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INTERGOVERNMENTAL NEGOTIATING COMMITTEE
FOR A FRAMEWORK CONVENTION ON CLIMATE CHANGE
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Item 3 (a) of the provisional agenda

IMPLEMENTATION OF ARTICLE 11 (FINANCIAL MECHANISM), PARAS. 1-4

Addendum

Approaches to the determination of agreed full incremental costs

Note by the secretariat

I. INTRODUCTION

A. Mandate

1. At its seventh session, the Committee requested the Executive Secretary to work on approaches to the determination of "agreed full incremental costs" and to inform it at its eighth session of the progress achieved in this regard (A/AC.237/31, para. 32(g)).

2. The above request was made in the context of the Committee's conclusions at that session with regard to policies, programme priorities and eligibility criteria to be decided by the Conference of the Parties (COP) for the financial mechanism. In that connection, the Committee underlined the importance of agreement on approaches to the determination of "agreed full incremental costs" (A/AC.237/31, para. 32(g)). This matter is addressed in Article 4.3 of the Convention.

B. Scope of the note

3. The secretariat directed its initial efforts in this regard towards the collection of information on experience gained with respect to the determination of incremental costs in the pilot phase of the Global Environment Facility (GEF) and in the operation of the Multilateral Fund for the Montreal Protocol on Substances that Deplete the Ozone Layer. This progress report presents to the Committee a number of issues identified on the basis of this initial information, to assist it in initiating its consideration of this subject.

II. BACKGROUND

4. "Agreed full incremental costs" are referred to in Article 4 (Commitments) of the Convention. Article 4.3 provides that the developed country Parties and other developed Parties included in Annex II shall provide new and additional financial resources, including for the transfer of technology, needed by the developing country Parties to meet the agreed full incremental costs of implementing measures that are covered by Article 4.1 and that are agreed between a developing country Party and the international entity or entities entrusted with the operation of the financial mechanism. This commitment follows another for the funding of the agreed full costs incurred by developing country Parties in complying with their obligations under Article 12.1.

5. The policy to be established by the COP with respect to "agreed full incremental costs" will therefore be essential in determining the amount of funding to be received by the developing country Parties through the financial mechanism in support of their implementation of activities listed in Article 4.1. These will represent an important part of the implementation of the Convention as a whole. Other applications of incremental costs could include the determination of activities that would achieve at least cost a country’s emissions commitment to the Convention and the ranking of projects on the basis of their cost-effectiveness in achieving global environmental benefits.

III. CONSIDERATIONS AND ISSUES

6. It is noteworthy that the concept of additionality and incrementality are linked in the same paragraph of the Convention. They may be seen to constitute two counterweights in the final agreement reached on this paragraph. As neither concept is rigorously defined and their practical application meets with difficulties, pragmatism will have to prevail in applying both concepts in practice. As far as incremental costs are concerned, approaches have been developed to design an operational methodology. A number of issues found in such approaches are outlined below.

7. Costs to be taken into consideration for assessing incrementality should, as appropriate, include capital costs, operating costs, initial costs as well as those occurring later, and direct costs as well as indirect or induced costs. The costed measures may be precisely delineated, but their implementation may involve costs affecting -- beyond the project or enterprise -- the whole economy or a sector thereof. An appropriate "system boundary" should be chosen that includes all important elements economically affected by the measures, so that no significant economic implications would be missed in the costing.

8. Incremental costs will be defined vis-à-vis a baseline situation, which could be not to implement a measure at all, or to implement it in a manner that does not aim at achieving the objectives of the Convention. The incremental cost will be the difference between the cost of the baseline activity (which may be zero) and that of the actually implemented measure.

9. Baselines, which are essential for defining incremental costs, are necessarily hypothetical. Defining them constitutes a major issue in the determination of incremental costs and is inevitably a matter for negotiation among the parties concerned. In the field of climate change, incremental costs are very sensitive to both the proposed measure and the baseline. In cases where the latter is specific to the country situation, this makes the codification of standard incremental costs on the basis of an indicative list of measures impractical.

10. The consideration of various economic implications of the implementation of mitigation measures, including indirect implications, leads to considering both costs and benefits generated by the measures. Benefits may include -- in addition to global ones relevant to the aims of the Convention -- economic benefits for the developing countries where the measures are implemented. This raises the issue of the treatment of such local incremental benefits in the determination of incremental costs of these measures. An economic approach would suggest the subtraction of local benefits from the costs so that only "net incremental costs" would qualify for financing. Such a financing rule under the Convention would have the effect of concentrating funds channelled through the financial mechanism on the acquisition of global benefits, thereby avoiding any transfer of resources from the financial mechanism that might result in local advantages for the developing country hosting the project. (Such advantages could be viewed as a form of "free ride" for that country.) This is viewed as consistent with a strict distinction between development funding and global funding for global benefits. This financing rule is also seen as maximizing the global benefits generated for a given amount of funding available through the financial mechanism.

11. Another effect of this rule would be to render ineligible measures that are economic, in that their local benefits exceed costs. In this manner, the "best" projects, those generating the most benefits, would be ineligible for funding from the financial mechanism. For such economically attractive projects to be implemented, other sources of funding, such as development funding or private investment, would have to be available. This is not necessarily the case, however, so that this funding rule could jeopardize the implementation of many important activities that are both economically and environmentally beneficial. In fact, projects that appear to be economic, and therefore ineligible, could be viewed as eligible if a number of related costs that are less easy to quantify, such as risks, transactions, information gathering or market development, were included in the system boundary. Some of the most cost-effective interventions are likely to be shifts of entire sectoral development plans to reduce the emissions of greenhouse gases. In such cases one would need to compare the cost of a proposed plan with that of a baseline plan rather than operate on a project-by-project basis.

12. This financing rule would also have the effect of eliminating any financial incentive for the recipient country to prefer a project generating both global and local benefits over one generating only the same local benefits. In

addition, if a global benefit is generated through a project funded from development funding, this would not be consistent with the strict distinction between development funding and global funding. (It would, in fact, be a form of "free ride" for the international community.) The word "full" in the expression "agreed full incremental costs" could be viewed as a signal in favour of a more liberal interpretation of the costs to be covered.

13. The current practice is neither full compensation of incremental costs, nor full subtraction of local benefits. In the case of the Montreal Protocol, for example, the Multilateral Fund is only required to take savings and benefits "into account". In the operational interpretation of this provision developed by the World Bank this is taken to mean that direct financial savings would be subtracted from the overall cost of the measure being implemented, while other types of domestic benefits such as environmental and intangible benefits, side benefits not financially justifiable on their own by the country concerned and benefits that are contingent or uncertain would not be subtracted in full, if at all. A similar interpretation is being adopted in the operations of the GEF.

14. The consideration of costs occurring at different points in time, whether capital costs or operating costs, leads to the need to determine and apply a discount rate. Some analysts, emphasizing intergenerational equity, recommend the use of a low discount rate to account for the long time-horizon needed to envision climate change issues. Others feel that funds spent for climate change mitigation measures should be able to yield the same returns as development projects and, therefore, that these measures be screened by the same discount rates.

15. The above issues, as well as many other less fundamental ones encountered in approaches to the determination of agreed full incremental costs, confirm that policy guidance from the COP is imperative in this area. Above all, the funding of incremental costs must be sufficiently "full" to provide an incentive for developing country Parties to implement the Convention and a pragmatic approach will be necessary if such funding is to be "agreed" and thus available. Further work is needed on ways to combine an incremental approach to funding measures in the areas of climate change with effective operations ensuring expeditious disbursements. Studies in this regard could be undertaken by the secretariat if the Committee so recommends.

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