



Global Environment Facility

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Agenda Item 8

NOTE ON INCREMENTAL COSTS

Recommended Council Decision

The Council reviewed document GEF/C.13/7, *Note on Incremental Costs*, and approves the steps proposed to be undertaken to make the process of determining incremental costs more transparent and its application more pragmatic. The Council requests the Secretariat to keep it informed of progress made in completing the proposed activities.

1. The Council had before it at its meeting in October 1998 an information paper *Progress on Incremental Costs* (GEF/C.12/Inf.4). That paper outlined the steps that had been taken in response to the recommendations of the November 1997 Council meeting and the first GEF Assembly which called for making the process of determining incremental costs more transparent and its application more pragmatic. The paper also included a number of proposals to improve the process of determining incremental costs.

2. Since the last Council meeting, the Secretariat has made efforts to address the actions suggested in the document GEF/C.12/Inf.4. The Secretariat, together with the Implementing Agencies and the Convention Secretariats, worked in partnership with the International Institute for Environment and Development (IIED) to continue consultations on the issue of incremental costs. Specifically, a workshop of GEF stakeholders was organized in March 1999 to provide input to the development of guidelines for negotiating incremental costs as well as simplified approaches to incremental costs in the GEF focal areas.

3. Prior to the workshop three sets of papers were commissioned which served to focus the discussions of the workshop:

(a) country experience papers;

(b) focal area papers; and

(c) expert review papers.

4. IIED has prepared a report summarizing the discussions and recommendations that emerged from the workshop. The report will be available at the Council meeting.

5. At the workshop, general consensus emerged on a number of recommendations. The major recommendations are:

(a) with regard to the process for negotiating incremental costs, the workshop recognized the need for:

(i) strengthened country involvement in this process;

(ii) clear guidelines and procedures to be put in place for negotiating agreed incremental costs;

(iii) greater clarity and transparency with regard to the roles of each of the partners,

(iv) training in the incremental cost approach for country counterparts involved in incremental cost negotiations; and

(v) simpler, user-friendly materials on the incremental cost approach translated into more languages.

(b) applying the incremental cost approach more systematically in project design and using the logical framework approach would resolve many of the problems encountered in incremental cost estimation.

(c) medium size projects warrant the simplest of approaches, and the GEF might consider more flexible rules concerning co-financing associated with these projects.

(d) simplified guidance concerning the determination of the baseline would facilitate the estimation of incremental costs.

6. The GEF is committed to clarifying and streamlining its approach to incremental costs in a manner which is expeditious, consultative and constructive. In this context, some of the above recommendations can be addressed through existing and/or proposed commitments on the part of the GEF, while others will require further deliberation and consultation before they could be realized. The critical task in implementing these recommendations is to ensure that they are consistent and harmonized with the operations and mandate of the GEF.

7. This note outlines the next steps the Secretariat, in collaboration with the Implementing Agencies, will take to respond.

8. Two on-going activities of the GEF are particularly relevant to these recommendations: (i) the Country Dialogue Workshops that were approved by the Council in October 1998; and (ii) continuing efforts to streamline the project cycle.

(a) The GEF Country Dialogue Workshops project, which is in the final stages of being endorsed, seeks to build country co-ordination and capacity to participate in GEF activities through targeted, participatory workshops. These country level workshops will provide a unique opportunity to provide training on the incremental cost approach to a broad-based national audience. Through the project, resources will be available to develop new “user-friendly” materials that will explain the incremental cost approach of GEF financing as well as the procedures and processes behind project design and negotiation of incremental costs. At present, it is proposed that a training module be prepared for explaining incremental costs, drawing upon the efforts described in this paper. The training module concerning project development will emphasize the use of the logical framework in project design as a critical element towards incremental cost estimation. Material prepared for purposes of the workshop will also be available for dissemination to interested parties unable to attend a workshop. Wider distribution of these and other materials (including information on best practices) through regular channels and the website will be strengthened. Also, in document GEF/C.13/13 (*Constituencies and Assistance for Country Level Coordination*), it has been proposed that resources be made available for translation of GEF documentation, including information on incremental costs, with a view to strengthening country level involvement.

(b) Procedures for implementing the GEF project cycle are currently being updated in an effort to respond to requests for continuous streamlining of the project cycle and to ensure that quality standards for the various decision points in the project cycle are clearly understood and uniformly applied across Implementing Agencies, regions, and focal areas. This provides a timely opportunity to address the procedures and processes relating to the negotiation of agreed incremental costs and to formalize agreed procedures in the project cycle. Work to clarify and harmonize procedures will be undertaken in consultation with the Implementing Agencies and brought to the attention of the Council.

9. The GEF Secretariat has initiated work on the preparation of a regular training program for staff of the GEF family (including Secretariat, Implementing Agencies, executing agencies, co-financiers and other stakeholders) with the objective of ensuring common understanding of the GEF's mandate and procedures. This opportunity for training those directly involved in the estimation and negotiation of incremental costs (staff and consultants) should contribute to ensuring that the dialogue with recipient countries is increasingly consistent.

10. With regard to steps to simplify incremental cost estimation, there was support at the workshop for a broader application of the *Streamlined Procedures for Incremental Cost Assessment* (these procedures are attached to this note). These streamlined procedures show how the incremental cost approach can be applied pragmatically through different stages of the project cycle. The Secretariat will work with the Implementing Agencies to further clarify these procedures, as necessary, with a view to promoting their more wide spread application in GEF operations.

11. In the next two to three months, the Secretariat will work with the Implementing Agencies to explore options for addressing approaches for simplifying even further the agreement of incremental costs for medium size projects. An agreed approach or approaches will be piloted through this funding pathway, and the experience gained might provide lessons for further simplification that can be applied to all GEF projects.

12. There were other issues raised at the workshop beyond the consensus recommendations raised in paragraph 5. For example, it was proposed that the GEF should initiate early upstream consultations with other possible co-funders so as to leverage the maximum resources for a project very early on in the project development phase. The Secretariat and the Implementing Agencies will explore the ideas raised with a view to seeking continuous improvement in the agreement process for determining incremental costs. When there are new approaches or modalities that appear promising, the Secretariat will bring these to the attention of the Council.

13. Some of the suggestions made at the workshop are specific to individual focal areas. For example, there was a suggestion that guidelines be prepared for distinguishing global and domestic benefits more clearly and also for estimating baseline costs – especially for biodiversity projects. The development of an incremental cost framework to address the needs of the private sector in the case of climate change projects was also proposed. Another issue raised in several country experience papers was the incompatibility that could arise between the GEF's incremental

cost policy and its policy to promote community participation in GEF projects. The focal area task forces will be invited to look into these issues and propose pragmatic ways forward, paying special attention to the input from the consultative processes undertaken so far.

14. All workshop participants found the country experience papers particularly insightful. The Secretariat will make every effort to continue the practice of inviting individuals or agencies executing projects to document their experiences as a means to obtain direct feedback as well as to disseminate best practices.

15. The Secretariat will report to Council on progress made in implementing the proposed actions, taking into account the comments of the Council on this note.

STREAMLINED PROCEDURES FOR INCREMENTAL COST ASSESSMENT

INTRODUCTION

1. The purpose of this note is to set out streamlined procedures for the estimation of the incremental costs of GEF projects, and to set these procedures in the context of the streamlined procedures for GEF operational programming.
2. As set out in the GEF Instrument¹, GEF finances the incremental costs of projects, and has adopted an approach for estimating them which is set out in a policy paper². Streamlined procedures do not introduce any new types of, or policies for, incremental cost. Rather they show how the approved approach can be applied pragmatically in different situations by drawing on lessons of experience. Supplementing these procedures, there are also case studies and paradigms that can guide Task Managers in the estimation of the incremental costs eligible for GEF financing.
3. So far, experience with the application of the incremental cost approach has taught several things:
 - (a) First, sometimes the whole project (or a clearly identified activity within it) merely complements, rather than substitutes, existing activities. Where such a project is required only as a way of meeting global environmental objectives, a simpler analysis of incremental costs would be appropriate because the full complexity of the analysis is really only needed where there is substitution or the generation of additional (non-global) benefits. Many biodiversity conservation projects, medium size projects, and small grants proposals could be treated in this simpler way.
 - (b) Second, where the project design shows more clearly how the project will make a difference to the global environment, it is easier to estimate the incremental cost.
 - (c) Third, when project design and incremental cost issues have been resolved upstream, the administrative costs of making any changes needed to conform with the approved GEF approach are, as expected, lower.

The streamlined procedures are based on these lessons.

STREAMLINED PROCEDURES FOR OPERATIONAL PROGRAMMING

4. The Secretariat and the Implementing Agencies have already agreed on streamlined procedures for operational programming. The procedures begin with upstream consultations on conceptual issues, which can be addressed at relatively low administrative cost to the Implementing Agencies; progress through a more detailed bilateral review meeting on project design issues, which may

necessitate some fine-tuning; and finish with the proposal's inclusion in the Work Program that is presented by the CEO to Council for their consideration.

5. The streamlined procedures for incremental cost assessment are elaborations of the operational programming procedures. Broadly, the procedures, are as follows:

- (a) At the upstream consultations, discussion of the project concept alone would be sufficient, even without explicit consideration of any "incremental cost" issues because getting the strategic fit and the right project design are what really facilitates subsequent discussion on incremental cost.
- (b) At the bilateral review meeting, it would then be necessary to draw out the implications, for incremental cost, of the decisions taken earlier about project design and to provide guidance on the steps needed to complete the assessment satisfactorily.
- (c) At the Work Program stage, the proposal would be included if the incremental cost estimate was made in accordance with the guidance given at the bilateral review meeting.

UPSTREAM CONSULTATIONS ON PROJECT CONCEPT

6. Strategic Fit of the Project

When a project is first considered, the IA may wish to discuss with the Secretariat certain strategic issues prior to any discussion of the incremental cost itself (e.g., how the proposal conforms to one of the Operational Programs, the short-term criteria, or the operational criteria for Enabling Activities). This is not only to ensure that the project is eligible, but also to facilitate subsequent incremental cost discussion at the Bilateral Meeting. The project must "make a difference" to the global environment. Use of a project logical framework would also facilitate discussion.

7. Design of the Project

Activities. Most projects consist of diverse activities (e.g., training, investing in alternate pest management, and establishing a national conservation center). It is useful to identify a small number of major activities at the outset to make it easier to analyze the project and, subsequently, to estimate their incremental costs.

Baselines. Good project design demands that there be a clear understanding and articulation of the course of events that is threatening the global environment in order to show that the activities, as proposed, will reduce or remove the threats. This course of events is often termed the "baseline," and one would expect that each activity would be shown to make sense in terms of a baseline that it was addressing (e.g., the current institutional capacity, food production and pesticide runoff, and conservation outreach). Getting these clear at the start will also make it easier to estimate the extent to which any alternative course of events would cost more.

Complements and substitutes. For each activity, it would be necessary to understand whether it was intended simply to add something without changing the baseline (e.g., constructing a conservation center) or whether it was intended to change the baseline by substituting something better (e.g., using an appropriate form of integrated pest management as a substitute for ecologically damaging pesticides). Knowing whether an activity is complementary or substitutional makes it easier to demonstrate how it would thereby protect the global environment and why this would not happen without it, to determine how catalytic the activity will be, to show any financial leverage, and to estimate the incremental cost. Note that at this stage this is still just a way of thinking about the proposed project, the additional effort it may require, and the extra burden it may impose, not yet a "calculus" of incremental costs.

8. A typical complementary activity in biodiversity is a conservation activity that has no direct or major impact on other economic activities, such as protected area management (gazettal, demarcation, management, conservation centers etc.) and strengthening of *in situ* capacity for biodiversity conservation. (A short illustrative list³ is appended at Annex A. Many of these projects are in fact small-scale training, capacity-building, institutional strengthening, or planning activities.) In climate change, one example of a complementary activity is a module for capacity building in energy planning that is explicitly required for mitigation scenarios; another is the removal of a barrier to energy conservation or renewable energy. In international waters, an illustrative complementary activity is an end-of-pipe pollution control measure required only to prevent trans-border pollution.

9. A substitutional activity is one that *changes* the way of doing business to one that is friendly to the global environment. Questions one could ask in some situations to determine whether an activity is a substitute or whether it:

- (a) modifies economic production techniques;
- (b) modifies or substitutes for a regular development project;
- (c) removes a social or economic cause of biodiversity loss, provides an alternative livelihood, or substitutes a
- (d) renewable energy technology for one that emits GHGs;
- (e) supports planning for an economic sector (energy, agriculture, forestry, fishing, industry, etc.); or
- (f) yields economic benefits for the local population (or for the country as a whole).

10. In biodiversity, substitutional activities would modify baseline development activities that would anyway be sustainable in terms of the biological resource of economic importance (timber, fish, food etc.) to ensure that *biodiversity or its components* (habitats, species, or gene pools of global importance but with little local economic value) would also be used sustainably. Over time this is likely to facilitate the transfer of more resources than would be possible with respect to conservation projects alone. Thus far there are not many GEF biodiversity projects of this sort, but a short indicative list is appended at Annex B. The incremental costs would need to be treated in full with consideration of baseline activities and alternative that maintains the development goal. If an explicit cause is identified and the project is in an economic sector (e.g., irrigation, cattle grazing pest control in crops etc.) this should not present any unusual difficulties. In climate

change, substitutional activities are those that provide the same service (e.g., power or energy) by substituting the supply by one that emits less greenhouse gas (e.g., renewable energy substituting for fossil fuel energy).

BILATERAL REVIEW MEETINGS

11. The bilateral review can build on the project design decisions to identify, case-by-case, the most streamlined way of estimating the incremental cost. Incremental costs should be considered for each major *activity* according to whether that activity is *complementary or substitutional*. Typically a project activity that is only complementary will not require much analysis to justify the incremental cost, but such projects are less often catalytic and do not leverage financial resources. A project activity that substitutes for a baseline course of events will require some further effort to separate the costs of the baseline from the incremental costs of the proposed activity, but the activity will have the advantage that it will thereby leverage funds that would otherwise have gone to finance that baseline. The following sequence of issues needs addressing:

12. For all activities

Q1. Is baseline financing secured?

Baseline financing is required. This is because, in the case of a complementary activity, the baseline provides the essential context and support, and because, in the case of a substitutional activity, its full funding requires both GEF incremental cost financing and non-GEF co-funding equivalent to the costs of the baseline that would be substituted. For example, if incremental cost financing is required for the complementary activity of a commercial tree inventory that is needed to collect biodiversity data, the whole project would be threatened if the underlying commercial inventory (baseline) did not proceed for lack of finance. Or, to take a substitutional example, a solar energy plant would not go ahead if funds equivalent to the avoided costs of the fossil fuel alternative were not diverted to the solar plant.

Q2. Is the alternative least cost?

The proposed activity is the least cost way of achieving the identified global environmental benefit. If a more costly alternative is actually proposed (for other reasons obviously, such as additional employment generation, a higher inter-national "profile," etc.) the incremental cost will be the cost of the lowest cost alternative. If any activity of the project or activity could conceivably be omitted without jeopardizing the global environmental objective (e.g., the further development of ecotourism once the habitat has been protected), the incremental cost is the cost of the project without that activity.

13. For complementary activities

If the activity is deemed to be complementary, the emphasis will be on establishing this complementarity through the following questions:

Q3. What evidence is there that the amount of GEF financing is genuinely additional, with no crowding out or deleveraging of other or pre-existing sources taking place? What assurances are there for the continuance of existing levels of finance from government agencies or others that have previously financed similar activities (e.g., national park protection)?

Q4. What cost-sharing with beneficiaries would be appropriate, and how could cost recovery mechanisms be built into the project to encourage environmental responsibility and financial sustainability in the absence of continued GEF support?

Q5. What level of Implementing Agency, bilateral, private, or NGO co-funding is available in the light of the benefits enjoyed by the local population or the country as a whole? A budget would then need to be prepared prior to Work Program submission.

14. For substitutional activities

If the activity is substitutional, the emphasis will be on describing and costing the baseline (all the activities that will be replaced or affected by the project). Before the project is submitted for the Work Program, a system boundary that captures all the main effects will need to be described and an incremental cost matrix will need to be produced in accordance with the Standard Reporting Format⁴ of the incremental cost approach. A decision could also be made about which of the existing "paradigm cases" is the best model to follow.

TRANSITIONAL AND FOLLOW UP ARRANGEMENTS

15. The streamlined procedures will apply to all new project proposals, as described above. Also, in order to help introduce them rapidly, the Implementing Agencies may wish to "retro-fit" them to proposals that are currently being processed.

16. In the spirit of case-by-case pragmatic application of the incremental cost approach, further guidance or annexes may be produced later on the basis of experience with a view to clarifying or streamlining the approach. For example, further common practices for preparing climate change projects, international waters projects, and "barrier removal" projects in all focal areas will be prepared.

ANNEX A: TYPICAL COMPLEMENTARY ACTIVITIES IN BIODIVERSITY

Provided they fit strategically in an Operational Program, follow GEF policies, and are soundly conceived, the following activities could be regarded as wholly complementary. Note that it is not so much the type of activity (e.g., training) that determines whether it is complementary or substitutional, but the situation.

INSTITUTIONS AND PLANNING

- (a) Establishing, strengthening, restructuring or managing a national park or protected area;
- (b) Developing the coordinating, regulatory or legal frameworks needed to preserve ecological zones;
- (c) Integrating farmer conservation efforts into national and international gene bank programs;
- (d) Zoning for environmental conservation, and regional conservation planning;
- (e) Incorporating biodiversity concerns into national development planning;
- (f) Developing guidelines for sustainable use (e.g., of forestry products).

MONITORING AND EVALUATION

- (a) Monitoring environmental conditions (e.g., community-based monitoring of wildlife populations);
- (b) Undertaking surveys and biodiversity inventories, and identifying hotspots;
- (c) Developing national environmental information networks and M&E systems.

TARGETED RESEARCH

Analyzing habitat and causes of biodiversity loss.

EDUCATION AND OUTREACH

- (a) Providing conservation education and public awareness of environmental issues (such as developing public-private partnerships for sustainable development and involving the community in habitat protection);
- (b) Providing environmental management fellowships and making twinning arrangements.

FINANCIAL INSTRUMENTS

- (a) Establishing (but not necessarily funding) a conservation trust fund and testing its feasibility;
- (b) Developing financial strategies.

DEMONSTRATIONS AND REPLICATIONS

Formulating and testing approaches to protecting biodiversity, e.g., for controlling exotics.

ANNEX B: TYPICAL SUBSTITUTIONAL ACTIVITIES IN BIODIVERSITY

For the following substitutional activities, one would need to:

1. identify the cause of loss of diversity of biological resources that exists even when natural resources are used sustainably;
2. design the activity to remove that cause while maintaining the sustainable development purpose (Note: All these activities will make a "difference" through alternatives, changing, reducing etc.); and
3. estimate the incremental cost is the difference in the cost between the baseline and proposed alternative, according to the approved approach.
 - (a) Reducing pesticide runoff threatening an important wetland habitat, by using more costly natural pest control methods;
 - (b) Reducing industrial pollution of a national park, through more costly pollution control methods;
 - (c) Reducing irrigation water abstraction (e.g., to maintain a wetland habitat or to remain within groundwater recharge limits). Irrigation is usually practiced where there are large rivers and lakes, since groundwater is scarce and often saline;
 - (d) Changing sustainable logging practices to protect habitat of a species;
 - (e) Substituting environmentally friendly subsistence fishing to prevent danger to endemic species of fish;
 - (f) Removing the incentives for the introduction of exotic species by simultaneously raising productivity of indigenous species and maintaining restrictions;
 - (g) Introducing new fish traps to maintain fish catches while preventing the trapping of (inedible) species of high biodiversity value;
 - (h) Relocating a plant (industrial, sewage, etc.) to prevent discharges into an ecologically sensitive area;
 - (i) Changing water resource use and distribution patterns that would even out grazing pressure and prevent deterioration of vegetation;
 - (j) Modifying a wildlife ranching system so that it is compatible with biodiversity conservation;
 - (k) Changing already sustainable livestock management and grazing patterns specifically to protect biodiversity;
 - (l) Altering intensified production techniques to prevent "land mining";
 - (m) Making sustainable the provision of other services and industries that use biological or ecological resources (such as ecotourism and microproduction);
 - (n) Conserving rural energy (or switching to an alternative renewable supply) in order to conserve natural vegetation that, from a biodiversity perspective, is important as habitat or in its own right;

- (o) Improving research facilities to enable them to manage biodiversity collections and data;
- (p) Providing alternative income opportunities.

ENDNOTES

1 *Instrument*, para. 2.

2 GEF/C.7/Inf.5

3 Note that the annexes are illustrative only, and list the projects typically meeting the criteria for being complementary or substitutional. Proposals must be considered case by case.

4 GEF/C.7/Inf., annex.

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