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 "Erathna Hydro Power Project, Sri Lanka" (Ref. no. 1204)

Dear Mr. Stehr,

SGS has been informed that the request for registration for the CDM project activity "Erathna Hydro Power Project, Sri Lanka" (Ref. no. 1204) 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 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.*

2. *As the other barriers listed in the PDD are purely economic, it should be indicated that the project activity is not financially attractive given the financial assumptions made at the time of the decision to proceed with the project activity.*

SGS Response:

The financial institutions in Sri Lanka were not too keen to finance small hydro electric projects. Project proponent had submitted the loan application in September 2002 to various banks but until six months, banks could not indicate the status of approval or availability of loan for the project. Subsequently, project proponent informed the DFCC Bank, which later became the primary bank for loan for the project activity. Regarding the consideration of possible revenues from incentives from CDM due to emission reductions, Project proponent had submitted copy of letter to the DFCC Bank mentioning the possible CDM incentives, during validation the same was validated and accepted by SGS. This is attached as Annex 1. . The copy of the letter indicates that project proponent had seriously considered CDM incentives for overcoming the investment barrier for the project activity.

Although it is not a usual practice for the banks to provide documents explaining the reasons to approve or reject loans, Project proponent had asked DFCC Bank to provide a letter, as a special case mentioning the reason for loan approval. Copy of the same letter is attached as Annex 2 for reference. The letter clearly indicates that the DFCC Bank 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.

The financial analysis of the project activity and the underlying assumptions and figures including the decision to proceed with the project activity was discussed and checked during validation. The investment barrier was found to be the major barrier for the project activity. The assumptions and the related evidence was checked during the validation site visit and found satisfactory. The financial analysis was carried out with following assumptions:

Project cost: SLRs* 700 Millions
Equity: SLRs 200 Millions
Loan: SLRs 500 Millions
Rate of Interest: 16%
Capacity Utilisation factor: 35 %
Annual energy generation: 30.4 GWh
CER price: 7 Euro/ tCO_2e
Electricity sale price: SLRs. 5.9 /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 financial analysis was carried out to determine the equity IRR. Since the project proponents would invest in the project basically looking at the return on their equity investment, IRR on equity was considered. The financial analysis has been worked out for the power purchase agreement period of 15 years from the proposed date of commissioning of the project activity.

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. It may be seen from the excel spreadsheet that the equity IRR for the project activity without CDM incentive is 12.62% and that with CDM incentive is improved to 14.78 %. Thus the project activity crosses the 14% internal benchmark value and thus becomes financially attractive and sustainable. Project proponent had decided to invest in the project activity mainly due to the following reasons:

(i) anticipating possible CDM revenues that could be generated by the project activity; and
(ii) to contribute for GHG emission reductions by displacing equivalent amount of fossil fuel dominated grid electricity.

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 earlier 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

Sanjeev Kumar
Lead Auditor
Sanjeev.kumar@sgs.com
T: +91 124 4313600
M: +91 98717 94628

Irma Lubrecht
Technical Reviewer
Irma.lubrecht@sgs.com
T: + 31 181 693287
M: + 31 651 851777

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.