SGS

Mr. Hans Jürgen Stehr
Chair, CDM Executive Board
UNFCCC Secretariat
CDMinfo@unfccc.int

September 17th 2007

Re: Request for review of the request for registration for the CDM project activity "Way Ganga Hydro Power Project, Sri Lanka" (Ref. no. 1173)

Dear Mr. Stehr,

SGS has been informed that the request for registration for the CDM project activity "Way Ganga Hydro Power Project, Sri Lanka" (Ref. no. 1173) is under consideration for review because three requests for review have been received from members of the Board.

The requests for review are based on the reasons outlined below. SGS's response to the issues raised by the request for review are as below:

Request 1, 2 and 3:

1. *Further validation of the suitability of the benchmark rate chosen is required, in particular in relation to the use of equity IRR rather than project IRR.*

2. *The assumptions on the electricity tariff, the electricity generation and the number of years used for the IRR calculation should be substantiated.*

3. *A revision of the financial analysis with justified assumptions should be submitted.*

4. *Further evidence is required regarding the difficulty in obtaining finance; in particular it should be validated that the loan could not be obtained without the CDM.*

SGS Response:

Since the availability of debt financing is known, including the cost and percentage of debt capital, the project proponent was more concerned with the equity IRR. The project proponent was not confronted with selecting an alternative project to invest. If that was the case, project IRR would have been chosen as an appropriate benchmark. However, in this instance the project is available for implementation with necessary statutory and non statutory approvals in place and the debt financing could be obtained at a predetermined cost. The lenders were concerned with adequate security and comfortable Debt Service Coverage ratios. In this situation equity IRR was considered more appropriate for validation of the suitability of the project for the equity investor. The financial analysis excels spreadsheet giving the equity IRR was checked during the validation site visit. The same was revised with the assumptions used, and is attached herewith as Annex 1.

For IRR computation the tariff stated in the Standardized Power Purchase Agreement (SPPA) was used for the entire period without escalation because PP had no way projecting the future tariffs. The period is for the SPPA duration. (15 Yrs from the commercial operation). It was expected the plant capacity to be 40% based on the past rainfall data as assessed by the hydrological survey of the site. The project cost was estimated to be Rupees 650 Million and debt was to be repaid as per the terms applicable to debt financing for small hydro power projects by local bank.

Financial analysis and the assumptions used calculate IRR to show the project additionality was validated during the site visit and discussed in the validation report as well. The financial analysis for the project activity was revised taking into consideration the following assumptions which were also mentioned in the excel spreadsheet used for IRR calculations.

Project cost: SLRs* 650 Millions
Equity: SLRs 200 Millions
Loan: SLRs 450 Millions
Rate of Interest: 16%
Capacity Utilisation factor: 40 %
Annual energy generation: 29.4 GWh
CER price: 7 Euro/ tCO_2 e
Electricity sale price: SLRs. 5.85/kWh as per the Tariff stated in the Standardized Power Purchase Agreement.
* SLRs – Sri Lankan Rupees – (Currency of Sri Lanka)
1 Euro= Rs. 85.

The project proponent had a benchmark of 14 % as minimum expected returns on their investments. A copy of the corporate decision mentioning the benchmark for equity IRR is attached as Annex 4 herewith. The projected equity IRR was 13.54% and with the expected Carbon Credit Revenue the projected IRR improved to 14.92%. Thus the project activity crosses the 14% internal benchmark value and thus becomes financially attractive.

The Private Sector Infrastructure Development Company Limited (PSIDC) has approved the loan. The copy of letter written to the PSIDC for loan approval was verified during validation and same. The same is attached herewith as Annex 2. Although it is not the usual practice of the banks to give documents explaining the reasons to approve or reject loans, Project proponent had asked PSIDC to provide a letter, as a special case mentioning the reason for loan approval. Copy of the same letter is attached as Annex 3 for reference. The letter clearly indicates that the PSIDC had indeed considered the possible CDM incentives which the project activity will generate; in the decision making to provide a loan for the project activity.

This clearly demonstrates that the project activity was not financially attractive without CDM revenue and project proponent went ahead with the implementation of the project activity anticipating possible CDM incentives.

Therefore, we feel that the clarification sought by board members has been taken into account. We do however apologize if this was not sufficiently clear from the validation report.

Vikrant Badve (+91 9967005290) will be the contact person for the review process and is available to address questions from the Board during the consideration of the review in case the Executive Board wishes.

Yours sincerely

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Annex 1: Letter to DFCC bank
Annex 2: Letter from DFCC bank
Annex 3: Excel spreadsheet giving the IRR calculations
Annex 4: Corporate decision on 14% as benchmark for any investment.