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MANAGEMENT RESPONSE TO: EVALUATION OF INCREMENTAL COST ASSESSMENT

**(Prepared by the Secretariat in consultation with the
Implementing and Executing Agencies)**

EXECUTIVE SUMMARY

This is the management response, prepared by the Secretariat in consultation with the Implementing and Executing Agencies, to document, GEF/ME/C.30/2 *Evaluation of Incremental Cost Assessment*, an evaluation of the application of the incremental cost principle in GEF interventions undertaken by the GEF Evaluation Office.

We would like to thank the GEF Evaluation Office for having undertaken this very important evaluation. We generally agree with the conclusions and recommendations of the evaluation. It is timely as the GEF is entering a new replenishment period with a set of policy recommendations for implementation. The GEF focal areas are in the process of finalizing their strategies for the fourth replenishment period with a clear presentation of strategic objectives and expected outcomes from GEF-supported interventions. Furthermore, the implementation of the resource allocation framework (RAF) in the biodiversity and climate change focal areas presents new ways of dealing with incremental costs since the RAF pre-allocates GEF funding to countries for a 4-year period based on environmental governance indicators and the potential to address global environmental concerns. The conclusions and recommendations of the Evaluation will provide a good basis to move towards a pragmatic, strategic and cost-effective application of the incremental cost principle in GEF interventions.

The various findings of the evaluation all converge into one single overall conclusion: while the principle of incremental funding is valid and rooted in the mandate of the GEF, its current application, especially the incremental cost assessment and reporting, does not add any value to the project design and its implementation. There is much confusion and weak understanding about the application of the incremental cost principle among all key stakeholder groups, including countries and agency staff. Hence, the Evaluation recommends defining a more pragmatic, strategic and cost-effective approach to the incremental costs of GEF interventions consistent with the GEF instrument and operational principle 2 of the GEF operational strategy.

Over the last 10 years, the GEF has changed considerably. Indicators are, for example, the expansion of the GEF focal area system by adding land degradation (desertification and deforestation) and POPs as focal areas; and a stronger and more conscious link of GEF operations to the global sustainable development agenda and the related MDGs. For example, responding to several GEF Council requests, the land degradation focal area and the strategic priority on adaptation have attempted to explain the application of the incremental cost principle to individual interventions that are rooted in community-based development activities. While the incremental reasoning for GEF investments in these types of interventions has greatly helped the idea of mainstreaming global environmental concerns into livelihood-based interventions, the incremental cost assessment was based on a pragmatic cost-sharing approach for achieving the agreed global environmental benefits. In these cases, the incremental cost assessment based on the classical principle of costing activities that lead to either national/local or global environmental benefits has posed a serious challenge.

The independent evaluation of the application of the incremental cost principle across all GEF focal areas has confirmed that there is need to adapt its application in a way that it becomes a transparent, cost-effective and useful tool in project preparation and implementation. We

therefore agree with the recommendations of the Evaluation, and would like to propose that the current way of applying the incremental cost principle, especially the assessment and reporting be scrapped and a more pragmatic and strategic approach be adopted. This new approach is rooted in incremental reasoning and the focal area strategies approved by the GEF Council for each replenishment period. The GEF Secretariat, together with the GEF agency partners will meet in the coming months to refine the proposed new approach to incremental costs and develop an outreach program on related operational issues. A proposal will be presented to the Council for review at its June 2007 meeting.

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INTRODUCTION

1. This is the management response to document, GEF/ME/C.30/2, *Evaluation of Incremental Cost Assessment*, an evaluation of how incremental cost calculations 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 recently completed evaluation of the role of local benefits in global environmental programs. The primary objectives of the incremental cost evaluation were to evaluate the processes and methodologies used for incremental cost assessment, and the process of negotiation of incremental costs. In line with these objectives, the following dimensions of incremental cost were evaluated:

- (a) The **incremental cost annex reporting**, in terms of its quality and compliance to GEF guidelines (in particular the incremental cost annex);
- (b) The process of **incremental cost assessment**, in terms of its operational approach, conduct and content (the process of conducting the incremental cost assessment); and
- (c) The **process of negotiation** according to who is involved and what is negotiable/negotiated at each of the key stages of project identification, preparation and design.

2. The management response has been prepared by the GEF Secretariat in consultation with the Implementing and Executing Agencies. We generally agree with the conclusions and recommendations of the evaluation. The GEF is entering a new replenishment period with a set of policy recommendations for implementation. The GEF focal areas are in the process of finalizing their strategies for the fourth replenishment period with a clear presentation of strategic objectives and expected outcomes from GEF-supported interventions. It is appropriate and timely that the discussion on the incremental costs is integral part of this process. Furthermore, the implementation of the resource allocation framework (RAF) in the biodiversity and climate change focal areas presents new ways of dealing with incremental costs since the RAF pre-allocates GEF funding to countries for a 4-year period. The conclusions and recommendations of the Evaluation will provide the basis for a more pragmatic, strategic and cost-effective application of the incremental cost principle in GEF interventions.

Conclusions

3. We agree with the overall conclusion emerging from the four major findings of the evaluation that despite the incremental cost principle being alive and well applied in GEF projects, the current way of assessing the incremental costs for projects is confusing, non-transparent and adds very little value to project design, documentation and implementation. Of special concern is the fact that even in the GEF entities, the understanding of the concept and principles of the incremental cost is weak, and that diverse views exist.

Conclusion 1: The principle of incremental funding is alive and well in GEF projects

4. The incremental cost principle is fundamental to the GEF. Operational Principle 2 of the GEF Operational Strategy (1996) states that “the GEF will provide ... funding to meet the agreed incremental costs of measures to achieve the agreed global environmental benefits”. We agree with the Evaluation’s finding that all projects approved by the GEF Council (FSP) and CEO (MSP) are consistent with the GEF Operational Strategy and GEF criteria, including the presentation of global environmental benefits and the associated incremental costs. While we agree that there should be no blueprint on how to calculate these costs, the incremental reasoning provided for the presentation of costs for activities associated with the project’s global environmental benefits and the approval of projects by the Council and the CEO.

Conclusion 2: There remains weak understanding and much confusion about incremental cost concepts and procedures

5. We agree with the Evaluation’s finding that there is great variation in understanding the concepts and principles underlying incremental costs by the various stakeholders in GEF projects, and widely differing interpretations of the role of incremental cost assessment in project conceptualization, design and implementation. Despite numerous attempts to develop a formal approach to calculate the incremental costs for GEF projects, as of today, no such one-fits-all approach has been developed. Focal areas have developed their own rational based on the agreed global environmental benefits and identified related eligible activities for GEF support. While this approach has been accepted by the Council for some focal areas, other focal areas, because of their nature and focus face the challenge of defining global environmental benefits. In these cases, the GEF inter-agency task forces have made efforts to provide focal area-specific guidance for international waters, climate change (adaptation) and land degradation. There is need for simplifying the process and defining a pragmatic way for applying the incremental cost principle to GEF operations that is applicable to all GEF focal areas.

6. The weak understanding and related confusion on incremental costs can also be associated with the lack of targeted GEF outreach activities that would inform stakeholders at all levels about the application of the GEF operational principles to GEF operations. A GEF wide corporate outreach program needs to be designed that will provide stakeholders with operational information useful for engaging with the GEF in from of a transparent and effective dialogue. This is of particular importance during GEF-4 since countries will be more proactively engaged in operational decisions related to biodiversity and climate change because of the RAF.

Conclusion 3: Most project documents register low quality and compliance when measured against GEF requirements for incremental cost assessment and reporting

7. In GEF interventions, the incremental cost principle is currently applied through two major components: incremental reasoning (qualitative presentation of global environmental benefits) and incremental cost assessment (quantitative presentation of costs to achieve these benefits in form of the incremental cost annex). We concur with the finding that the quantitative assessment of the incremental costs for activities leading to global environmental benefits is in many cases of limited quality. As mentioned before, we also agree that each focal area has

different areas of emphasis, strength and weakness when carrying out incremental cost assessment. Since the incremental cost assessment is activity-based, many projects have encountered the problem that a strict division of activities into those creating global environmental and those leading to sustainable livelihood benefits is not feasible and in most cases, counterproductive to the idea of mainstreaming. This is especially true for projects working in production landscapes. Hence, these projects use a more pragmatic approach for agreeing on the incremental costs: cost-sharing.

8. The observation of low quality and compliance against GEF requirements has to be seen in the context of a GEF that has evolved over the past 12 years while most of the requirements have not been adapted to these changed conditions. What might be a feasible approach of calculating incremental costs in a technology-based project in the climate change focal area, cannot be applied in a project dealing with natural resources management, where other dynamics and interactions are imminent.

9. The GEF incremental cost guidelines that lay out the background to incremental cost assessment and the requirements for annex reporting in project documents are rarely used because they do not reflect the evolved types of projects the GEF is financing today. As mentioned, the focal areas have adopted their own, often more pragmatic, approaches to the application of the incremental cost principle. Hence, we support the call by the Evaluation for commonly-accepted “best practice” for incremental cost assessment for each focal area but not for the entire GEF system. The suggestion of a blue print for incremental cost assessment does not reflect today’s diverse nature of GEF interventions.

10. It is important to note that the Evaluation did not find that “weak understanding” of the incremental cost concept and “weak quality” for incremental cost assessment adversely affected the overall performance of any focal area portfolio and the GEF in general.

Conclusion 4: As currently applied, incremental cost assessment and reporting do not add value to project design, documentation and implementation

11. We take note of the Evaluation’s findings that complying with minimum requirements for incremental cost reporting does not influence the quality of a project. We agree that incremental reasoning at the concept phase and clear identification of global environmental benefits influences the quality of the project. We strongly believe that if the incremental reasoning and related discussion on global environmental benefits with key stakeholder groups is seen as a negotiation process, there will be a stronger sense of ownership and realism when it comes to defining expected project results. We agree that the quantitative assessment is not the appropriate platform for stakeholders to discuss the design of a GEF project. We also acknowledge that in many cases, there is disconnect between the incremental reasoning and the incremental cost assessment.

12. We concur with the view of the Evaluation that in the majority of cases, the incremental cost annex does not present new information or insights. It summarizes and often repeats the information related to the incremental reasoning contained in the main text of the project

document. We agree that this brings into question its utility as a stand-alone component of the project document.

13. We also agree with the conclusion that there is a fundamental mismatch between the requirement that GEF funds are used to cover the “future *economic* burden on the country” of securing global environmental benefits, versus the *financial* cost estimates that are actually provided in the incremental cost annex and matrix. In practice, it is the short-term costs of direct project expenditures (not the future economic burden or opportunity costs to a country), expressed at market prices (not at adjusted economic prices), that are calculated in the incremental cost assessment and represented in the matrix.

Recommendations

Recommendation 1: Incremental cost assessment and reporting should be dropped as requirements for GEF projects

Recommendation 2: Incremental reasoning in project objectives and design should be acknowledged and recognized, in particular at the project concept stage, during implementation and at completion

Recommendation 3: The process towards better identification of global environmental benefits needs to be strongly supported, including improved dissemination and awareness raising on focal area strategic priorities and objectives.

14. The GEF Secretariat in principle agrees with the three closely interlinked recommendations and finds that the suggested concrete steps will allow the GEF to define a more pragmatic, strategic, and cost-effective approach to incremental costs. This approach should be rooted in the incremental reasoning for the proposed intervention and the Council approved focal area objectives and strategies.

Conclusions and Next Steps

15. We would like to thank the GEF Evaluation Office for having undertaken this very important evaluation. The conclusions and recommendations of the Evaluation will provide a good basis to propose to Council a more pragmatic, strategic and cost-effective approach to incremental costs that is consistent with the GEF Instrument and the GEF Operational Strategy.

16. The various findings of the Evaluation all converge into one single overall conclusion: the current way of applying the incremental cost principle to GEF operations is non-transparent, costly and confusing; it does not reflect the changed nature of the GEF and its close relationship to the global sustainable development agenda. Over the last 10 years, the GEF has evolved from an entity focusing on protecting the global environment to a catalyser that builds partnerships for mainstreaming global environmental concerns into the sustainable development agenda of countries. The GEF requirements, however, have not adapted to these changed circumstances. Given the changed circumstances and need for pragmatism and transparency, we think that no gain would be achieved by developing GEF guidelines for calculating the incremental costs of GEF interventions. We therefore agree with the recommendation of the Evaluation that the time

has come to rethink and reformulate GEF requirements concerning incremental cost processes and methodologies, while maintaining the core principle and underlying rationale of incremental reasoning.

17. The GEF Secretariat, together with the GEF agency partners, recommends to Council a pragmatic, strategic, and cost-effective approach to incremental costs that is rooted in dialogue with client countries on the potential for delivering global environmental benefits in interventions promoting the sustainable development agenda of countries. Strategic priorities for each focal area approved by the GEF Council will be fully taken into account. The following approach to incremental costs in GEF interventions is proposed:

- (a) Incremental reasoning in project objectives and design, in form of a dialogue with the countries at the project concept stage, during implementation and at completion.
 - (i) What are planned and/or ongoing regional/national/local programs addressing the identified problem? What is the national investment into these programs?
 - (ii) What is the value added by involving the GEF? What components are missing or needed to address more effectively global environmental concerns in these programs?
 - (iii) What are the expected global environmental benefits?
- (b) Strategic reasoning for the project in the GEF focal area context.
 - (i) How does the project fit the approved focal area strategy/ies?
 - (ii) How does the project contribute to the identified targets for the focal area performance?

18. In addition, the GEF will develop an outreach program on operational issues that will facilitate the dissemination and awareness raising on agreed global environmental benefits, focal area strategic priorities and objectives. This will enable countries to fully participate in the dialogue on negotiating the agreed incremental costs of achieving/optimizing global environmental benefits in GEF-supported interventions.

19. The GEF Secretariat, together with the GEF agency partners will meet in the coming months to refine the proposed new approach to incremental costs and develop a related outreach program on operational issues. A proposal will be presented to the Council for review at its June 2007 meeting.