



GREEN
CLIMATE
FUND

Further Development of the Initial Investment Framework: Sub-Criteria and Methodology

GCF/B.09/07

23 February 2015

Meeting of the Board

24-26 March 2015

Songdo, Republic of Korea

Agenda item 11

Recommended action by the Board

It is recommended that the Board:

- (a) Take note of the information presented in document GCF/B.09/07 *Further Development of the Initial Investment Framework: Sub-Criteria and Methodology*; and
- (b) Adopt the draft decision presented in Annex I to this document.

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Further Development of the Initial Investment Framework: Sub-Criteria and Methodology

I. Introduction

1. The Board, through its decision B.07/06, adopted the initial investment framework of the Green Climate Fund.
2. At the same meeting, the Board requested the Investment Committee to submit the following for consideration at the next Board meeting, with technical support provided by the Secretariat and other stakeholders and taking into consideration recommendations made by the Private Sector Advisory Group, before the Fund approves funding proposals:
 - (a) Definitions for activity-specific sub-criteria and a set of activity-specific indicators, taking into account the Fund's initial investment framework, its initial result areas and initial results management framework, and decisions B.05/03, B.05/05 and B.06/07, as well as subsequent decisions on additional result areas for adaptation;
 - (b) Minimum benchmarks for each criterion, taking into account the best practices of other institutions; and
 - (c) Identification and comparison of methodologies that enable the Secretariat to assess the relative quality and innovativeness of comparable proposals in comparable circumstances, including through a survey, for the application of the sub-criteria mentioned in paragraph 2 (a) above in the selection of proposals (decision B.07/06, paragraph (c)).
3. The Board also requested the Secretariat to develop methodologies for the selection of programmes and projects that best achieve the Fund's objectives as stated in decision B.07/03.
4. The purpose of this document is to outline the elements as defined in paragraphs 2 (a)–(c) and 3 above.
5. Additionally, the further development of the investment framework is intended to achieve the following objectives:
 - (a) Signal as clearly as possible to countries, accredited entities, project developers and other stakeholders what kind of projects or programmes the Fund seeks to finance;
 - (b) Enable efficient project and programme funding proposal preparation;
 - (c) Enable the Secretariat and Technical Assessment Panel (TAP) to make comparable assessments in an open and transparent manner; and
 - (d) Enable the Board to be clear on what basis the Secretariat and TAP are making their recommendations to the Board for a funding decision.
6. This document is prepared under the guidance of the Investment Committee. It has benefited from inputs and feedback by other Board Members, the Private Sector Advisory Group, civil society organizations and private sector representatives.
7. Following the Investment Committee's guidance, a call for public input was issued in August 2014. Responses from institutions of both developing and developed countries were received, carefully reviewed and incorporated into the document. To this end, consultation calls were held to further understand the received inputs and feedback. All written responses were compiled and posted on the Fund's website.
8. As of the publication date of this document, the Investment Committee has not yet reached consensus on this document, particularly on the proposed assessment methodology.

Therefore, two assessment methodology options are presented in Annex III.A and Annex III.B, respectively, and also reflected in the proposed draft decision of the Board (see Annex I) for the Board's consideration.

II. Activity-specific sub-criteria and indicative assessment factors

9. In response to the decision mentioned in paragraph 1 above, the initial activity-specific sub-criteria are defined taking into account the Fund's initial investment framework, its initial result areas and initial results management framework, and other relevant decisions.

10. Annex II outlines the definitions of the initial activity-specific sub-criteria, which apply to both mitigation and adaptation. In cases where they are only applicable to mitigation or adaptation, it is clearly indicated. Furthermore, the proposed activity-specific sub-criteria will only be applied when appropriate and applicable in the context of each specific funding proposal.

11. Annex II also introduces indicative assessment factors (including indicators) for the investment sub-criteria. The indicative assessment factors seek to provide clarity on how the sub-criteria could be assessed and respond to the Board's request for activity-specific indicators. For the sub-criteria that are suitable for quantitative analysis, indicators are defined. For the sub-criteria that are qualitative by nature, qualitative assessment factors are identified.

12. The indicative assessment factors are not exhaustive and will continue to be improved over time as experience is gained and lessons are learned. Not all indicative assessment factors are applicable to all activities, and the funding proposal should therefore focus on analysing and responding to the factors that are relevant to that proposal and the country context and priorities.

III. Identification and comparison of assessment methodologies

13. In order to draw upon the design and practices of other climate funds and international financial institutions, the following climate funds and financial institutions have been consulted or surveyed: the Adaptation Fund (AF), the Climate Investment Funds (CIF), the Global Environment Facility (GEF) (including the Least Developed Countries Fund (LDCF) and Special Climate Change Fund (SCCF)), the African Development Bank (AfDB), the Inter-American Development Bank (IDB) and the World Bank. Their respective assessment methodologies were identified and analysed, the results of which are shown in Annex IV, Tables 1 and 2.

14. Table 1 in Annex IV shows a summary of the overall assessment methodologies of the other climate funds and international financial institutions listed in the previous paragraph. In the table, four elements are considered and additional comments are provided as needed. The four elements are as follows:

- (a) Whether or not the organization uses specific and separate investment or review criteria for mitigation and/or adaptation projects;
- (b) Whether or not the organization's project assessment uses primarily quantitative or qualitative investment, or review criteria in assessing a project;
- (c) Whether or not the organization assigns an overall project score; and
- (d) Whether or not a fully competitive selection process is used.

15. Table 2 in Annex IV shows a summary of assessment levels, criteria and benchmarks used by these funds or institutions (listed in paragraph 13 above). In the table, the following four elements are considered:

- (a) What level of detail the organization uses in order to evaluate project proposals, equivalent to the Fund's initial investment framework criteria and sub-criteria;
 - (b) Whether or not the organization uses rating or scaling as an outcome of the assessment, and at what level;
 - (c) Whether or not the organization applies the investment criteria based on minimum benchmarks; and
 - (d) Whether or not the organization assigns a weight or relative value to the investment criteria.
16. The incremental cost approach, used by the Multilateral Fund for the Implementation of the Montreal Protocol and the GEF, and eligibility criteria were also analysed as part of the research process. Annex V contains a detailed discussion of these concepts and how they each relate to the initial investment framework.

IV. Findings

17. The main findings based on the research laid out in the previous section and Annex IV are as follows:
- (a) Specific and separate criteria are used for mitigation and adaptation, for all of the climate funds consulted;
 - (b) In most cases, a combination of quantitative and qualitative methods is used to assess funding proposals. Qualitative evaluations are often supplemented with quantitative analysis in relevant areas and under specific circumstances;
 - (c) Weighting systems are generally not used by climate funds or international financial institutions. Among the funds and institutions surveyed, only the CIF private sector set-aside programmes piloted weighting systems in proposal selections;
 - (d) Minimum benchmarks are used to a limited extent for assessing specific aspects (cost-effectiveness, economic and financial rate of return or development effectiveness). Under these circumstances, minimum benchmarks function more as points of reference and managerial discretion is applied. For instance, projects with a rate of return lower than the hurdle rate may be approved if they have high transformational impact; and
 - (e) Rating or scaling is sometimes used to indicate the extent to which the proposal performs against each of the criteria. It is consistently conducted at the criteria level.
18. In addition to the findings presented above, certain technical challenges arise in the development of potential activity-specific sub-criteria, indicators and minimum benchmarks to assess project proposals.
19. The first challenge is to establish quantitative indicators for each criterion or sub-criterion across the initial investment framework. Some criteria or sub-criteria lend themselves to quantitative indicators with relative ease. For example, emissions reductions and renewable-energy installed capacity can be quantified. In other cases, particularly for those criteria that are qualitative by nature, the task is significantly more complex.
20. The second technical challenge is to establish benchmarks. Benchmarks are meant to provide a deeper level of quantitative detail and comparability across funding proposals. Establishing these benchmarks is technically difficult given the wide range of activities across different sectors, technologies, countries, development levels and a variety of other factors. When used as a point of reference for minimum requirements under specific circumstances, benchmarks can, however, be a useful technical tool in project assessment.

21. The survey and consultations with other funds and institutions lead to the following three key conclusions:

- (a) First, the initial investment framework as currently designed, including the criteria, coverage area, proposed activity-specific sub-criteria and indicative assessment factors, is comprehensive and consistent with the practices of the funds and institutions described in Tables 1 and 2 in Annex IV. The investment framework should remain strategic and flexible in the face of changing market conditions, fast technological development and varying country circumstances;
- (b) Second, the common practice in other funds and institutions is to define several high-level review criteria and a set of primarily qualitative questions. Quantitative indicators are then identified where feasible and applicable. Assessment at the criteria level provides a higher level of comparability and consistency across a diverse range of funding proposals. It is also consistent with the practice of other institutions. Criteria-level assessments apply to all funding proposals, unlike assessments at the sub-criteria level, where only some sub-criteria are applicable and relevant for a given funding proposal (for example, mitigation-specific sub-criteria). Criteria-level assessment, enriched where applicable by sub-criteria data, therefore represents a balanced approach that streamlines both the proposal development and assessment processes while facilitating good quality and comparable and consistent assessment;
- (c) Third, implementation experience will provide the best source of information to test the design of the investment framework and to further improve it over time. The Fund will be a scalable, flexible and continuously learning institution in line with paragraph 3 of the Governing Instrument (GI), and the investment framework should also reflect these features.

22. Finally, the analysis in Annex V of eligibility and the incremental cost approach yields two key additional conclusions. For eligibility, the analysis finds that the six investment criteria adopted in decision B.07/06, along with the further development of the framework set out in this document, define the eligibility of proposals for funding consideration.¹ Paragraph 35 of the GI stipulates which countries are eligible to receive resources from the Fund (i.e. developing country Parties to the Convention) and the project costs that can be supported by the Fund (i.e. agreed full and agreed incremental costs). Eligibility as defined in the GI therefore relates to countries in general and not to proposals seeking possible funding, and does not imply that the Fund should establish eligibility criteria for assessing funding proposals.

23. With regard to the incremental cost approach, the analysis finds that incremental cost is not an applicable concept that the Fund should apply globally across all its investments, and a broader approach is needed. The investment framework adopted in decision B.07/06, together with its further developments, including the sub-criteria and indicative assessment factors contained in this document, provide a comprehensive and robust method of assessing funding proposals. It suits a broad range of investments, which allows for more flexibility and wider applicability, and also encompasses the notion of eligibility criteria and incremental cost.

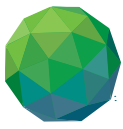
V. Proposed assessment methodology

24. Two assessment methodology options, labelled option A and option B, are proposed in Annex III.A and Annex III.B, respectively. They provide guidance on how the investment

¹ The indicative minimum benchmarks proposed in Annex III.A further develop and operationalize the concept of a proposal's eligibility for further funding consideration.

framework will be applied in assessing funding proposals. Both options reflect the analysis, research and lessons learned from other funds and institutions. They differ in two key respects:

- (a) The use of indicative minimum benchmarks; and
 - (b) The application of a scaling system to assess the investment criteria.
25. The comparison of assessment methodologies has found that some funds and institutions use indicative minimum benchmarks to set minimum requirements, while others do not to maintain greater flexibility (see Table 2 in Annex IV). Option A and option B reflect these two different approaches.
26. Similarly, some funds and institutions use a rating or scaling system, which is only applied at the criteria level, whereas others do not. Assigning a scale (low, medium or high) or rating for each investment criterion can provide an indication of the extent to which the proposal expects to perform against the criteria (option A). Not assigning a scale or rating makes the assessment rely more on narratives and qualitative judgment (option B).
27. The assessment methodology in option A begins with several indicative minimum benchmarks, which are intended to give an early indication of whether the funding proposal broadly aligns with the Fund's investment criteria. The indicative minimum benchmarks cannot solely determine whether a proposal should or will be approved. Instead, they represent the minimum requirements that the proposals should meet under normal circumstances in order to become eligible for further funding consideration. The application of indicative minimum benchmarks in relevant and applicable areas is in line with the practice of some institutions.
28. Under the assessment methodology in option A, investment criteria are also individually assigned a scale of low, medium or high. The rationale for these scalings will be provided.
29. The assessment methodology in option B does not include indicative minimum benchmarks as part of the assessment methodology, nor does it apply a scale (low, medium or high) to the investment criteria. It is otherwise identical to option A. Option B provides more flexibility in assessing proposals, particularly in cases where proposals perform unevenly across investment criteria. For example, the paradigm shift potential may be very high for a funding proposal while the co-financing ratio is below the minimum benchmark. Under the assessment methodology in option A, this funding proposal could only proceed for further funding consideration on an exceptional basis.
30. Under both assessment methodology options, funding proposals should address only the relevant activity-specific sub-criteria and indicative assessment factors, which are intended to complement one another and provide additional analytical depth beyond the indicative minimum benchmarks. Activity-specific sub-criteria and indicative assessment factors, as noted in a previous section, build on the investment criteria and coverage areas as adopted in decision B.07/06. They seek to add clarity and a more granular interpretation of the higher-level investment criteria.
31. Quantitative analysis, which the research in Annex IV concludes is an important part of funding proposal assessment in specific and relevant circumstances, should be incorporated wherever it can strengthen the funding proposal.
32. Accredited entities would be expected to demonstrate in their funding proposals how the project/programme performs against the investment criteria, applicable activity-specific sub-criteria and indicative assessment factors. Accredited entities may refer to the Fund's online Appraisal Toolkit (to be developed) for guidance on development of funding proposals.
33. When the analysis and documentation have been completed and compiled, the Secretariat will submit to the Board or approving authority for a funding decision. The Board or approving authority will receive the full documentation package and take the funding decision.



34. Based on the analysis and findings outlined in the previous section, as well as the rationale for the proposed methodologies presented above, the draft decision is prepared and presented in Annex I for the Board's consideration.

Annex I: Draft decision of the Board

The Board, having reviewed document GCF/B.09/07 *Further Development of the Initial Investment Framework: Sub-Criteria and Methodology*:

- (a) Adopts the initial activity-specific sub-criteria and indicative assessment factors contained in Annex II, which take into account the Fund's initial investment framework, the Fund's initial result areas and initial results management framework, and other relevant decisions, with the understanding that any national, economic, and sector-wide sub-criteria can be used only at the discretion of the recipient countries;
- (b) Adopts the initial assessment methodology outlined in [Annex III.A] [Annex III.B], which should be used by the Secretariat and the Technical Advisory Panel to conduct technical assessments of funding proposals;
- (c) Recognizes that the application of the investment framework in conducting the ex-ante technical assessment of a funding proposal will involve a degree of qualitative judgement and, in certain relevant and applicable areas, quantitative analysis. It will also take into account varying country needs, circumstances and capacities, sectoral and technological contexts, as well as the level of funding being proposed relative to the expected outcomes; and
- (d) Recognizes that these activity-specific sub-criteria, indicative assessment factors [and indicative minimum benchmarks] are not necessarily final and exhaustive, and will continue to be improved upon, over time, as experiences are gained and lessons are learned through the operations of the Fund and good practices of similar operations elsewhere.

Annex II: Initial investment framework: activity-specific sub-criteria and indicative assessment factors

The accredited entity will develop its funding proposal with due consideration of the investment criteria and the applicable and relevant activity-specific sub-criteria and indicative assessment factors. In the formulation of the proposal, the accredited entity is expected to respond to all six of the investment criteria but only the applicable and relevant sub-criteria and indicative assessment factors. Not all activity-specific sub-criteria and indicative assessment factors will be applicable or relevant for every proposal.

Table 1: Activity-specific sub-criteria and indicative assessment factors

Criterion	Definition	Coverage area	Activity-specific sub-criteria	Indicative assessment factors (including indicators) ¹
Impact potential	Potential of the programme/project to contribute to the achievement of the Fund's objectives and result areas	Mitigation impact	Contribution to the shift to low-emission sustainable development pathways	<p>Expected tonnes of carbon dioxide equivalent (t CO₂ eq) to be reduced or avoided (PMF-M Core 1);²</p> <p>Degree to which activity avoids lock-in of long-lived, high-emission infrastructure;</p> <p>Expected increase in the number of households with access to low-emission energy;</p> <p>Expected increase in the number of small, medium and large low-emission power suppliers (PMF-M 6.0 and related indicator(s)), and installed effective capacity;</p> <p>Expected decrease in energy intensity of buildings, cities, industries and appliances (PMF-M 7.0 and related indicator(s));</p> <p>Expected increase in the use of low-carbon transport (PMF-M 8.0 and related indicator(s));</p> <p>Expected improvement in the management of land or forest areas contributing to emissions reductions (PMF-M 9.0 and related indicator(s));</p>

¹ Indicative assessment factors include both quantitative indicators and qualitative factors.

² PMF-M Core 1 refers to a linkage with the first core indicator in the mitigation performance measurement framework, as contained in document GCF/B.08/07. PMF-A 5.0 refers to a linkage with the indicator 5.0 in the adaptation performance measurement framework and so on.

Criterion	Definition	Coverage area	Activity-specific sub-criteria	Indicative assessment factors (including indicators) ¹
				<p>Expected improvement in waste management contributing to emission reductions (e.g. the change in the share of waste managed using low-carbon strategies and/or the change in the share of waste that is recovered through recycling and composting); and/or</p> <p>Other relevant indicative assessment factors, taking into account the Fund’s objectives, priorities and result areas, as appropriate on a case-by-case basis.</p>
		Adaptation impact	Contribution to increased climate-resilient sustainable development	<p>Expected total number of direct and indirect beneficiaries (reduced vulnerability or increased resilience); number of beneficiaries relative to total population (PMF-A Core 1);</p> <p>Degree to which the activity avoids lock-in of long-lived, climate-vulnerable infrastructure;</p> <p>Expected reduction in vulnerability by enhancing adaptive capacity and resilience for populations affected by the proposed activity, focusing particularly on the most vulnerable population groups and applying a gender-sensitive approach;</p> <p>Number of people affected by climate change related natural disasters (including deaths);</p> <p>Number and type of institutions using climate information to inform policy and decision-making;</p> <p>Expected strengthening of institutional and regulatory systems for climate-responsive planning and development (PMF-A 5.0 and related indicator(s));</p> <p>Expected increase in generation and use of climate information in decision-making (PMF-A 6.0 and related indicator(s));</p>

Criterion	Definition	Coverage area	Activity-specific sub-criteria	Indicative assessment factors (including indicators) ¹
				<p>Expected strengthening of adaptive capacity and reduced exposure to climate risks (PMF-A 7.0 and related indicator(s));</p> <p>Expected strengthening of awareness of climate threats and risk-reduction processes (PMF-A 8.0 and related indicator(s)); and/or</p> <p>Other relevant indicative assessment factors, taking into account the Fund's objectives, priorities and result areas, as appropriate on a case-by-case basis.</p>
Paradigm shift potential	Degree to which the proposed activity can catalyse impact beyond a one-off project or programme investment	Potential for scaling up and replication, and its overall contribution to global low-carbon development pathways being consistent with a temperature increase of less than 2 degrees	<p>Potential for expanding the proposal's impact without equally increasing its cost base (scalability)</p> <p>Potential for exporting key structural elements of the proposal to other sectors, regions or countries (replicability)</p> <p>Level of contributions to global low-carbon development pathways, consistent with a temperature increase of less than 2 degrees, in the light of potential for scalability, replicability and impact on technology costs</p>	<p>Demonstration of a robust and convincing theory of change for replication and scale up</p> <p>Opportunities for scaling up the scope and impact of the intended project/programme without equally increasing the total costs of implementation</p> <p>Expected opportunities and the corresponding impact potential for replication of the proposed activities in the project/programme in other sectors, institutions, geographical areas or regions, communities or countries</p> <p>Description of how the project/programme contributes to global low-carbon development pathways, and how it is consistent with a temperature increase of less than 2 degrees, in terms of technology advancement, technology cost reduction, an innovative business model, etc.</p>
		Potential for knowledge and learning	Expected contribution to the creation or strengthening of knowledge, collective learning processes, or institutions	<p>Vision of the long-term goals, how they will be reached, and relevant measurable indicators of success</p> <p>Identification of key actors, milestones and opportunities for knowledge generation</p>

Criterion	Definition	Coverage area	Activity-specific sub-criteria	Indicative assessment factors (including indicators)¹
		Contribution to the creation of an enabling environment	<p>Innovativeness</p> <p>Sustainability of outcomes and results beyond completion of the intervention</p> <p>Mobilization of other relevant actors</p> <p>Market development and transformation</p>	<p>Opportunities for targeting innovative solutions, new market segments, developing or adopting new technologies, business models, modal shifts and/or processes</p> <p>Arrangements and provisions for long-term continuation of relevant outcomes and key relevant activities derived from the project/programme</p> <p>Expected potential to mobilize other relevant public, private and other actors at the local and/or national level with a view to enhancing the long-term success of the proposed project/programme</p> <p>Extent to which the project/programme creates new markets and business activities at the local, national or international levels</p> <p>Degree to which the activity will change incentives for market participants by reducing costs and risks, and eliminating barriers to the deployment of low-carbon solutions</p>
		Contribution to the regulatory framework and policies	Potential for strengthened regulatory frameworks and policies to drive investment in low-emission technologies and activities, promote development of additional low-emission policies, and/or improve climate-responsive planning and development	<p>Expected changes in the national/local regulatory or legal frameworks to systemically address investment in low-emission technologies and activities, development of low-emission policies, and improvement of low-emission planning and development</p> <p>Degree to which the activity shifts incentives or promotes mainstreaming of climate change activities into policies and regulatory frameworks and decision-making processes at national, regional and local levels, including private-sector decision-making</p>

		Overall contribution to climate-resilient development pathways consistent with a country's climate change adaptation strategies and plans	<p>Potential for expanding the proposal's impact without equally increasing its cost base (scalability)</p> <p>Potential for exporting key structural elements of the proposal to other sectors, regions or countries (replicability)</p>	<p>Opportunities for scaling up the scope and impact of the intended project/programme without equally increasing the total costs of implementation</p> <p>Expected opportunities and the corresponding impact potential for replication of the proposed activities in the project/programme in other sectors, institutions, geographical areas or regions, communities or countries</p>
Sustainable development potential	Wider benefits and priorities	Environmental co-benefits	Expected positive environmental impacts, including in other result areas of the Fund, and/or in line with the priorities set at the national, local or sectoral level, as appropriate	Positive environmental externalities can reasonably be expected through the implementation of the proposal in areas such as air quality, soil quality, conservation, biodiversity, etc.
		Social co-benefits	Expected positive social and health impacts, including in other result areas of the Fund, and/or in line with the priorities set at the national, local or sectoral levels, as appropriate	Potential for externalities in the form of expected improvements, for women and men as relevant, in areas such as health and safety, low-emission energy access to vulnerable groups, access to education, improved regulation and/or cultural preservation. These co-benefits may also derive from the mechanisms to be used in the implementation of the proposal and the social and political changes needed to implement them, such as the clarification of land tenure and enhanced participation in decision-making
		Economic co-benefits	Expected positive economic impacts, including in other result areas of the Fund, and/or in line with the priorities set at the national, local or sectoral level, as appropriate	Potential for externalities in the form of expected improvements in areas such as expanded and enhanced job markets, job creation for women and men (directly and indirectly in the technology cycle and management/finance roles), increased and/or expanded involvement of local industries; increased collaboration between industry and academia; growth of private funds attracted; contribution to an increase in productivity and competitive capacity; improved sector income-generating capacity, contribution to an increase in energy security; change in water supply and agricultural productivity in targeted areas, etc.

		Gender-sensitive development impact	Potential for reduced gender inequalities in climate change impacts and/or equal participation by gender groups in contributing to expected outcomes	Explanation of how the project activities will address the needs of women and men in order to correct prevailing inequalities in climate change vulnerability and risks
Needs of the recipient	Vulnerability and financing needs of the beneficiary country and population	Vulnerability of the country	Level of exposure of people, and/or social or economic assets or capital, to risks derived from climate change	Level of exposure to climate risks and the degree of vulnerability (e.g. particularly vulnerable countries, including least developed countries, small island developing States and African States)
		Vulnerable groups and gender aspects	Comparably high vulnerability of the beneficiary groups	Proposed project/programme supports groups that are identified as particularly vulnerable in national climate or development strategies, with relevant sex disaggregation
		Economic and social development level of the country and the affected population	Specific vulnerable groups (minorities, disabled, elderly, children, female heads of households, indigenous, etc.) addressed	Level of social and economic development of the target population compared to the average of the country
		Absence of alternative sources of financing	Opportunities for overcoming specific barriers to financing	Explanation of the existing barriers that create absence of alternative sources of financing and how they will be addressed
		Need for strengthening institutions and implementation capacity	Opportunities to address any lack of institutional and implementation capacity in the key or relevant institutions in the context of the proposal	Description of a specific plan for how key or relevant institutions' institutional and implementation capacity will be strengthened
Country ownership	Beneficiary country ownership of, and capacity to implement, a funded project or programme (policies, climate strategies and institutions)	Existence of a national climate strategy	Country has a current and effective national climate strategy or plan, nationally appropriate mitigation action (NAMA), national adaptation plan (NAP) or equivalent, as appropriate	Proposal addresses the country's existing and effective climate priorities and national, local or sectoral plans, and attracts sustained high-level political support in implementing countries
		Coherence with existing policies	Proposal has not been objected by the country's National Designated Authority (NDA) or focal point	Proposal received no objection by NDA or focal point in accordance with the Fund's no-objection procedure Proposal demonstrates coherence and alignment with one or more priority areas identified in the country's national

			Objectives are in line with priorities in the country's national climate strategy	<p>climate strategy, including in the context of NAMAs or NAPs, as appropriate and applicable</p> <p>Degree to which the activity is supported by a country's enabling policy and institutional framework, or includes policy or institutional changes</p> <p>Project/programme sponsor identified as a credible champion</p>
		Capacity of accredited entities or executing entities to deliver	Experience and track record of the accredited entity or executing entities in key elements of the proposed activity	Proponent demonstrates a consistent track record and relevant experience and expertise in similar or relevant circumstances as described in the proposed project/programme (e.g. sector, type of intervention, technology, etc.)
		Engagement with civil society organizations and other relevant stakeholders	Stakeholder consultations and engagement	Proposal has been developed in consultation with civil society groups and other relevant stakeholders, with particular attention being paid to gender equality, and provides a specific mechanism for their future engagement in accordance with the Fund's environmental and social safeguards (ESS) and stakeholder consultation guidelines. The proposal places decision-making responsibility with in-country institutions and uses national systems to ensure accountability
Efficiency and effectiveness	Economic and, if appropriate, financial soundness of the programme/project	Cost-effectiveness and efficiency regarding financial and non-financial aspects	<p>Financial adequacy and appropriateness of concessionality</p> <p>Cost-effectiveness (mitigation only)</p>	<p>Demonstration that the proposed financial structure (funding amount, financial instrument, tenor and term) is adequate and reasonable in order to achieve the proposal's objectives, including addressing existing bottlenecks and/or barriers</p> <p>Estimated cost per t CO₂ eq (defined as total investment cost/expected lifetime emission reductions) (PMF-M Core 2)</p> <p>Economic and other co-benefits vis-à-vis project cost</p>
		Amount of co-financing	Potential to catalyse and/or leverage investment (mitigation only)	Expected volume of finance to be leveraged by the proposed project/programme and as a result of the Fund's financing, disaggregated by public and private sources (PMF-M Core 3)

				<p>Co-financing ratio (total amount of co-financing divided by the Fund's investment in the project/programme)</p> <p>Potential to catalyse private- and public-sector investment, assessed in the context of performance on industry best practices</p> <p>Expected indirect/long-term low-emission investment mobilized as a result of the implementation of activity</p>
		Programme/project financial viability and other financial indicators	<p>Expected economic and financial internal rate of return</p> <p>Financial viability in the long run</p>	<p>Economic and financial rate of return with and without the Fund's support (i.e. hurdle rate of return or other appropriate/relevant thresholds)</p> <p>Description of financial soundness in the long term (beyond the Fund's intervention)</p>
		Industry best practices	Application of best practices and degree of innovation	<p>Explanations of how best available technologies and/or best practices, including those of indigenous people and local communities, are considered and applied</p> <p>If applicable, the proposal specifies the innovations or modifications/adjustments made based on industry best practices</p>

Annex III.A: Initial assessment methodology (option A)

Step 1: The Secretariat and the Technical Advisory Panel will assess the proposal's expected performance against the indicative minimum benchmarks using Table 1 below. Indicative minimum benchmarks can give an early indication of whether the funding proposal broadly aligns with the Fund's investment criteria. The benchmarks are to be considered as a point of reference and are expected to be met or exceeded under normal circumstances. The proposal's initial benchmark results and remarks should be documented within the funding proposal package.

Funding proposals that meet or exceed the indicative minimum benchmarks are considered eligible for further funding consideration, but do not guarantee that the proposal will receive funding. Conversely, a proposal that does not meet all of the applicable benchmarks may still be considered for further funding consideration on an exceptional basis, with convincing justification.

Table 1: Indicative minimum benchmarks for investment criteria

Investment criterion	Indicative minimum benchmark ¹	Results and remarks
Impact potential	<ul style="list-style-type: none"> Lifetime emission reductions at least 150,000 t CO₂ eq for proposals in least developed countries (LDCs), small island developing States (SIDS) and African States (mitigation only) Lifetime emission reductions at least 750,000 t CO₂ eq for proposals in all other developing countries (mitigation only) Number of direct beneficiaries at least 5,000 (adaptation only) 	
Paradigm shift potential	<ul style="list-style-type: none"> Potential of achieving scale up or replication is at least two times that of the proposed activity in the targeted area; or Significant contribution to the creation of enabling environments or regulatory framework(s) and policies that will lead to tangible and measurable climate results 	
Sustainable development potential	<ul style="list-style-type: none"> Significant level of co-benefits projected in at least two of the four following areas: environmental, social, economic or gender-sensitive development 	
Needs of the recipient	<ul style="list-style-type: none"> Clear evidence that the Fund's intervention addresses the needs of vulnerable people and groups (defined as the most vulnerable 75 per cent of the population in terms of exposure, sensitivity and adaptive capacity to climate change) for proposals in LDCs, SIDS and African States; Clear evidence that the Fund's intervention addresses the needs of vulnerable people and groups (defined as the most vulnerable 50 per cent of the population in terms of exposure, sensitivity and adaptive capacity to climate change) for proposals in all other developing countries; or Clear evidence that the Fund's intervention addresses the lack of alternative sources of financing or institutional capacity 	
Country ownership	<ul style="list-style-type: none"> No objection letter received from National Designated Authority; and Demonstration of alignment with a country's climate strategy or plan 	
Efficiency and effectiveness	<ul style="list-style-type: none"> Estimated cost per t CO₂ eq (defined as total investment cost/expected lifetime emission reductions) below US\$ 420 per t CO₂ eq for proposals in LDCs, SIDS and African States (mitigation only); Estimated cost per t CO₂ eq (defined as total investment cost/expected lifetime emission reductions) below US\$ 230 per t CO₂ eq for proposals in all other developing countries (mitigation only); Risk-adjusted financial rate of return above zero (applies to mitigation or private-sector proposals); and Ratio of crowding in additional financing at least 2:1 (applies to mitigation or private sector proposals). 	

¹ The quantitative indicative minimum benchmarks reflect the research done on the portfolios of other multilateral climate funds. They typically represent the fifth to tenth percentile of approved project or programme expected performance in a comparable portfolio. That is, 5-10 per cent of the approved projects or programmes in a comparable portfolio are expected to be below the minimum benchmarks.



Step 2: The Secretariat and the Technical Advisory Panel will each apply the investment criteria, applicable activity-specific sub-criteria and indicative assessment factors in reviewing the funding proposal, using qualitative judgement and conducting quantitative analysis where applicable and taking into account varying circumstances and sectoral and technological contexts.

Step 3: Based on the review results, the Secretariat and the Technical Advisory Panel will each assign a scale (low, medium or high) at the investment criteria level to reflect the extent to which the proposal expects to perform for each investment criterion. The assessment rationale for the assigned scale at the criteria level will be documented as “assessment findings”.

Table 2: Criteria-level scale and assessment findings

Investment criterion	Scale at criteria level (Low, medium or high)	Assessment findings
Impact potential		
Paradigm shift potential		
Sustainable development potential		
Needs of the recipient		
Country ownership		
Efficiency and effectiveness		
Assessment summary and recommendation:		

Step 4: The Secretariat will compile the full funding proposal documentation package,² including the Technical Advisory Panel’s assessment, and submit it to the Board or approving authority for consideration.

Step 5: The Board or approving authority will take the funding decision.

² The full funding proposal package contains the following documentation: the final funding proposal as submitted by the accredited entity; a summary of the second-level due diligence carried out by the Secretariat, including an assessment of compliance with safeguards and policies, performance of the project or programme against activity-specific criteria, and the Secretariat’s funding recommendation; and finally, the Technical Advisory Panel’s assessment regarding the performance of the project or programme against activity-specific criteria.



Annex III.B: Initial assessment methodology (option B)

Step 1: The Secretariat and the Technical Advisory Panel will each apply the investment criteria, applicable activity-specific sub-criteria and indicative assessment factors in reviewing the funding proposal, using qualitative judgement and conducting quantitative analysis where applicable and taking into account varying circumstances and sectoral and technological contexts.

Step 2: Based on the review results, the Secretariat and the Technical Advisory Panel will each assess the proposal’s expected performance for each investment criterion. The assessment rationale will be documented as “assessment findings”.

Table 1: Assessment findings for the investment criteria

Investment criterion	Assessment findings
Impact potential	
Paradigm shift potential	
Sustainable development potential	
Needs of the recipient	
Country ownership	
Efficiency and effectiveness	
Assessment summary and recommendation:	

Step 3: The Secretariat will compile the full funding proposal documentation package,¹ including the Technical Advisory Panel’s assessment, and submit it to the Board or approving authority for consideration.

Step 4: The Board or approving authority will take the funding decision.

¹ The full funding proposal package contains the following documentation: the final funding proposal as submitted by the accredited entity; a summary of the second-level due diligence carried out by the Secretariat, including an assessment of compliance with safeguards and policies, performance of the project or programme against activity-specific criteria, and the Secretariat’s funding recommendation; and finally, the Technical Advisory Panel’s assessment regarding the performance of the project or programme against activity-specific criteria.

Annex IV: Identification and comparison of assessment methodologies

Table 1: Summary of overall assessment methodologies of project proposals

Fund or institution ¹	Mitigation & adaptation specific and separate	Quantitative or qualitative	Project scoring	Competitive selection	Comments
AF	Yes	Primarily qualitative	No	No	
CIF (regular)	Yes	Primarily qualitative	No	No	CIF (regular) refers to projects/programmes developed within the pilot countries' investment plans. Pilot country selection occurs before project/programme selection and is primarily quantitative and competitive.
CIF (private sector)	Yes	Both	Sometimes	Sometimes	CIF (private sector) refers to private-sector-dedicated and set-aside programmes. The Strategic Climate Fund set-aside programmes adopt a competitive selection process with project scoring, while the assessment of Clean Technology Fund-dedicated programmes are primarily qualitative.
GEF	Yes	Primarily qualitative	No	No	GEF uses a resource allocation system, which is based on country-level quantitative analysis.
AfDB	N/A	Primarily qualitative	No	No	
IDB	N/A	Both, mainly qualitative	Limited	No ²	The Development Effectiveness Matrix for each project has a minimum required score. If this minimum threshold is not reached, the project needs to be restructured in cooperation with the beneficiary country.
World Bank	N/A	Both, mainly qualitative	No	No	Economic analysis is usually quantitative; other criteria may vary. Funds are pre-allocated to countries but there is considerable flexibility in reallocating money.

¹ The full names of the funds and institutions in Table 1 are as follows (in the order presented): Adaptation Fund, Climate Investment Funds, Global Environment Facility, African Development Bank, and the Inter-American Development Bank.

² Any investment (loan) needs to be requested by the beneficiary country. In the case of loan operations, investments are included in a multi-year pipeline (country strategies) negotiated by the IDB and the respective finance ministry and is assigned a classification (A or B) on the basis of the relevance for the country and time of presentation to the Board of Executive Directors of the IDB. Annual programming exercises reprioritize (using A or B classification) both private- and public-sector projects depending on country needs.

Table 2: Summary of assessment levels, criteria and benchmarks

Fund or institution	Level of assessment	Rating/ scaling, level	Minimum benchmarks used	Weighting on criteria level	Comments
AF	Coverage area, sub-criteria	No	No	No	
CIF (regular)	Coverage area, sub-criteria	No	Yes, in suitable areas	No	Benchmarks are defined for CTF in two specific areas: cost (US\$/CO ₂ eq) and coal and gas power investments.
CIF (private sector) ³	Sub-criteria	Yes, at criteria level	Yes, in suitable areas	Both* (see comments column)	Criteria weighting and rating applies to the Strategic Climate Fund private-sector set-aside programmes.
GEF	Coverage area, sub-criteria	No	No	No	Assessment is qualitative and indicators for individual criterion are not consistently defined.
AfDB	Sub-criteria	Limited, at criteria level	No	No	Rating applies for risk assessment only. For private-sector operations, a partially quantitative Additionality and Development Outcome Assessment is applied.
IDB	Sub-criteria	Limited, at criteria level	Yes, in suitable areas	No	- Development effectiveness uses rating and minimum threshold. - Rating applies for financial risk, and environmental and social risks.
World Bank	Sub-criteria	No	Yes, in suitable areas	No	Minimum benchmarks are used for economic and financial rate of return and cost-effectiveness, but managerial discretion is applied. Projects with negative returns may be approved if they have a high transformational impact.

³ See <[https://www.climateinvestmentfunds.org/cif/sites/climateinvestmentfunds.org/files/Private sector operational guidelines revised OCT2012.pdf](https://www.climateinvestmentfunds.org/cif/sites/climateinvestmentfunds.org/files/Private%20sector%20operational%20guidelines%20revised%20OCT2012.pdf)>.

Annex V: Eligibility and incremental cost

I. Introduction

1. This annex seeks to place the Fund's financing approach, as outlined in the Governing Instrument (GI) and the Board's decisions on the initial proposal approval process (decision B.07/03), and an Initial investment framework (decision B.07/06), within the context of the approaches taken by other climate funds such as the Global Environmental Fund (GEF) and the Multilateral Fund for the Implementation of the Montreal Protocol.

2. The issues under review in this background paper are:

- (a) Guidance provided by the GI and prior Board decisions concerning eligibility; and
- (b) A review of the economic analysis of full and incremental costs in climate financing, and how they relate to the Fund's approved investment framework.

II. Eligibility: guidance from Governing Instrument and Board decisions

3. Paragraph 35 of the GI (Section V, part B) states:

B. Eligibility

All developing country Parties to the Convention are eligible to receive resources from the Fund. The Fund will finance agreed full and agreed incremental costs for activities to enable and support enhanced action on adaptation, mitigation (including REDD-plus), technology development and transfer (including carbon capture and storage), capacity-building and the preparation of national reports by developing countries.

4. This paragraph of the GI stipulates which countries are eligible to receive resources from the Fund (i.e. developing country Parties to the Convention) and the project costs that can be supported by the Fund (i.e. agreed full and agreed incremental costs). Eligibility as defined in the GI therefore relates to countries in general and not to proposals seeking possible funding. The GI moreover does not imply that the Fund should establish eligibility criteria for assessing funding proposals. Eligibility of funding proposals has therefore been addressed as part of the investment framework.

5. In May 2014, the Board adopted its initial proposal approval process (decision B.07/03), and an initial investment framework (decision B.07/06). The latter decision reflects the Fund's theme/activity-based resource allocation system as laid out in decision B.05/05. The investment framework provides six high level investment criteria against which funding proposals will be assessed.

6. This Board document continues and deepens decision B.07/06 by defining sub-criteria for the six high-level investment criteria, and providing an assessment methodology used in the second-stage due diligence process to provide inputs to the Board for funding decisions. In essence, the six investment criteria adopted in decision B.07/06, together with its further development, including the sub-criteria and indicative assessment factors contained in this document, define the eligibility of proposals for funding consideration.¹

¹ The indicative minimum benchmarks proposed in Annex III.A further develop and operationalize the concept of a proposal's eligibility for further funding consideration.

III. Incremental cost

3.1 Definition of incremental cost

7. The concept of incremental cost has been used in two important climate funds: the Multilateral Fund for the Implementation of the Montreal Protocol (Montreal Protocol) and the GEF.

8. **Montreal Protocol definition:** While the Montreal Protocol does not explicitly define the concept of incremental cost, it has, over time, come to a clear understanding of how it should be applied. According to the United Nations Environment Programme (UNEP) report on the Montreal Protocol:²

The Protocol states that funding should be given on the basis of agreed 'incremental costs', but the Parties did not define this term, or suggest how it should be applied to projects as diverse as converting facilities manufacturing refrigerators, eliminating the use of a pesticide (methyl bromide) on farms, and producing public awareness materials. Over time, the Fund developed a clear definition of incremental cost, which, by and large, ensured that the entity undertaking the project at issue was left, at completion, in a financial sense, equivalent to where it was before the project was started. [...]

9. **GEF definition:**³ The GEF, on the other hand, articulates the following definition of the concept (from the GEF website on incremental costs):

GEF funds the 'incremental' or additional costs associated with transforming a project with national benefits into one with global environmental benefits; for example, choosing solar energy technology over coal or diesel fuel meets the same national development goal (power generation), but is more costly. GEF grants cover the difference or 'increment' between a less costly, more polluting option and a costlier, more environmentally friendly option.

10. **UNFCCC definition:**⁴ Perhaps the most comprehensive definition is contained in the 2006 UNFCCC Handbook (Box 1), which also provides clarifications of the terms "full costs" and "agreed costs":

Box 1. "Incremental", "full" and "agreed" costs in accordance with the Global Environment Facility

Although the Convention refers to "agreed full costs" and "agreed full incremental costs", it does not provide an operational definition of these terms, which is done by the GEF Council. These concepts have however been defined by the GEF. In its 1996 policy paper on incremental costs, the GEF provided basic definitions and criteria for "incremental costs", "agreed full costs" and "agreed full incremental costs". [...]

"Incremental costs" are the additional costs associated with transforming a project with national benefits into one with global environmental benefits. As stated in the Instrument for the Establishment of the Restructured GEF (1994), the GEF provides funding "to meet the agreed incremental costs of measures to achieve agreed global environmental benefits". Incremental costs have therefore to be identified in order to determine the share of project costs that would be eligible for funding from the GEF. [...]

"Agreed" means that the funded costs of a project are agreed upon in advance between the GEF and the country where the project takes place. [...]

² See <http://ozone.unep.org/Publications/MP_A_Success_in_the_making-E.pdf>.

³ Global Environment Facility Evaluation Office, *Evaluation of Incremental Cost Assessment*, (Washington, DC, Global Environment Facility, 2007).

⁴ UNFCCC (2006). *UNFCCC Handbook*, box 13.1.

The provision for “full” incremental costs involves two aspects: first, the incremental costs funded for a project are not to be diminished as a result of any additional domestic benefits that a project with global environmental benefits might yield in comparison with the baseline activity. Second, “every effort will be made to identify all the significant incremental costs and not just the most obvious ones”. The “agreed full costs” are to be funded for activities carried out in connection with Parties’ reporting obligations under the Convention. “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. [...]”

3.2 Limitations to the incremental cost methodology

11. In 2006 the GEF Evaluation Office performed an evaluation of the use of incremental costs in GEF projects, and published its findings and recommendations in a report.⁵ The report noted that funding for Montreal Protocol projects is based on the same incremental cost methodology approach as the GEF’s, and presumably many of the findings would also apply.

12. The report concludes that the application of the concept has been open to differing interpretations and a lack of transparency. Key points from the report are as follows:

The original idea that it would be possible to develop a quantitative methodology that would be universally applicable and meet the ambitious goals of determining incremental cost and structuring its negotiation was clearly unrealistic. In reality, and as currently required and applied, incremental cost assessment has undermined (or at best, played little role in) the process of determining incremental cost in GEF projects. [...] There is no apparent value added from incremental cost assessment and annex reporting requirements as laid out by the GEF. (p. 8)

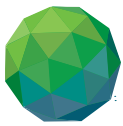
13. The GEF Evaluation Office identified a number of limitations of incremental cost assessment methodology (p. 32), which include:

- (i) Lack of transparency and clarity related to estimation methods; negotiation of incremental costs; problems in establishing baselines; and arbitrariness of the determination of incremental costs;
- (ii) Perception that incrementality is open to significant manipulation due to a lack of clear guidelines;
- (iii) Limited negotiation among stakeholders—primarily with recipient countries;
- (iv) Lack of understanding among countries of incremental cost assessment;
- (v) Lack of in-country expertise and capacity to carry out incremental cost assessment;
- (vi) Lack of guidelines; and
- (vii) Use of international incremental cost consultants, which creates an expert process and reduces participation.

14. It should be noted that while the methodology is also used under the Montreal Protocol, the application of the concept has, in this case, been considered to have been more successful, notably for the elimination of specific categories of ozone depleting substances. This is perhaps because of the more limited scope of Montreal Protocol interventions,⁶ which focus on two main

⁵ Global Environment Facility Evaluation Office, *Evaluation of Incremental Cost Assessment* (Washington, DC, Global Environment Facility, 2007).

⁶ The Montreal Protocol’s dedicated fund, the Multilateral Fund, has to “meet all agreed incremental costs to assist developing countries to meet the control measures of the Montreal Protocol for the phase-out of consumption and production of ozone depleting substances (ODS)”.



types of ozone depleting substances (ODS): chlorofluorocarbons and hydrochlorofluorocarbons. Montreal Protocol projects have focused primarily on phasing out these damaging pollutants, which are most commonly found in refrigerants and air conditioning.

IV. Application of full and incremental costs to mitigation and adaptation investments

4.1 Carbon dioxide abatement cost curves and incremental costs

15. The economic literature on the costs of climate change mitigation typically ranks investments according to increasing cost of abatement of carbon dioxide (CO₂), as measured in US\$ (or EUR) per tonne of CO₂ equivalent (t CO₂ eq) avoided compared to the 'business as usual' (BAU) scenario. Figure 1 provides one of the better known such curves, prepared by McKinsey and Co. The y axis provides the cost of CO₂ abatement as defined above, while the x axis provides the abatement potential of each ranked investment measured in gigatonnes of avoided carbon dioxide equivalent per year compared to the BAU scenario.

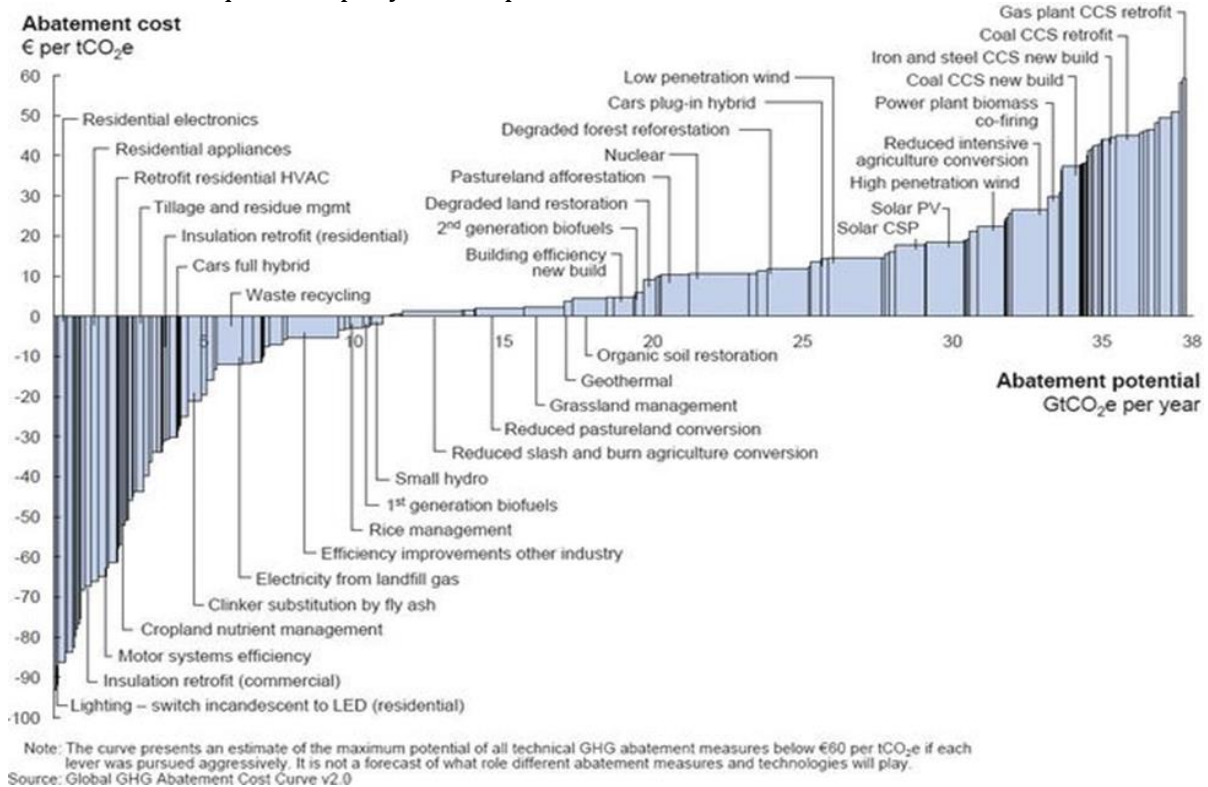


Figure 1: Marginal abatement curves by industry/sector

16. Abatement curves are essentially a graphical representation of the incremental costs for each type of investment, ranked by increasing cost of CO₂ abatement measured in US\$/t CO₂ eq per year. The curves provide additional information concerning the abatement potential of each type of investment if undertaken across the entire industry, at a global level, as well as the global abatement for any given abatement cost. ⁷

⁷ In mathematical terms, the global abatement potential for any abatement cost is the absolute value of the integral under the curve from -∞ to the abatement cost in question.

17. Abatement curves are useful from a macroeconomic point of view in determining, for any given required global CO₂ reduction level, the amount of investment that would be needed worldwide; which industries would be investment priorities (i.e. have the lowest abatement costs); and the marginal cost of avoided CO₂ eq at that reduction level. At the microeconomic level, they also provide very useful industry-wide or sector-wide benchmarks for incremental costs.

4.2 Mitigation: win-win and win-lose investments

18. Depending on where they lie on the cost curve, mitigation investments are termed as “win-win” or “win-lose”. In the case of win-win investments, both the global community and the investor benefit from the investment compared to the BAU scenario. In the case of win-lose investments, the global community benefits but the investor would bear an incremental cost compared to the BAU scenario.

- (a) **Win-win investments:** A review of the above abatement cost curve shows that around one-quarter to one-third of climate investments (in terms of abatement potential) yield a positive return for the investor even without taking into account broader climate benefits that accrue to the global community.⁸ Examples of such investments are insulation retrofits; improving the management of cropland nutrients; and micro-scale hydropower projects (see figure 1). Each of these investments would generate a positive return for the investor if they made the investment. The investments are not being undertaken in the BAU scenario despite their economic and financial attractiveness because of various kinds of market failure.

Such market failures include, inter alia:

- (i) Insufficient information on non-climate benefits which would accrue to the investor (e.g. insulation retrofits);
- (ii) Lack of market-based delivery mechanisms for the goods and services (e.g. management of cropland nutrients); and
- (iii) Financial instruments, both banks and capital markets, unable or unwilling to provide the needed long-term financing (e.g. micro hydro).

For these different reasons for market failure, the investment does not occur despite its economic attractiveness for the investor. It should be noted that for these investments, incremental cost as defined above is negative, i.e. an incremental benefit.

- (b) **Win-lose investments:** On the other hand, around two-thirds of CO₂ abatement investments, in terms of abatement potential, would cost more to the investor than the BAU alternative.⁹ For these win-lose investments, investors are undertaking the rational decision – in terms of their own interests at least – to forego the investment. The global community would benefit from the investment but the investor would incur an incremental cost if they were to undertake the investment compared to the BAU scenario. For the investment to occur therefore, it is necessary that an outside agent (e.g. the Fund) finance the incremental cost experienced by the investor, so that the return on their investment would be no worse than that of the BAU situation.

It can moreover be shown that in such win-lose situations, determining the required level of financing needed for a mitigation investment via its incremental cost, is mathematically equivalent to determining the required level of financing by means of restoring the rate of return on the investment to the investor’s hurdle rate. This latter

⁸ The industries lying on the left-hand side of the abatement curve.

⁹ Those industries lying on the right-hand side of the abatement curve.

approach is the one adopted by the Fund in its investment framework, under criterion 6 (efficiency and effectiveness, for those cases where the incremental cost concept makes sense.

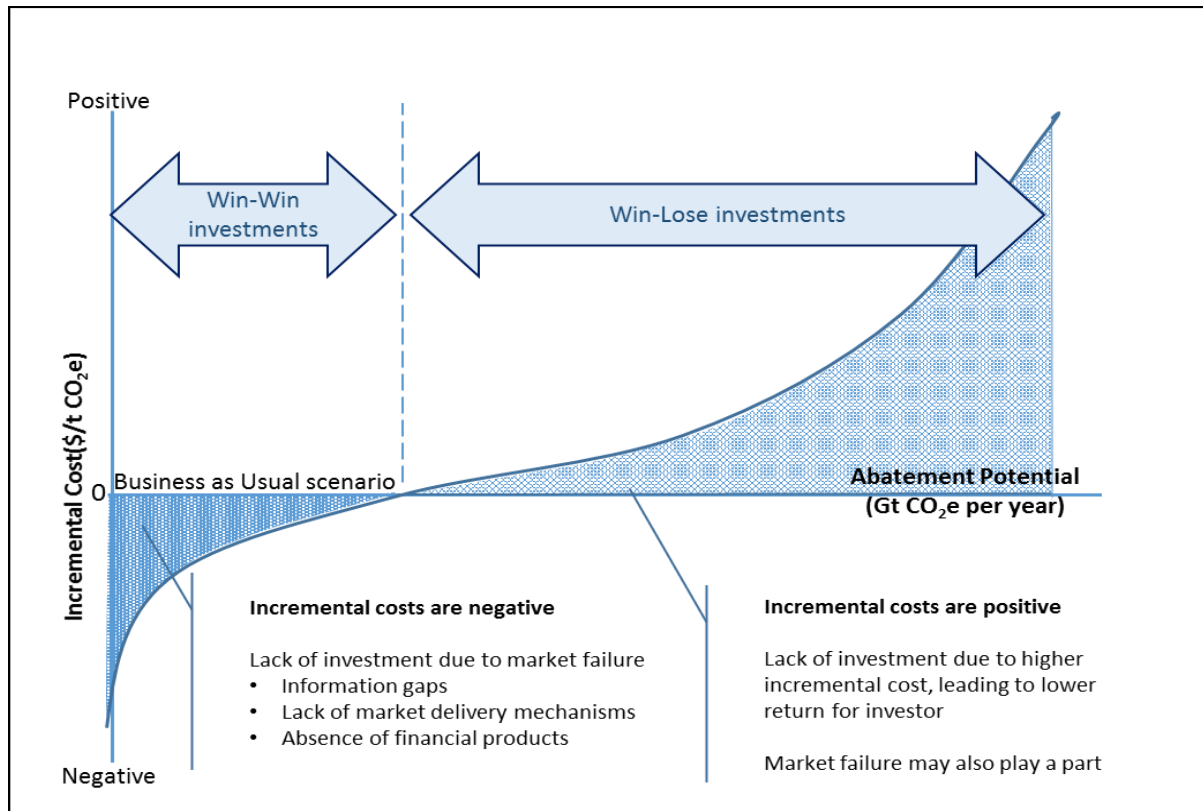


Figure 2. Mitigation: incremental costs, win-win and win-lose investments

19. In economic terms, the externalities¹⁰ of both win-win and win-lose mitigation investments accrue to the global community in the form of lower CO₂ emissions and therefore avoided climate change. Carbon markets and carbon taxes are mechanisms designed to internalize these externalities that is to provide a means by which to allow such external benefits to accrue, at least in part, to the investor, therefore changing their investment behaviour. If such mechanisms function efficiently (in the economic sense), carbon externalities would be fully internalized and there would be no need for an outside agent to finance incremental costs, as these would be offset by the carbon market credit to the investor or avoided carbon tax.

20. More than a decade's experience with carbon markets has shown that for a number of reasons, including the non-binding nature of many national emission reduction commitments and the absence thus far of global adherence to the emission reduction framework, carbon markets lack the required financial depth and do not function efficiently. Their volatility (due to the shallowness of the markets) is an added obstacle to private investment as it reduces the predictability of future revenue flows. Carbon taxes, an alternative to tradable carbon credits, have not gained universal traction (despite their attractiveness from an economic point of view) even across Organisation for Economic Co-operation and Development countries. It would not be realistic to expect that they could be deployed on a global scale, including across all

¹⁰ In economics, an externality is defined as the cost or benefit that affects a party who did not choose to incur that cost or benefit. (James Buchanan, and Wm. Craig Stubblebine "Externality". *Economica* vol. 29, No. 116 (November 1962). pp. 371–384.) An example is the cost that CO₂-induced climate change incurs on third parties not responsible for the emissions.

developing countries, in the near future. This provides the economic rationale for the approach taken by the UNFCCC, in creating an external mechanism to finance mitigation costs through the Green Climate Fund.

4.3 Adaptation investments

21. The approach taken by the UNFCCC in creating the Fund is ground-breaking in many respects, including in particular the grouping within the same financing mechanism, of both mitigation and adaptation investment objectives. These two objectives are contained in the GI and in decision B.06/06 on the initial allocation of Fund resources, which aims for a 50:50 balance between mitigation and adaptation over time.

22. From an economic point of view, investments in adaptation differ from investments in mitigation in several important respects, and must be analysed differently. The three most important differences are:

- (a) **Low or no global externalities:** The benefits conferred through increased climate resilience by adaptation investments relate to the country or community concerned, rather than to the global community. Adaptation investments made in the present will eliminate future costs to the country or community due to climate change. While it could be argued that more resilient national economies do provide a benefit to the global community, such benefits are not of the same nature as the avoidance of clear measurable costs in terms of lower CO₂ emissions and avoided climate change as in the case of mitigation investments. Global externalities, when they exist, are social¹¹ and much more difficult – or impossible – to estimate and measure.
- (b) **In many cases, absence of clearly identified revenue streams:** While adaptation investments confer clear benefits on the country or community where they are undertaken, these benefits often do not occur in a form that creates a clearly defined revenue stream. (They tend to be mostly made up of avoided future costs, which are difficult to monetize in the economy.) In such cases, the involvement of the private sector is more problematic¹² as private investors need a relatively predictable revenue stream (rather than avoided cost) in order to service debt and generate financial returns for investors. Where external funding is provided for such investments, for example through the Fund, the financing would often need to take the form of grants or heavily concessional financing, to be reimbursed by the government through increased fiscal revenue, in order to maintain the fiscal sustainability of the country. In those cases where adaptation investments do make it possible to involve the private sector, for example the provision of risk mutualization through insurance, this should be pursued.
- (c) **Co-benefits:** Adaptation investments, which aim to increase climate resilience, often have other non-climate benefits for the country or community in which they are made. Such non-climate benefits are termed “co-benefits”. Examples of co-benefits are, for example, the positive impacts that improved road infrastructure or crop diversification, undertaken in order to increase resilience to climate change, might have on the affected community or country in addition to their adaptation benefits. These adaptation co benefits resemble the case of mitigation market failure, because despite their

¹¹ For example, adaptation investments in very poor countries that would lead to less damage to infrastructure due to climate change might reduce the associated developed country aid budget requirements for infrastructure remediation, allowing these resources to be deployed to other uses which might have higher socioeconomic returns. But this is an oblique benefit that is difficult to estimate in numeric terms.

¹² Although in some cases public-private partnerships might be considered, where the bulk of the investment would be provided through concessional public finance and the operation of the asset entrusted to the private sector; or where the public sector pays an annual fee to the private sector in return for the latter putting in the upfront investment and for the operation of the assets.

non climate related benefits they are not currently being financed. The reasons might be similar to those of mitigation market failure: inadequate information, lack of delivery mechanisms or absence of funding.

23. For these reasons, an incremental cost approach to financing adaptation investments is not an adequate conceptual framework. Like win-win mitigation investments it will be necessary to consider financing up to agreed full costs; unlike mitigation investments, however, the role of the private sector in identifying and financing adaptation investments might be more difficult.

4.4 Fund’s alternative to incremental cost methodology

24. The entire range of potential projects and programmes that can be financed by the Fund is summarized in the table 1 below. These include win-win mitigation investments, win-lose mitigation investments, and adaptation investments.

Table 1: Summary of investment types and Fund Strategies

TYPE OF INVESTMENT		BENEFITS		REASON FOR LACK OF INVESTMENT	POSSIBLE MEASURES
		To global community	To investor		
MITIGATION INVESTMENTS	WIN-WIN	Positive	Positive	– Market failure	Resolve market failure by financing: – Demonstration projects – Market development – Deployment of long term financial instruments, etc.
	WIN-LOSE	Positive	Negative	– Incremental cost	Finance incremental cost by restoring project returns to hurdle rate
ADAPTATION INVESTMENTS		Difficult to measure, but significantly less than to country or region	Positive	– Cost – Lack of clearly identifiable revenue stream	Finance up to full cost through grant or concessional financing

25. Given that incremental cost is not an applicable concept that the Fund can apply globally across all its investments, a broader approach is needed. In order to be able to decide whether or not to finance a proposed investment irrespective of whether it belongs to the category of win-win mitigation, win-lose mitigation or adaptation, the Fund’s Board needs to be able to determine:

- (a) Its economic and financial soundness to see whether it is worth supporting;
- (b) Its merits compared to alternative funding proposals; and
- (c) How much financing would be needed to enable the investment to proceed.

26. The methodology to assess these three elements is contained in the Fund’s investment framework, under the following two criteria:

- (a) Sustainable development potential; and
- (b) Efficiency and effectiveness.

27. The combination of the criteria creates broader coverage than incremental cost and is applicable to the entire range of investments, not only win-lose.

Table 2: Coverage under existing investment framework criteria

Criteria	Definition	Coverage area	Sub-criteria
Sustainable development potential	Wider benefits and priorities	Economic co-benefits	<i>Expected positive economic impacts</i> , including in other result areas of the Fund, and/or in line with the priorities set at the national, local or sectoral level, as appropriate
Efficiency and effectiveness	Economic and, if appropriate, financial soundness of the programme/project	Cost-effectiveness and efficiency regarding financial and non-financial aspects	<i>Financial adequacy and appropriateness of concessionality</i> Cost-effectiveness (mitigation only)
		Amount of co-financing	Potential to catalyse and/or leverage investment (mitigation only)
		Programme/project financial viability and other financial indicators	<i>Expected economic and financial internal rate of return</i> (i.e. hurdle rate of return) Financial viability in the long run
		Industry best practices	Application of best practices and degree of innovation

28. Again, the establishment of sub-criteria and benchmarks, notably hurdle rates of return, will enable the funding amount to be quantified.¹³

29. In conclusion, the investment framework adopted in decision B.07/06, together with its further development, including the sub-criteria and indicative assessment factors contained in this document, provides a comprehensive and robust method of assessing funding proposals. It suits a broad range of investments, which requires more flexibility and wider applicability, and encompasses the notion of eligibility criteria and incremental cost.

¹³ It should be noted that this quantification will be made by the accredited entity as part of its appraisal process. The results will be validated as part of the second stage due diligence process carried out by the Secretariat and the Technical Advisory Panel.