



**GREEN
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Incremental cost methodology: potential approaches for the Green Climate Fund

Summary

This document identifies potential incremental cost methodologies and measures that GCF can adopt in its project approval processes. The document examines the concept of incremental cost and its applications to climate change projects, in addition to current practices of other climate funds. Alternative methodology options are analysed to best meet the purpose of supporting project review and approval processes; guiding national designated authorities and accredited entities in project design and development; and improving GCF policies, including funding eligibility criteria and the results management framework.

I. Introduction

1. The Governing Instrument for the GCF, paragraph 35, states that GCF will finance the agreed full and incremental costs for activities to enable and support enhanced action on adaptation, mitigation, technology development and transfer, capacity-building and the preparation of national reports by developing countries. By decision B.11/11, paragraph (j)(vi), the Board decided to review the proposal approval process with a view to, inter alia, strengthening project/programme eligibility criteria, including categories of incremental cost eligible for funding. In paragraph (k) of the same decision, the Board requested the Secretariat to submit a final report on the review at the thirteenth meeting of the Board. By decision B.17/10, paragraph (c)(i), the Board requested the Secretariat to prepare, under the guidance of the Co-Chairs, a proposal to be discussed at the nineteenth meeting of the Board for “the development and application of an incremental cost calculation methodology and/or alternative methodologies, as appropriate”. This document responds to these requests.

2. This document is divided into six sections:

- (a) Review of the principle of incremental cost and how it applies to climate change projects;
- (b) Review of practices of other environmental funds;
- (c) Key issues to be considered by GCF in developing an approach to incremental costs;
- (d) Methodology alternatives for GCF;
- (e) Application of the selected methodology in the context of the proposal approval process; and
- (f) Recommended approach.

II. Incremental costs and climate change

2.1 General definition of incremental costs

3. In economics and cost accounting, incremental cost refers to the additional expenses incurred with respect to a baseline to produce a new output or an equivalent output in a different manner.¹ The definition of incremental cost highlights two key concepts: the cost of the baseline or business as usual (BAU) project/scenario, and the cost of the alternative or counterfactual project/scenario with which the baseline is being compared. Following these definitions, total cost in the alternative scenario refers to the baseline plus the incremental costs.

2.2 The United Nations Framework Convention on Climate Change and incremental costs

4. The United Nations Framework Convention on Climate Change (UNFCCC), in its Article 4, states that developed countries shall provide financial resources “needed by the developing country Parties to meet the agreed full incremental costs” incurred in fulfilling the commitments under the Convention. Article 12 of the Convention states that developing countries may propose projects for financing, including, if possible, an estimate of all incremental costs of the

¹ This concept is different from marginal cost, which refers to the change in total costs associated with producing an additional unit of output.

reductions of emissions and increments of removals of greenhouse gases, as well as an estimate of the consequent benefits. As part of the initial discussion to further elaborate Article 11 of the Convention on the financial mechanism, the interim UNFCCC secretariat prepared a technical note² making the following key points, which continue to be relevant:

- (a) Incremental costs are very sensitive to proposed measures and the baseline. In cases where the latter is specific to the country situation, this may complicate any attempt to codify standard incremental costs on the basis of an indicative list of measures;
- (b) The determination of incremental costs would be facilitated by the development of model projects, corresponding to the substitution of typical baseline activities by typical alternatives; and
- (c) The use of net versus gross incremental costs may lead to different funding levels. If net costs are used, any local benefits from the project would be subtracted (e.g. development co-benefits arising from a climate change intervention) and therefore the amount of incremental costs would be reduced. In many cases, these benefits take the form of savings such as the reduction in operating costs of a solar with respect to a thermal plant.

2.3 Incremental costs in climate change

5. Different approaches have been used to define the concept of incremental costs associated with projects to address climate change adaptation and mitigation. The Intergovernmental Panel on Climate Change (IPCC), for example, defines incremental costs as “the cost of capital of the incremental investment and the change of operating and maintenance costs for a mitigation or adaptation project in comparison to a reference project. It can be calculated as the difference of the net present values of the two projects”.³

2.4 Defining the reference project and baseline costs

6. The IPCC definition presented above reinforces the importance to the incremental cost determination of defining a reference project. This is necessary to establish the baseline cost. In some cases, the reference project, often known as the BAU scenario, can be relatively easy to determine and cost. For example, a project retrofitting an existing power plant to reduce its consumption of fossil fuels and/or its generation of emissions would have as its reference or BAU case the known cost associated with its continuing operation. The incremental cost could therefore be calculated as the capital cost of the investment necessary to undertake the retrofit, plus or minus the change in operational and maintenance cost resulting from the conversion. In general, and as illustrated in the additional examples included below, the determination of incremental costs is more likely to be simpler in mitigation activities, and their related global climate benefits are also more likely to be easier to identify and quantify.

7. On the other hand, one might consider the climate change related incremental cost of an adaptation project, for example, to improve the resilience to weather events of rural populations in traditionally vulnerable regions. Such an assessment is likely to require an analysis of the degree to which the outcome sought to be addressed is the result of climate change. Such an analysis might be difficult to undertake in a precise quantitative manner.

² *Approaches to the Determination of Agreed Full Incremental Costs*. A/AC.237/50/Add.1. 1994. Intergovernmental Negotiating Committee for a Framework Convention on Climate Change. Ninth session.

³ IPCC. 2014. *Climate Change 2014: Mitigation of Climate Change*. Contribution of Working Group III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change. Cambridge: Cambridge University Press.

8. Box 1 presents some additional examples of the different types of projects that GCF may consider and how the issue of incremental costs would arise in each case. These examples illustrate that the calculation of incremental costs is likely to need to be different in the adaptation and mitigation contexts.

Table 1: Illustrative examples of how incremental cost might be considered in the context of a small subset of hypothetical GCF project types

Case 1 project proposal: construction of a greenfield solar energy plant and transmission and distribution infrastructure to serve an area currently without electrification. Counterfactual in the absence of GCF support: expansion of generation capacity of existing coal plant in adjacent region and construction of transmission and distribution infrastructure. The net incremental costs of a related GCF project would be the difference in capital investments and operating costs between the solar plant and the counterfactual. In such a case, including operating costs could take into account and net out the expected savings generated by the lower operating costs that the solar plant would have.

Case 2 project proposal: retrofit of existing small and medium-sized enterprises production processes for higher energy efficiency. In addition to the capital investments required, operating costs initially increase owing to the need to train personnel and calibrate new equipment. Counterfactual in the absence of GCF support: business as usual: No capital investments in retrofitting and continuation of existing operating costs. The net incremental cost of a related GCF project would be the capital investments of the proposed project plus the difference in operating costs. Such operating costs may be initially higher for the project than for the existing baseline.

Case 3 project proposal: expansion of port facilities with increased resilience to climate change using construction standards consistent with expected intensity of weather events due to climate change. Counterfactual in the absence of GCF support: equivalent expansion (i.e. infrastructure necessary to handle a similar amount of tonnage) with resilience standards consistent with an increasing intensity of weather events. The net incremental costs of a related project could consider the additional capital investments required to build to the enhanced standards and the degree to which those standards were required as a result of climate change (versus historically observed weather). A variation of this example would be one in which the proposed project generates additional co-benefits – if, for example, as a result of the enhanced infrastructure to increase resilience the port can handle larger ships than it could otherwise, and such ships generate additional economic benefits. Those additional benefits could be subtracted when calculating the net incremental costs.

Case 4 project proposal: enhanced livelihoods and resilience of agricultural communities in semi-arid regions. Counterfactual: project generating similar improvements in livelihoods with interventions consistent with historical weather patterns and addressing the long-term path of soil degradation without considering future changes due to climate change. In this case, as well as in case 3 above, an additional element of complexity is the need to estimate and reach agreement on the degree to which the proposed intervention is needed because of climate change.

III. Review of practices in other funds

3.1 Multilateral Fund for the Implementation of the Montreal Protocol

3.1.1 Mandate and role of incremental costs

9. The Multilateral Fund for the Implementation of the Montreal Protocol (Multilateral Fund) is the financial mechanism that supports developing countries in complying with their obligations under the Montreal Protocol to phase out the use of ozone-depleting substances (ODS) and reduce their use of high global warming potential hydrofluorocarbons (HFCs).

10. As agreed in the Montreal Protocol and its amendments, the Multilateral Fund provides funding to cover only the incremental costs incurred in converting from these substances to

more environmentally friendly alternatives. In that regard, funding is approved for the net agreed incremental cost associated with the difference between a proponent's BAU scenario and the converted project. Costs compensated for are those included in a list of categories of agreed incremental costs incurred to convert to non-ODS/non-HFC technologies. This general rule has been refined over a period of years to consider such factors as technology upgrades and economies of scale.

3.1.2 Principles and use of an indicative list of categories of incremental costs⁴

11. The indicative list of incremental cost categories is applied to proposals under several principles. It calls for the incremental cost to be assessed based on the most cost-effective and efficient option available to achieve the reductions. In addition, it calls for both savings and benefits to be considered when calculating incremental costs. This latter point is particularly important, as, if the benefit generated to the project's sponsor exceeds its cost, the project is not eligible for Multilateral Fund support. The indicative list covers three types of activities – those that seek to (i) facilitate the supply of ODS substitutes; (ii) eliminate the use of ODS as an intermediate good in manufacturing; and (iii) eliminate the end use of ODS. For each one of these areas, an indicative list of cost categories eligible for compensation is defined. For example, with respect to the supply of ODS substitutes, there is a list of 11 categories of incremental costs eligible for funding that includes capital investments, operational costs, training and research. In practice, it is up to the Multilateral Fund's Executive Committee to decide how to apply the list, and to determine whether and to what extent costs not on the list should be eligible. For example, agreed costs for capacity-building are not on the indicative list – yet they have been fully supported by the Multilateral Fund.

3.1.3 Calculation of incremental cost and approval process

12. Over time the Multilateral Fund gained significant experience in estimating incremental costs for many of the conversions it supports. This enabled it to define a range of cost-effectiveness thresholds for incremental costs for specific types of activities based on the cost of the tonnes of ODS reduced. Additional experience also enabled the Multilateral Fund to modify those allowable costs further to take into consideration such factors as economies of scale for smaller projects and lower consuming countries. The Multilateral Fund secretariat verifies the consistency of these calculations as well as the eligibility of expenditures as per the indicative list of categories of incremental costs during the process of funding proposal review. One final important factor related to the Multilateral Fund's focus: the Multilateral Fund generally pays for the net incremental capital and operational cost of converting an existing facility from the use of an ODS or HFC towards the use of a non-ODS or non-HFC. This payment for global benefits is virtually always in the form of a grant. The Multilateral Fund does not pay, for example, for the incremental cost of expanding an existing facility to use a non-ODS or non-HFC technology or building a new greenfield plant that will use a non-ODS or non-HFC technology.

3.2 The Global Environment Facility

3.2.1 Mandate and role of incremental costs

13. The Global Environment Facility (GEF) is one of the entities of the financial mechanisms supporting five major environmental conventions, including the UNFCCC. The instrument for the establishment of the GEF states that it provides “new and additional grant and concessional

⁴ This discussion is based on the Multilateral Fund's *Policies, Procedures, Guidelines and Criteria as of April 2017*.

funding to meet the agreed incremental costs of measures to achieve agreed global environmental benefits”.⁵ In this case, the GEF provides resources to cover the difference in costs between a baseline project that would provide only national benefits and one that would provide global ones. The GEF website explains this concept as follows: “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.”⁶

3.2.2 Use of incremental cost

14. In 2006, the GEF Evaluation Office conducted a review of the application of incremental cost assessments in the project approval process and found that while the incremental cost concept underpinned the design of GEF projects, there was substantial confusion among stakeholders regarding interpretation of this concept. In particular, there was no consensus as to whether incremental costs were meant to be a specific quantitative measure or a more qualitative form of reasoning used during project design to separate the “incremental” aspects of the project seeking to provide global benefits. As a result of this review, a new set of guidelines on incremental costs, currently in use, was approved by the GEF Council in 2007. These guidelines focus efforts on a more qualitative approach underpinned by five steps geared towards requiring incremental reasoning as part of project design: (i) determination of the environmental problem, threat or barrier, and the BAU scenario (i.e. what would happen in the absence of the GEF intervention?); (ii) identification of the global environmental benefit (i.e. the incremental benefit that the GEF is enabling); (iii) development of the result framework of the project describing both the BAU and the incremental activities to achieve the global benefits; (iv) provision of the incremental reasoning; and (v) negotiation of the role of co-financing. In fact, the vast majority of the projects done under the GEF provide grants to cover the incremental cost of the global benefit. The remainder is meant to be covered by co-financiers with whatever instrument they negotiate with the project partner.

3.3 Clean development mechanism

3.3.1 Mandate and role of baselines methodologies

15. The clean development mechanism (CDM), established under the Kyoto Protocol, allows emission reduction projects in developing countries to earn certified emission reductions. To establish eligibility, projects must show the amount of emission reductions achieved when compared with a baseline, such as a reference BAU project. This baseline is established using CDM methodologies that should be based on (i) existing actual or historical emissions, as applicable; or (ii) emissions from a technology that represents an economically attractive course of action, taking into account barriers to investment; or (iii) the average emissions of similar project activities undertaken in the previous five years, in similar social, economic, environmental and technological circumstances, and whose performance is among the top 20 per cent of their category. Following these principles, the CDM has reviewed and approved close to 200 methodologies as of its most recent update of the *CDM Methodology Booklet* in November 2016. The appropriate methodology is selected based on the project’s sector (e.g. energy, manufacturing, construction, transport) and applied technology (e.g. biomass, grid electricity, off-grid electricity, renewable thermal energy).

⁵ GEF. 2015. *Instrument for the Establishment of the Restructured Global Environment Facility*. Article 1.

⁶ Available at <<https://www.thegef.org/documents/incremental-costs>>.

3.3.2 Incorporation into project proposal

16. Project proponents use one of the approved methodologies to estimate the emissions generated by the counterfactual project and to monitor the expected reduced emissions from the proposed project. Proponents can use alternative methodologies, particularly when these are needed to adapt to national circumstances, provided that they are submitted for technical review by the CDM. These methodologies can also be used to define standardized baselines for specific countries (e.g. cookstoves in Senegal).

3.4 Climate Investment Funds

3.4.1 Mandate and role of incremental costs

17. The Climate Investment Funds (CIFs) have two main funds: the Clean Technology Fund (CTF) and the Strategic Climate Fund (SCF). SCF has three programmes: the Forest Investment Program (FIP), the Pilot Program for Climate Resilience (PPCR) and the Program for Scaling Up Renewable Energy in Low Income Countries (SREP). The relevance and treatment of incremental costs vary according to the mission of each one of them:

- (a) **CTF:** CTF provides resources to scale up low-carbon technologies with significant potential for long-term greenhouse gas emission savings. While the CTF Governance Framework does not explicitly refer to incremental cost criteria, it states that “CTF financing will provide a grant element tailored to cover the identifiable additional costs of the investment necessary to make the project viable”.⁷ Further guidance prepared as part of the CTF’s private sector operation guidelines states “Financial support through the CTF should be targeted at global benefits of the projects and proportional to incremental costs of their achievement.”⁸ Consistent with this approach, project proponents identify in their proposals the incremental costs of the proposed activities;
- (b) **FIP:** FIP provides funding to address the drivers of deforestation and forest degradation both within and outside the forest sector to support forests and development and address climate change challenges. Given the nature of its mandate, FIP can support the full costs of projects and therefore an explicit assessment of incremental costs is not required;
- (c) **PPCR:** PPCR supports climate change adaptation and resilience-building by funding activities to pilot and demonstrate ways to integrate climate risk and resilience into core development planning, while complementing other ongoing activities. While PPCR does not explicitly focus its financing on incremental activities, its focus on supporting pilot activities makes this issue less important. The additionality of PPCR lies in contributing to demonstrating the viability of certain adaptation activities and therefore in this process it may support the full costs of activities; and
- (d) **SREP:** SREP supports the demonstration in low-income countries of the economic, social and environmental viability of renewable energy. In developing its financial instruments, SREP has emphasized the need to focus resources to address the “incremental risks” associated with renewable energy projects as opposed to the usual technical and financial risks that other BAU projects may have and which could be mitigated through other mechanisms.

⁷ *Governance Framework for the Clean Technology Fund*. 2008.

⁸ *CTF Private Sector Operations Guidelines*. 2012.

3.5 Conclusions potentially applicable to GCF

18. **Three main conclusions can be derived from the review of practices in the Multilateral Fund, the GEF, the CDM and the CIFs:**

- (a) **Incrementality and climate change:** The use of incremental costs and the need to compare the proposed intervention to a BAU case may provide a clear and transparent framework to more directly link the proposed activities with climate change;
- (b) **Complexity, mandate of the institution and quantitative vs. qualitative measures:** Both the Multilateral Fund and the CDM have developed approaches to define the baseline and counterfactual case and use them to quantify the incremental costs of the supported interventions in the case of mitigation activities. None of the funds, however, has done comparable quantitative work in the area of adaptation. Instead, the work of GEF, including its adaptation work through the Least Developed Countries Fund and the Special Climate Change Fund, has used a qualitative approach whereby an incremental reasoning is applied in the process of project design to ensure that GEF funding is focused on the incremental activities necessary to generate global benefits. In the adaptation context, a qualitative determination of incremental cost is likely to be less precise, as it would involve agreement on the degree to which the adaptation intervention is needed as a result of climate change; and
- (c) **Full cost support:** the Multilateral Fund, the GEF and the CIFs provide full (not only incremental) support for a host of supporting activities, including capacity-building and barrier-removing activities and pilot projects designed to demonstrate new technologies. Full cost support is anticipated by the Governing Instrument, and items such as those noted are also critical to the GCF country-driven, paradigm-shifting business model. Similar treatment should continue to be supported in GCF.

IV. **Key issues to be considered by GCF in developing an approach to incremental costs**

4.1 Objective

19. The approach that GCF develops with respect to incremental costs should be anchored on the main purpose, or purposes, of developing this approach. These could include:
- (a) Further facilitate the application of the GCF Investment Framework, particularly with respect to the effectiveness and efficiency criterion to ensure that GCF funding appropriately targets the incremental cost of climate-related activities;
 - (b) Facilitate Secretariat and independent Technical Advisory Panel review and Board decision-making at the funding proposal approval stage by providing a detailed assessment of the components of a proposed project that are directly related to climate change adaptation and mitigation as opposed to other co-benefits such as economic development;
 - (c) Guide national designated authorities (NDAs)/focal points and accredited entities (AEs) in developing funding proposals by providing a framework more directly articulating project component funding requests to climate change considerations;
 - (d) Incorporate into funding eligibility criteria, financial instrument selection and concessionality policies by having differentiated criteria in those policies depending on whether the activities and related funding requested in a proposal is incremental; and

- (e) Integrate into the GCF results management framework and impact evaluation by more directly linking each activity in a funding proposal to the results and impact more directly related to the climate activities of GCF.

4.2 Incrementality and the Governing Instrument

20. Based on paragraph 35 of the Government Instrument and given the other funding decisions taken by the Board, the incremental set of costs with respect to a hypothetical BAU project that GCF would support are those necessary to ensure that the project enables and supports “enhanced action on adaptation, mitigation ... , technology development and transfer (including carbon capture and storage)”. In practical terms, this would imply that the incremental costs that GCF would fund are those necessary to turn a BAU scenario into a project to mitigate the effects of, and adapt to, climate change.

4.3 Gross versus net incremental costs

21. The use of net costs implies subtracting the value of any benefits generated by the incremental investment. Such benefits may be additional positive financial flows or a decrease in expenditures due to savings. This approach was used in the Multilateral Fund to avoid funding activities that the recipient ought to undertake in any case even in the absence of measures to reduce ODS. The fact that many of the Multilateral Fund interventions involved firms with measurable financial benefits and costs facilitated the use of this approach. Theoretically, in GCF the valuation of benefits not related to climate change could facilitate differentiating the level of investments or the funding instrument used to support climate change adaptation and mitigation and the attainment of co-benefits. In practice, the netting out of benefits must be considered carefully, and in the GCF context, should consider the Board’s direction that GCF funding should cover costs necessary to enable the successful implementation of the related proposal.

4.4 Qualitative versus quantitative approaches for calculation of incremental costs

22. Developing a detailed quantitative approach to incremental costs would potentially facilitate a more rules-driven framework. It should, however, be experience-based and developed over time, and with a view to maintaining a focus on the overall paradigm-shifting mandate of GCF. As the experiences of the Multilateral Fund and the CDM show, quantitative methodologies can be more easily developed for mitigation proposals. Developing a more simplified qualitative approach for adaptation projects could facilitate achieving convergence on an overall path forward that can be relatively easy to communicate and be used by a large set of stakeholders.

4.5 Linkages to other ongoing policy initiatives

23. The final approach to incremental costs calculation should consider, and inform, prior policy decisions and ongoing initiatives, including:
- (a) Further guidance on the selection of financial instruments, including concessionality, which may differentiate instruments depending on whether or not the funding is covering certain types of incremental costs. For example, GCF may choose to give

- priority to covering incremental costs associated with activities directly related to climate change with grants and other highly concessional instruments;
- (b) Co-financing, which may imply different levels of required co-financing for activities not related to incremental costs related to climate change; and
 - (c) The definition of an incremental costs approach can also contribute to sharpening minimum benchmark indicators. Simultaneously, the minimum benchmarks, which aim to assess and develop cost benchmarks, may also provide guidance on the development of baseline cost methodologies.

V. Recommended approach for GCF – evolving a GCF methodology for incremental cost: quantitative for mitigation projects/qualitative for adaptation projects

24. The determination of incremental cost is critical to fulfilling the mandates of the Governing Instrument and targeting GCF funding to the climate impacts that GCF was designed to address. The discussion above has demonstrated that quantitative approaches can be developed and applied effectively and consistently for determining incremental cost in the context of mitigation projects. It has also demonstrated that similarly precise quantitative calculations have not been completed, to date, as regards adaptation projects. Given these facts, GCF should pursue the development of one or more quantitative methodologies for determining the incremental cost of mitigation proposals, and a qualitative approach for making such determinations in the context of adaptation proposals.

5.1 Framework

25. The approach for both mitigation and adaptation proposals would be underpinned by two main principles:
- (a) Funding proposals must include a comparison between the proposed project as well as a description of the baseline BAU project, and should clearly identify those project components and associated costs that are directly related to climate change; and
 - (b) The comparison of the baseline and the project proposal should clearly identify accruing savings, separately.⁹
26. **Agreed full and incremental costs.** As GCF can fund “agreed” full and incremental costs, achieving such agreement requires AEs to describe in each funding proposal the following aspects essential to differentiate between the full and the incremental costs. This is done by providing five types of information:
- (a) A narrative, linked to the proposed project’s logic framework, that links each investment to climate change;
 - (b) The baseline BAU project or how the proposed intervention would be structured in the absence of climate change considerations;

⁹ Theoretically, all the benefits arising from the BAU project would be part of the full set of co-benefits from the project. The incremental investment would add other co-benefits or could in fact decrease them (e.g. increasing the resilience to climate change of a road may lead to new design characteristics with higher environmental and social impact risks).

- (c) The incremental investments that the project proposal recommends to achieve results in one or more of the GCF eight result areas, including an identification of barriers to climate change-related activities that the proposed project would be addressing;
- (d) An estimate of the fraction of the costs of each one of the components of the project proposal that are related to those incremental investments. For mitigation proposals, this would imply both a detailed costing of the BAU scenario, and a detailed estimate of the incremental costs. For adaptation proposals, this would imply a more qualitative description and estimate of the degree to which the proposed intervention is necessary as a result of climate change versus historically observed conditions; and
- (e) For funding proposals already in the pipeline, AEs would empirically calculate the incremental costs of each one of the proposed activities and the overall proposal, pending the collaborative development by the Secretariat of a list of incremental costs and one or more experienced-based methodologies that could enable the consistent application of incremental cost principles.

5.2 Strengths and weaknesses

27. The proposed approach would facilitate the process of project preparation, assessment and approval by establishing a framework to clearly link proposed activities to climate change and enabling GCF to assess and target funding to the incremental cost of those investment activities as called for in the Governing Instrument. The use of a bifurcated approach that recognizes the difference between mitigation and adaptation funding proposals should be relatively easy to communicate and implement for all GCF stakeholders, including NDAs and AEs, and should not impose substantial additional costs on them. While the initial use of varying quantitative approaches by AEs for the determination of incremental costs in mitigation projects could lead to less precise outcomes than would be desired, its improvement over the current system and its value in providing greater experience work in its favour. Further, variability could be decreased during the project review. Finally, related experience will be used over time to develop a more standardized experienced-based methodology and agreed list of incremental cost. Similarly, the use of a qualitative approach in the case of adaptation projects will provide less precision than might be desired, but given the lack of experience in precisely quantifying incremental cost in the context of adaptation projects, a more qualitative approach is seen as feasible.

5.3 Next steps necessary to implement this approach

28. Implementation of this approach would require the Secretariat to adjust the existing concept note and funding proposal templates to align them to an incremental cost approach. For example, with respect to the funding proposal, the current description of the “baseline scenario” would have to be modified. Currently, it refers to describing the existing situation in the absence of the proposed GCF project as opposed to what the baseline or BAU project means in the context of incremental costs (i.e. a description of how an alternative project without climate change considerations would be). In addition to changes in the templates, the Secretariat, as part of its support to NDAs/focal points and dialogue with AEs, would have to prepare a technical note and carry out a series of training sessions to ensure that proposals are consistent with the new principles discussed above. At the same time, the Secretariat should initiate discussions with the AEs with a view to evaluating different proposals for the standardization of methodologies and the development of an indicative list of agreed incremental costs.

5.4 Initial focus on the option: quantitative for mitigation projects/qualitative for adaptation projects

29. Based on the review of approaches taken by other funds and the GCF objective of promoting the paradigm shift towards low-emission and climate-resilient development pathways using a broad set of climate change adaptation and mitigation projects, the Board may wish to consider implementing a gradual approach to incremental costs, which in its first phase would focus on the option presented above.

5.5 Explore further use of the incremental cost methodology in the medium term

30. As reflected in prior discussions on matters related to the approval of funding proposals, NDAs and AEs may require further guidance on the type of activities that GCF would seek to support. On the other hand, such guidance should not be overly restrictive as to prevent the development of innovative, transformational projects whose characteristics may be difficult to determine ex ante. An assessment of the approach can be done relatively quickly following a number of concept notes and funding proposals providing the necessary information in order to modify the approach if needed. The Board may consider specifying a timeline to explore the further development of the methodologies for incremental costs towards a more quantitative approach.

Annex I: Draft decision of the Board

The Board, having considered document GCF/B.19/34 titled “Incremental cost methodology: potential approaches for the Green Climate Fund”:

- (a) Decides that the incremental cost approach should be implemented on the basis of the following two main principles:
- (i) Funding proposals must include an economic comparison between the proposed project/programme and the baseline business as usual project/programme, and clearly identify the project/programme components and their costs that are directly related to climate change; and
 - (ii) The comparison set out in paragraph (a)(i) above should clearly and separately identify accruing savings;
- (b) Also decides that each funding proposal submitted to GCF should contain the following information to allow for the difference between the full and incremental costs to be clearly identified:
- (i) A narrative, attached to the proposed project/programme logic framework, explaining the linkage of each investment to climate change and the baseline business as usual project/programme, or how the proposed intervention would be structured in the absence of climate change considerations;
 - (ii) An explanation of how the proposed incremental investments to the project/programme will achieve results in one or more of the GCF eight result areas, including an identification of barriers to climate change related activities that the proposed project/programme would be addressing;
 - (iii) An estimate of the costs of each component for which incremental investments are required. On this basis, mitigation proposals should provide a detailed cost estimate of both the business as usual scenario and the incremental costs. Adaptation proposals should provide a qualitative description and estimate of the degree to which the proposed intervention is necessary as a result of climate change versus historically observed conditions; and
 - (iv) In respect of funding proposals that are at stage IV of the updated project and programme cycle as at the date of this decision, the accredited entities should empirically calculate the incremental costs of each proposed activity and the overall funding proposal based on the entities’ own methodologies, or the methodologies to be developed pursuant to paragraph (e) below;
- (c) Requests the Secretariat to modify the templates for concept note and funding proposals to reflect the requirements set out in paragraph (b) above;
- (d) Also requests the Secretariat to design and implement a capacity-building programme to support the accredited entities, particularly the direct access accredited entities, to enable them to carry out the incremental cost methodologies and requirements; and
- (e) Further requests the Secretariat to work with the accredited entities, particularly with direct access accredited entities, and experts to develop one or more standard experience-based methodologies that can be used by all entities that submit funding proposals to GCF to ensure consistent application of incremental cost principles to all GCF funding proposals.
-