Cost Analysis	At PIF approval	At CEO endorsement	During Implementation and at Completion
1. Analysis of "Business as Usual" Scenario	Overview of environmental problems and ongoing programs, policies, and political commitments What would happen without the GEF?	Detailed problem/threat/barrier analysis; detailed analysis and quantification of the ongoing projects and programs (foundational and catalytic interventions) How would the proposed project outcomes be affected if GEF would not invest?	Reporting on GEBs in annual project implementation review (PIR) and final terminal evaluation (TE)[3] using the indicators and tracking tools for each focal area
2. Analysis of Global Environmental Benefits and Strategic Fit	Identification of the type of GEB, and general understanding of the expected loss in GEB without GEF support; identification of the focal area strategic program	Indicators, definitions and tracking tools for the relevant GEB; Confirmation of how the project will address focal area strategic program objectives and outcomes	
3. Incremental cost reasoning and GEF role	Simple narrative of the main reasoning	One-page narrative explaining the distinction between GEF increment and underlying project	Reporting in PIR on disbursement of GEF funds according to incremental reasoning, and lessons learnt for future projects
4. Determination of Result-based Framework	Vision and goal of project. Main outcomes expected	Detailed logical framework matrix, including relevant indicators, risks and assumptions	Reporting on achievement of objective and outcomes of project through PIR, Mid-Term Evaluation (MTE) and TE.
5. Role of Cofinance	Simple narrative of the main reasoning, expected sources of cofinance Elaborate on the feasibility of the future project without GEF investment.	Identification of source, amount and type of cofinance. Identification of cofinancing sources and amounts that will pay for GEB. Outcome-based budget table showing GEF and cofinance by outcome.	Reporting in PIR, MTE and TE on amount of co-finance leveraged.

[3] GEF Evaluation Office: Guidelines for Implementing and Executing Agencies to Conduct Terminal Evaluations http://www.gefweb.org/uploadedFiles/Policies_and_Guidelines-Terminal_Eval_Guidelines(1).pdf