

# INCREMENTAL COSTS

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*At its meeting in May 1995, the GEF Council reviewed document GEF/C.6/Rev.2, Incremental Costs and Financing Modalities, and approved the approach on estimating agreed incremental costs set out in the document, subject to the comments agreed to during the Council meeting. This document presents the GEF policy on estimating agreed incremental costs as revised in light of the Council's comments. It is submitted to the Council for its information.*

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## 1. INTRODUCTION

1. Most countries have committed themselves to sustainable development, and *Agenda 21* reflects a global consensus and political commitment to this at the highest level. The successful implementation of this agenda is first and foremost the responsibility of governments.

2. Action to achieve sustainable development at the national level, although clearly necessary and directly in the country's own interests, is insufficient to maintain sustainability at a global level because many activities have detrimental global environmental effects. Additional national action beyond what is required for national development is therefore also needed. Such additional action imposes additional (or "incremental") costs on countries beyond the costs that are strictly necessary for achieving their own development goals, but nevertheless generates additional benefits that the world as a whole can share.

3. Global environmental benefits are obtained whenever a global environmental objective is met. Reduction in the emissions of greenhouse gases and protection of specified biodiversity are examples of global environmental benefits. In some cases, but not all, countries will incur incremental costs in order to realize global environmental benefits.

4. A simple example of an action that incurs an incremental cost in order to realize global environmental benefits is the use of advanced solar energy technology in a situation where a less costly coal-fired power generator with pollution control would have been sufficient to generate the electric power needed for development, while meeting reasonable environmental standards. This action, the choice of solar over coal, imposes an incremental cost and avoids emitting the greenhouse gases that would otherwise be emitted. Yet it still meets the same national development goal (power) while also protecting the national population from pollution, in accordance with reasonable standards. In such a case, the incremental cost is associated with the global environmental benefit of reduction in greenhouse gas emissions.

5. The Global Environment Facility (GEF) is one source of funding for global environmental actions. Its purpose, set out in the *Instrument*, is to provide new and additional resources for the "agreed incremental costs of measures to achieve agreed global environmental benefits" in four specified focal areas. *Agenda 21* (Section 33.16) also recognizes this specific purpose. Furthermore, both the United Nations Framework Convention on Climate Change (FCCC) and the Convention on Biological Diversity (CBD) name GEF as the interim operating entity of their financial mechanisms, and these conventions specify that new and additional resources be used to finance the "agreed full incremental costs" of the relevant measures to meet the objectives of the conventions. Although the conventions do not use the phrase "global environmental benefit," the achievement of any of their global environmental objectives is such a benefit and there is no inconsistency between the two formulations.

6. Financing the incremental costs from new and additional sources, ensures two desirable objectives. First, these scarce funds will be dedicated to achieving global environmental benefits rather than to achieving development and local environmental benefits, for which other sources of funds are appropriate. Second, and equally importantly, eligible countries need not divert

scarce development finance to achieve global objectives nor give up their national development goals to do so.

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## 2. APPROACH TO ESTIMATING AGREED FULL INCREMENTAL COST

7. Operational staff need to judge the level of GEF funding for each proposed project pragmatically, yet not arbitrarily. They can avoid arbitrariness and provide transparency by using a framework, yet remain pragmatic by using this framework case by case. The framework used by GEF is provided by the concept of incremental cost, described in broad terms below and in more detail in technical reports. This framework both structures the technical negotiations necessary to reach agreement in each case and provides a reference value for the required grant financing.

8. Staff may also need these reference values for other purposes. First, among alternative measures meeting the same or very similar global environmental objectives, the measure with the lowest incremental cost (that is, the most cost-effective measure) is preferred. *In general, incremental cost is an important -- but by no means the only -- consideration in project selection. Other considerations would be the program priority for projects of that type, national goals, equity considerations, the likelihood of success, and the environmental and social acceptability of the project.* Second, aggregate incremental costs will give a broad indication of the funds that will need to be mobilized to achieve specific global environmental objectives.

9. The following is the framework for estimating incremental costs. The framework is a set of principles that would apply to all focal and cross-cutting areas including capacity building. Detailed operational guidelines for applying these principles in different circumstances would be developed in conformity with this framework.

### 2.1 Incremental

10. The relevant costs are *incremental* rather than total. The cost of GEF eligible activity should be compared to that of the activity it replaces or makes redundant. The difference between the two costs -- the expenditure on the GEF supported activity and the cost saving on the replaced or redundant activity -- is the incremental cost. It is a measure of the future economic burden on the country that would result from its choosing the GEF supported activity in preference to one that would have been sufficient in the national interest.

#### Baselines

11. To estimate incremental cost, the analyst therefore must estimate both the expenditure on the activity in question and the cost saving on activities that, as a result of the GEF activity, will no longer be needed. Expenditure estimates are usually readily available for any fully prepared

project, but cost savings present a more difficult operational problem. Cost savings pertain to the projected "baseline" of future activities for sustainable national development that does not explicitly take global considerations into account. This baseline need not be very elaborate for simple projects, and in some cases the baseline clearly involves no action at all. For example, without global considerations, no country needs to prepare a greenhouse gas inventory, so the baseline is simply "no inventory activity" and the incremental cost of the inventory is actually the *total* cost. Only for more elaborate investment and capacity-building projects would the baseline need to include a number of development activities that would otherwise be needed. For biodiversity conservation, there are often pre-existing baselines of development activities in sectors where proximate causes of biodiversity loss have been identified (e.g., agriculture, industry, transport, etc.). This is because these have been established for other purposes, such as planning for sustainable development and other undertakings under Agenda 21.

12. To obtain reasonable baselines, the GEF and the recipient country would consult broadly. They would draw upon existing studies and sustainable development plans at the country or sectoral level. Such dialogue and joint determination would help ensure that GEF-supported activities become an integral part of countries' own efforts to protect the environment and help maintain mutual understanding. If financing for the incremental costs failed to materialize for any reason, one could reasonably expect the country to implement its baseline plan. A plausible baseline therefore has several important characteristics.

- (a) It addresses national development goals.
- (b) It is technically feasible.
- (c) It is an economically attractive course of action, while remaining broadly consistent with political and social constraints.
- (d) It is environmentally reasonable and therefore does not penalize progressive environmental action in recipient countries.
- (e) It is financially realistic. However, no individual project should be excluded from the baseline merely because specific financing has not yet been identified.

13. Recognizing that for every country the baselines are dynamic and evolving, for the more complex cases, GEF would use a baseline that had been prepared for overall development purposes rather than generated specifically for a particular GEF incremental cost estimation. There are several reasons for this:

- (a) First, preparing a baseline involves considerable time and effort and this may not be practicable or cost-effective on a project-by-project basis.
- (b) Second, consistent assumptions for all sustainable development activities help maintain the coherence of development programs. It would not be reasonable to have one estimate of, say, the economic cost of natural gas for the purposes of national development and another for the purpose of planning a GEF activity in the gas sector.

(c) Third, because the estimate of incremental cost (and therefore the financial transfer itself) is very sensitive to the baseline estimate, the most transparent and credible baseline is one that is established independently of the particular GEF activity under consideration.

14. GEF would recognize that obtaining reasonable baselines ([as in paragraphs 12 and 13](#)) may involve more than simply consulting a published plan in the recipient country. This is because available plans --

(a) may not always be explicit or detailed enough;

(b) may already incorporate proposed activities to meet obligations under global environmental conventions for which incremental costs would be incurred; or

(c) may be written to accelerate developmental action and encourage investment even though these will not always fully materialize.

Hence it may be necessary for GEF and the recipient country to draw on various sources to construct and agree on a reasonable baseline.

15. Baselines would be required for all activities, including capacity building, and for all focal and cross-cutting areas. When the incremental cost of an activity is deemed to be the total cost, explicit justification for the "no-action" baseline would be provided.

## **GEF Supported Alternatives**

16. The incremental cost also depends on the choice of the alternative (GEF) activity.

(a) For the country to regard the activity as a genuine alternative to its baseline activity, the GEF supported activity must deliver domestic benefits that are equivalent to those that the country had planned to achieve in its baseline. In many cases domestic benefits of the baseline and the alternative would be of the same type (e.g., electricity delivered) and physically equivalent. In some cases, domestic benefits may be more broadly defined (e.g., economic income derived from baseline agricultural development equivalent in monetary terms to that derived from a proposed alternative in sustainable forestry for ecotourism).

(b) The activity must deliver global environmental benefits over and above those achievable in the baseline.

17. The GEF alternatives are country driven. To be completely acceptable to the country, they would be expected to meet the first four of the five characteristics set for the baseline ([para. 12](#)). They need not, of course, be fully financeable without recourse to the GEF, and in fact, the GEF would be expected to meet the *full* incremental costs if such alternatives were agreed.

18. Domestic costs and benefits of the baseline and alternative situations may accrue to different groups. To ensure acceptability and sustainability of the proposed alternative, good project design would address any redistributive effects of the alternative.

### **Agreed Full Cost**

19. The FCCC requires, and the GEF Instrument makes provision for, certain activities, but not all, to be funded on an "agreed full cost" basis. Because these activities include items such as studies and communications, for which there is clearly no activity in the baseline, the total costs and the incremental costs are in fact the same. For these agreed full cost items, Indicative Lists of eligible expenditure items may be all that is required. The costs of some activities in support of the Convention on Biological Diversity (certain studies and ecological baseline surveys) are also amenable to a simplified treatment and could be included in Indicative Lists. The Secretariat will develop Operational Guidelines for reasonable expenditures.

## **2.2 Cost**

20. The burden of an activity on a country is the activity's *economic* cost. This economic cost could be higher than the *financial* cost of the activity (e.g., when inputs are subsidized) or lower (e.g., when inputs are taxed).

21. Likewise, the additional burden on the country resulting from the choice of an alternative activity is the economic incremental cost. It is the difference in economic costs of the alternative and the baseline activities to achieve the same domestic objectives. This incremental cost does not depend on *financial* prices. Since pricing policies incorporate many considerations, both economic and non-economic, this independence of the incremental cost estimation from pricing policy confers two advantages: one, grants based on incremental cost would not reflect non-economic considerations, and two, the grant amount would not be affected by pricing policy changes. In other words, GEF financing does not reward pricing policy distortions.

### **Treatment of Benefits**

22. To estimate the incremental costs it is necessary to quantify costs, but it is sufficient merely to identify benefits and to match domestic benefits between the baseline and the alternative, as shown below. (Of course, in approving the project one is also making an implicit judgment that the incremental global benefits exceed the incremental costs.)

#### **(a) Global Environmental Benefits**

23. Whenever a global environmental objective is met, the activity has to that extent achieved a global environmental benefit. For example, if the Conference of the Parties to the CBD deems a particular ecosystem or species worth protecting in the global interest, then the incremental cost of a GEF project that protects it is the incremental cost of achieving that agreed global environmental benefit.

#### **(b) Domestic Benefits**

24. The GEF supported activity must achieve an equivalent national development goal as the baseline. This benefit (i.e., achieving the goal) does not need to be monetized; one only needs to ensure that the goal is met in both cases.

25. Occasionally, a GEF supported activity will seem to deliver additional or secondary domestic benefits beyond those already identified in the baseline. The analyst should then carefully consider the following possibilities and courses of action:

(a) Some of costs of the proposed GEF activity might actually be associated with an expansion of the project beyond what is strictly required for the global environmental benefit (and would not therefore be eligible for GEF support). Neither the costs nor the benefits of the secondary expansion should be a part of the GEF project analysis.

(b) Some of the additional benefits help the country to avoid costs they would otherwise have incurred in the baseline. (For example: a biodiversity project that also protects a watershed and helps to reduce the costs of water supply.) So even though domestic *benefits* as such are not factored into incremental cost calculation, *avoided costs* are an integral part of the calculation, and need to be identified fully.

(c) Some of the additional benefits provided by the GEF supported activity may not be national priorities (i.e., these additional benefits are not in the baseline because they are uncertain, unquantifiable, unimportant or unfinanceable). For example, a renewable energy project may reduce local pollution levels *below* reasonable standards that would have applied to the baseline. No further analysis would be necessary, because no further costs would be avoided by this category of benefit.

#### **(c) Concurrent Domestic Benefits and Global Environmental Benefits**

26. In some cases the same action will yield both types of benefits. For example, all energy conservation projects provide domestic benefits (energy savings) and, where the source of energy is fossil fuel, will provide domestic environmental benefits (reduced air pollution) and global environmental benefits (reduced greenhouse gas emissions).

27. However, projects with global environmental benefits need not on that account alone, incur incremental costs for those global environmental benefits. This is because the domestic benefits alone may provide adequate economic justification for the project, and the project could therefore be implemented without GEF grant financing. In the case of energy conservation, for instance, energy savings of some projects outweigh their capital costs.

28. Where there are concurrent benefits, it is sufficient to specify a reasonable baseline series of actions and an alternative that delivers the same domestic benefits and greater global environmental benefits. Specifying the baseline is no different from preparing a financeable development plan, something which governments and Executing Agencies should do anyway for their regular business. Plausible sustainable development plans identify the domestic benefits being sought. The new element for the analyst is to devise a series of actions that is an alternative

to this baseline, one that *maintains* the level of domestic benefits yet *increases* the global benefits while incurring an incremental cost which is estimated by comparing the two situations.

## 2.3 Full

29. The conventions use the term "full" for incremental costs, and this is also the understanding in GEF. This implies two things.

### No Reduction

30. First, the grant is to be for the incremental cost (as described in paras. 10-28 above) and not for any lesser amount calculated by subtracting either any additional domestic benefit or the share of the global benefit that the country enjoys. For example, suppose the incremental cost of reducing greenhouse gases in a project is \$ 5 million. The grant would be \$ 5 million. It would not be \$ 4.5 million on the argument that the improvement in local air quality, above reasonable standards applicable to the baseline, is supposedly worth \$ 0.5 million. And it would not be \$ 4.9 million on the argument that the reduced global warming that results also benefits that particular country by \$ 100,000.

### All Significant Costs Identified

31. Second, every effort will be made to identify *all* the significant incremental costs and not just the most obvious ones. In principle, the baseline includes all the activities in the country and would include a full description of anticipated development and growth in all sectors according to the criteria of plausibility set out in [para. 12](#). Likewise, the alternative state-of-affairs would include not only the GEF-supported measure itself but also a full description of the measure's ramifications throughout the economy. In practice, of course, the amount of detail an analyst needs to consider will be limited. The preparation of a greenhouse gas inventory, for example, will not have by itself any significant ramifications and the baseline and the alternative state-of-affairs will not differ in any way other than the cost of preparing the inventory. For most investment measures though, the analyst will need to choose a "system boundary" for the analysis that is wide enough to capture the significant changes in cost between the situation with and the situation without the GEF-financed measure, yet still remain narrow enough to be tractable. By consciously seeking to capture all the relevant costs, the analyst will ensure that the incremental cost is estimated in full. Two examples of such attempts, which are not mutually exclusive, are given below:

#### (a) Environmental and Social Costs

32. No GEF activity would have a negative domestic environmental impact. If it the project contained a component that could have a negative impact, the project must also include a component that would mitigate this impact fully. To capture the full costs of the GEF supported activity, the costs of this component would have to be included.

#### (b) Indirect Costs

33. When a project imposes costs beyond the immediate physical project boundary, the indirect, or "system", costs should also be captured in the analysis. For example, a renewable energy project may not only cost more than other sources of energy, it may also impose costs on the whole power supply system by requiring additional reserve capacity to compensate for intermittent supply, or additional transmission lines or line stabilization to compensate for remote location. Clearly all these other costs are also incremental. They should be included by making the comparison not between individual projects but between a system plan that includes the GEF project and a baseline system plan that does not.

34. In economic literature, the full cost of a proposed measure is sometimes referred to as the "opportunity cost," which refers to the value of developments that would otherwise have taken place with the resources used by the measure. In the incremental cost framework, the full cost is identified within a system boundary that is wide enough to capture the most significant avoided costs in the baseline and the most significant costs of the alternative state-of-affairs. As a means of capturing the full costs, the incremental cost framework has two distinct advantages:

(a) it does not require any additional valuation technique for "opportunity costs" as a separate category of costs; and

(b) by requiring explicit, coherent, and plausible baselines it helps to maintain consistency and realism in claims concerning foregone opportunities.

## **2.4 Agreed**

35. The grant would be agreed between the GEF and the recipient. Because projects are country-driven and because implementation is ultimately voluntary, recipients need not incur incremental costs that they feel would not be reimbursed in full.

36. As the grant would be based on an agreed estimate of the incremental cost, it would be necessary to have a transparent process for reaching such agreements. Technical negotiations would need to take place between the GEF and the recipient. Although there would always be some uncertainties, the use of an incremental cost framework as outlined here would greatly narrow the range of possible estimates. The baselines would need to be derived in a transparent and credible way through a dialogue with the country; they would either come outside the GEF context (such as sectoral investment plans) or be independently verifiable, but would not be ad hoc. Other technical parameters would likewise have to be grounded in broader considerations. Reliance on just the identifiable monitorable expenditures and the planned baseline outlays avoids resort to rather more controversial economic valuation methods (such as those for monetizing environmental benefits and for calculating opportunity costs). This makes agreement more likely.

37. The Secretariat is working with the Implementing Agencies on paradigm cases of incremental cost analysis to guide operations. These paradigm cases are based on the approach above using technical outputs of the *Program for Measuring Incremental Costs for the Environment* (PRINCE) and GEF projects and proposals. This will be particularly important

where there are few automatic incentives for either the Implementing Agency or the recipient to ensure that enough time and effort has gone into making pragmatic yet credible judgments.

38. Discussions on the incremental cost would take place at various points in the project cycle. Initially the Task Manager would make an estimate in consultation with the technical counterparts in the country. The agreed incremental cost and the basis for the agreement, along with other project details, would be reviewed by GEF at the GEF Operations Committee (GEFOP) meeting that considers the proposal and its financing plan. After any revisions that may be needed following the GEFOP, a final recommendation would be made at the time of Project Approval.

39. The process of agreement takes place at several levels. First, much of the technical work of PRINCE is being and will continue to be conducted in collaboration with regional centers of excellence in developing countries. Second, baselines are identified in consultation with the recipient country using, wherever possible, outputs from accepted studies undertaken for broad development purposes rather than specifically for GEF projects. Third, the country and the Implementing Agency would confer on the process of estimating incremental cost, starting at an early stage in the project cycle, in order to expedite a reasonable agreement based on the application of the principles of incremental cost. Fairness and equity would be assisted further through the full documentation and disclosure of the transparent application of these principles in each case.

### **3. USE OF INCREMENTAL COST IN OPERATIONAL STRATEGY AND FINANCIAL POLICY**

40. The reason for developing an approach for estimating incremental cost is that incremental cost is pivotal to the operational strategy and financing policy of GEF. The only financing role for GEF -- in fact its special mandate -- is as the financier of agreed incremental costs of measures to achieve agreed global environmental benefits in the focal areas. It is important to retain this specific focus and not to lose the distinction between GEF financing and traditional development assistance. GEF does not finance non-incremental costs.

41. The current document sets out a general technical approach to estimating incremental cost (Section 2). This approach is the basis for the negotiated technical estimates of agreed incremental cost for any given project and is applicable to any type of incremental cost, including transaction and learning costs, and costs for capacity building, biodiversity protection, and private sector operations. The approach is stated, as generally as possible, consistent with the special mission of GEF. This special mission is to complement (but not substitute for) regular development assistance and cost recovery, which finance baseline (or "non-incremental") costs. Because the approach is intended to be *generally* applicable, rather than restricted to specific types of incremental costs (such as capital, operating, transaction, learning, costs), the latter are not listed as being explicitly eligible expenditures. Lists can be misinterpreted, since for any expenditure, it is only the *increment* that is eligible and not necessarily the whole amount.

42. Although Operational Strategy and financing policy are not the focus of this document, and are dealt with elsewhere, they motivated the development of this approach to incremental costs. As such, a brief outline of the role incremental cost plays in these matters is set out below. This is contextual material: It is important to realize that incremental cost is not the only consideration in the Operational Strategy or the financing policies, and that these are subject to separate Council approval. Incremental cost estimates are required for the following:

- (a) Removing barriers to sustainable development;
- (b) Reducing long-run costs of adjusting to sustainable development;
- (c) Selecting projects;
- (d) Choosing an appropriate financing modality;
- (e) Setting financial policy; and
- (f) Designing cost effective measures.

### **3.1 Removing Barriers**

43. The GEF Operational Strategy explicitly recognizes the importance of removing barriers to the developments that incorporate global environmental considerations. [1] Criteria have been set out for the development of operational programs that aim to remove barriers in the interests of the global environment, while respecting the complementary roles of other financiers. The approach to incremental costs is applied to barrier removal, in particular to ensuring proper baseline definitions so that complementarity of financing is maintained. Barrier removal is part of a dynamic perspective: technical, economic, financial, regulatory, and institutional measures are seen as part of learning process. That part of the learning cost that is made necessary by global environmental considerations is an incremental cost. Note that not all of the learning and transaction costs of the alternative are incremental because learning and transaction costs may also be incurred to some extent in the baseline. For example:

- (a) The transaction costs of doing business in small scale renewable energy systems may be high because there is little experience with or information about them, thin distribution networks, no economies of scale initially, and poor support infrastructure. But the baseline systems replaced (diesel pumps, for example) would also incur some, albeit smaller, transaction costs in remote areas and these costs would be partly avoided through substitution by the alternatives. If these avoided costs are significant, they would be taken into account in the incremental cost estimate.
- (b) There will be some learning costs for energy planning to use renewables or for sustainable fishing, but some costs would also be incurred in the baseline for similar activities and would be taken into account if significant. The cost of technical assistance

for (say) energy planning or sustainable fishing would be partly financed by GEF as an incremental cost (determined in accordance with this approach) and partly by other sources as a development assistance cost.

## 3.2 Reducing Long-Run Costs

44. Global environmental protection is part of a learning and adjustment process. As such, and correctly handled under the Operational Strategy, the costs of the transition to sustainability are expected to decline. Projects are selected according to Operational Programs either to have programmatic effects, such as inducing cost reductions [2] or through funding the costs of barrier removal, such as learning which is expected to be a onetime effort in the particular area for the particular activity. In these cases, the costs that one is attempting to reduce are the *incremental* costs of development that is friendly to the global environment relative to development that does not take global environmental considerations into account.

## 3.3 Selecting Projects

45. Projects are selected according to focal area strategies, by taking into account the incremental cost and any other criteria that those strategies require. Other things being equal, the project with the lowest incremental cost is preferred; but incremental cost is not the only factor.

(a) This paper makes no presupposition about the final selection of the project or its merits relative to other projects. For example, Council may adopt strategies in climate change and ozone layer depletion that require projects with the lowest incremental cost per unit of greenhouse gas abatement or ozone depleting substance phase-out to be chosen first. On the other hand, Council may adopt strategies that require projects to be selected for their long term potential to reduce costs or to have some other strategic effect despite a relatively high incremental cost.

(b) This paper does not provide a way of ranking project benefits. In all focal areas, identification and ranking of the benefits must be done in the strategy itself and in accordance with the program priorities of the relevant convention where applicable. By the time a project is finally approved, its benefit would have been identified and its incremental cost would have been estimated and agreed. At that point, an implicit judgment would have been made that the benefit exceeds the incremental cost.

(c) The calculation of incremental cost is neutral with respect to whether the domestic policy environment is conducive to the success of the proposed project. The incremental cost, as the cost to the country, is an economic cost and not a financial cost. It is therefore independent of the pricing policy and is not affected by the addition or removal of any taxes or subsidies. If such matters are relevant, they would be considered as part of focal area strategy at the time of project selection or as part of good project design at the time of appraisal.

## 3.4 Choosing a Financing Modality

46. In the interests of transparency, the estimation and agreement of incremental cost (Section 2) have been kept quite distinct from the operational decisions based upon the estimated incremental cost. After the data have been collected on incremental costs, on possible cost recovery mechanisms, on the uncertainty of the estimates, and on the distribution of incremental costs over time and social groups, a cost effective way of financing the incremental costs can be proposed. [3] These decisions will be made in part on the grounds of leverage and cost-effectiveness (determined in terms of incremental cost for obtaining a given objective).

### **3.5 Setting Financial Policy**

47. The approach itself, being technical, has not been modified to accommodate any strategic considerations, as the resulting mix of factual and policy matters would not have been clear, and the estimate would have lost its value as a reliable basis for policy debate. This paper makes no judgment about aspects of financial policy (such as eligibility and leverage), which Council may wish to consider separately. [4]

### **3.6 Designing Projects Well**

48. This paper does not address the project design issues. One element of good project design related to GEF grants is the distribution of costs and benefits of a GEF supported activity among the affected groups. The provision of a GEF grant that fully covers incremental costs to the country (the economic cost) does not by itself guarantee that each affected group will be adequately reimbursed for the (financial) costs they incur, because of taxation, transfers, or pricing policies. In the interest of ownership and sustainability, the Implementing Agency will have to address such issues during project design. There may need to be an agreement about appropriate government action to redistribute costs or divide the grant among multiple recipients. In exceptional circumstances where such redistribution is infeasible, Council may wish to consider on a case-by-case basis whether making a grant that exceeded incremental cost was justified in the interests of ensuring that no group was treated unfairly.

## ANNEX

### REPORTING FORMAT FOR INCREMENTAL COST

1. Each project proposal submitted to GEFOP will show how the approach to estimating incremental cost would be applied and will provide preliminary estimates of the incremental cost. This proposed application will be set out according to the steps below. Subject to GEFOP technical clearance, the Implementing Agency will then apply the approach in the agreed manner during project appraisal.

2. The Secretariat is working with the Implementing Agencies to prepare paradigm cases of incremental cost analysis. These are being prepared in accordance with the approved approach and reported in this standard format. They are based on material from PRINCE case studies, GEF projects, and GEF project proposals, and (where no other source exists) hypothetical situations. The paradigm cases will cover the major situations envisaged under the Operational Strategy e.g., the four focal areas, and special situations such as barrier removal, biodiversity protection, and private sector operations. The paradigm cases will be used by the Secretariat for staff training and by the Implementing Agencies to assist operational work.

### **1. Broad Development Goals and the Baseline**

3. The relevant broad developmental goal of the country (e.g., provision of energy services, maintenance of food and other biological resources of economic importance to the country).

4. The way the country can reasonably be expected to address the above development needs in its own economic interests (i.e., had it not been a party to the Conventions and, for focal areas not covered by relevant Conventions, had it not taken into account explicitly any global environmental considerations). The baseline can be drawn from existing studies and development plans and should meet the criteria set out in the approved approach.

### **2. Global Environmental Objective**

5. The objective of the proposal to GEF, namely to avert specified consequences for the global environment of the above baseline course of action (e.g., emissions of greenhouse gases, threats to biodiversity, or emissions of ozone depleting substances).

### **3. Alternative**

6. The proposed way to meet the baseline developmental goals and the global environmental objectives simultaneously. This section justifies the proposed alternative. The alternative will generally be the least-cost option, and any separable project components not related to the achievement of the global environmental objective would be identified. If the domestic benefits

of the proposed alternative and the baseline accrue to different groups of people, this section should discuss briefly how any redistributive effects of the alternative would be addressed.

## 4. Scope of the Analysis

7. The scope of the matters taken into consideration, sometimes referred to as "system boundary." This includes all the significant differences between the alternative and the baseline course of action. Any changes caused by the alternative -- not only the project itself but also any major downstream impacts, sectoral shifts, system adjustments, additional domestic benefits, and side-effects -- are included within the system boundary because they can have important cost implications for the country.

8. The scope should be broad enough to incorporate that part of the domestic benefit in the alternative that is additional to the benefit in the baseline. Where the additional domestic benefits are significant, the analyst should distinguish among those that:

(a) arise from project design beyond that necessary to achieve the global environmental and the baseline domestic development goals;

(b) achieve baseline domestic objectives and thereby avoid baseline costs; and

(c) are not national priorities. For the purposes of the analysis of incremental costs, the relevant alternative course of action is the one that achieves the global environmental objective at the least incremental cost while still providing approximately *equivalent* domestic benefits. This may not always be possible for technical reasons. These "concurrent" benefits are not by definition in the baseline, which represents all the affordable actions that are national priorities. Therefore, concurrent benefits can be ignored for cost estimation purposes.

## 5. Costs

9. All the economic costs within the system boundary of the proposed alternative course of action and those avoided by not undertaking the baseline course of action. This section will identify and provide preliminary estimates for the relevant costs. Costs should be estimated in present value terms. Assumptions about discount rate, time horizon, etc., should be stated and divergence from standard figures used elsewhere mentioned.

10. The preliminary results should be summarized and presented in a matrix that shows the costs, the domestic benefits, and the global environmental benefits associated with the baseline course of action and the proposed alternative course of action. The increments are the differences between the baseline and the proposed alternative.

	Baseline	Alternative	Increment
Global Environment Benefit			
Domestic Benefit			
Costs			

Note: If you are using a browser other than Netscape 1.1 or above you may not be able to view the above table. A copy of this table is available from the GEF Secretariat.

## 6. Process of Agreement

11. The proposed manner of reaching agreement with the relevant technical counterparts and authorities.

### ENDNOTES

1. *Operational Strategy*, Chapter Three (Climate Change). Although barrier removal is the theme of two operational programs in the climate change focal area, the concept can be applied within other operational programs (e.g., barriers to sustainable use of biological resources for the protection of biodiversity).
2. For example the Operational Program, *Reducing the Longterm Costs of Low Greenhouse GasEmitting Energy Technologies*.
3. *Financing GEF Projects*, GEF/C.7/Inf.
4. *Financing GEF Projects*, GEF/C.7/Inf.