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Guidelines for Project Financing

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Introduction

1. This paper aims to: (i) clarify GEF policies on project financing; and (ii) consolidate various concepts concerning the eligible costs for GEF project financing. Clarifications of these terms are provided on the basis that the overarching objective of GEF financing is to provide resources to recipient countries to meet the agreed incremental cost of activities that generate global environmental benefits (GEBs) in line with the mandate of the GEF. Among others, related terms such as the incremental reasoning, baseline project and co-financing¹ are also discussed.

GEF Financing of Projects

2. 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. The concept of incremental reasoning was further clarified in the June 2007 Council paper which provided operational guidelines to determine the incremental costs of a GEF project.² The following are the key steps towards determining incremental costs of a GEF-financed project or program at its preparation stage:

- (a) Describe the “Business-as-Usual scenario” (What would happen without GEF financing?) as enshrined in country planning documents, strategies, sectoral action plans, investment plans, etc;
- (b) Identify the Global Environmental Benefits and fit with the GEF strategic objectives for the project activities proposed financed by the GEF; and
- (c) Provide incremental reasoning and GEF’s role and agree on actual level of GEF financing.

Business-as-Usual Scenario - Baseline Project

3. Before proposing a project for GEF financing, the first step is to assess the current situation surrounding the proposed project. The objective of assessing the current situation is to establish the baseline project. The **baseline project** refers to the set of ongoing and planned activities underway without GEF financing and are therefore funded by, or proposed to be funded by non-GEF funding. Estimates can be made for the expected/projected loss of GEBs in the absence of the GEF, i.e. if left unattended without GEF intervention.

¹ Reference to the GEF Council document, the “Cofinancing” May 2003 (GEF/C.20/6/Rev. 1).

² GEF Council approved policy document, “Operational Guidelines for the Application of the Incremental Cost Principle,” June 2007 (<http://www.thegef.org/gef/node/3345>). The GEF position on incremental reasoning has not changed since this paper was prepared. Hence, the content of the current paper adopted the general principles discussed in the June 2007 paper and integrates other cost concepts to the incremental reasoning.

4. During the concept preparation, the Project Identification Form (PIF) or the Program Framework Document (PFD) should provide an overview of this business-as-usual scenario, and explain what happens or what is expected to happen without financing provided by the GEF.

5. The analysis of the business-as-usual scenario should provide quantitative estimates of the baseline project which may include the set of baseline activities that should have been fully-funded and implemented by the government or other financing sources. Examples of baseline activities include:

- (a) Government-endorsed strategies and policies;
- (b) Government announced investments in programs and infrastructure (e.g., power plants)
- (c) Legislative frameworks;
- (d) Energy development projects, agricultural/area development projects, etc
- (e) Transboundary accords, treaties and agreements; and
- (f) International funding lines from bilateral and multilateral agencies.

Global Environmental Benefits and Strategic Fit of the Focal Area

6. At PIF stage, after establishing the baseline project and clearly establishing the financing of the baseline projects, and having determined the environmental problems, threats, barriers, and the extent to which global environmental benefits are being lost, the role of GEF can be identified by assessing the GEBs to be delivered as a result of GEF financing. This assessment serves as an “alternative scenario.” The GEBs could be environmental problems solved or mitigated, threats/ barriers removed, avoided loss of global environmental benefits, etc. that are within the mandate of the GEF and that go above and beyond the benefits of the business-as-usual scenario and baseline activities. The identification of the GEBs should be closely aligned with the GEF focal area strategies and priorities as articulated in the replenishment programming strategies.

Incremental Reasoning

7. In the project design itself, project elements that contribute to baseline need to be clearly identified and evidence provided for their financing from sources other than the GEF. Baseline activities are the essential underlying activities for the GEF alternate/increment to succeed.

8. Elements in the project design that generate global environmental benefits are then considered for GEF financing. In consideration of the actual level of GEF financing for these elements, the GEF will take into consideration the levels of financing that can be provided from sources other than the GEF, prior to arriving at the “agreed incremental cost,” through a process of consultation between the recipient country and GEF Agency/GEF Secretariat.

Co-Financing – Providing Resources for the Baseline

9. In the context of the GEF, *co-financing* has a very specific definition. It first and foremost refers to the financing associated with the baseline project and any non-GEF financing associated with the incremental project, committed as part of the initial financing package.

10. Financing for activities that are not essential for achieving GEF objectives, i.e., not part of the baseline project, but are part of the overall project package are not counted as co-financing.

Sources of Co-Financing

11. Co-financing can be provided from different sources: (i) the GEF Agency; (ii) governments; (iii) other multilateral agencies, bilateral development cooperation agencies; (iv) the private sector; (v) private foundations, civil society organizations, and (v) beneficiaries.

12. Co-financing could be employed through a variety of instruments: (i) grants; (ii) credits; (iii) loans at concessional or market rates; (iv) equity investments; and (v) others.

Co-financing Requirement in the Project Cycle Stages

13. Council has affirmed that co-financing is a key principle underlying GEF's success in its efforts to have significant positive impact on the global environment. Co-financing for GEF projects is important because:

- (a) Co-financing is essential to ensure the sound performance of the baseline project and so that the GEF incremental project is effective;
- (b) Co-financing is an important indicator of the strength of the *commitment* of the counterparts, beneficiaries, and GEF Agencies to the projects; and
- (c) Co-financing helps ensure the *success* and local acceptance of those projects by linking them to sustainable development, and thereby maximizes and sustains their *impacts*.

14. Co-financing is a key consideration for projects considered for work program inclusion. At the PIF stage (for full-sized projects), GEF Agencies should provide indicative co-financing sources for the project, including names of co-financiers, if available. At CEO endorsement, confirmation of co-financing is a critical element of the endorsement. All co-financing commitment letters should be submitted along with the request for CEO endorsement. For medium-sized projects, co-financing commitment letters should be submitted along with the request for CEO approval of the project.

15. Historically, the GEF has provided more resources for financing than strictly interpreted by an incremental analysis, and hence granted resources that provided for significant achievements of local benefits. Such an approach was necessary because many of the issues were novel, and the GEF wanted to provide incentives to be innovative and undertake cutting edge initiatives. For example, issues dealt with in the land degradation focal area are largely developmental issues that are significantly local in character; it is very difficult to clearly identify

and argue for global incrementality. Similarly, interventions in the chemicals focal area largely address chemical pollution issues that provide significant local health benefits. After two decades of a very flexible approach to identifying incremental costs, given that issues are better identified and experiences have been gained, the GEF will take a more rigorous approach to identifying and clarifying the baseline project and the associated incremental.

Reporting and Monitoring of Co-financing

16. When the 2003 Council paper was approved by Council, it also requested the Secretariat in consultation with the GEF Agencies to implement the policy by taking into consideration of co-financing factor in projects for consideration for work program inclusion and to provide periodic reports on the overall progress in implementing the co-financing policy.

17. The Secretariat is modifying the PMIS to capture the co-financing data through the reporting by GEF Agencies in their submission to the GEF Secretariat the midterm review and to the GEF Evaluation Office (GEFEO) the project completion reports. The final co-financing data analysis will be included in the terminal evaluation reviews of projects by the GEFEO.