IETA
INTERNATIONAL EMISSIONS TRADING ASSOCIATION

Subject: IETA response to the call for input on the draft revised "Guidelines on the assessment of investment analysis"

January 12, 2011
UNFCCC Secretariat
Martin-Luther-King-Strasse 8
D 53153 Bonn
Germany

Dear Mr. Mahlung,

I am writing to you on behalf of the International Emissions Trading Association (IETA) in response to the call for input issued at EB58 regarding the draft revised "Guidelines on the assessment of investment analysis."

IETA would like to submit the following comments:

1. IETA does not believe that the proposed revision to the guidelines on the assessment of the investment analysis change the fact that new guidance is needed on how to calculate the WACC specifically.

2. Paragraph 14 of the guidance states that company internal benchmarks may only be used if companies consistently used them in the past. In many cases, CDM projects are implemented by companies that do not regularly make investment decisions, however. For example, a landfill operator may only operate one landfill and may not frequently perform financial analyses on other investment opportunities. In such cases the guidance should permit the use of a recognized approach such as CAPM.

3. IETA welcomes the presentation of default values listed in Appendix A although we would note that many appear significantly lower than have been used in CDM projects to date, and there is little distinction between the three groups which can face very different levels of risk.

   We also note that the method described does not include the application of a Beta value nor currency risk. As noted in previous submissions on this topic, omission of the Beta value will result in WACCs that misrepresent the economics and, ultimately the additionality, of a particular project. A WACC is meaningless if it doesn't take the following project-specific risks into consideration:

   - Industry - A project's WACC should take into account the asset beta. An asset beta measures the correlation of a project's risks to general market risk and can be determined by analyzing the returns of comparable companies via publicly available data. The draft guidance essentially assigns a value of 1 to the Beta for the cost of equity of each project. A beta of 1 will overstate the riskiness of projects that typically experience lower correlations with market risk (such as power generation facilities, for example) and understate the risks of new technologies and other projects that are highly correlated with market risk. The draft guidance will make it harder for innovative projects and new technologies to qualify for CDM.

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- Leverage - A project's cost of equity should consider the planned debt of the project. Large, expensive projects generally require more debt financing than smaller projects. As equity holders are subordinate to lenders, an equity investment in projects with more debt is riskier than equity investments in projects with little or no debt. By neglecting the role debt plays in project risk, the draft guidance will disqualify large, complex projects that have the potential to "move the needle" for reducing GHG emissions.

IETA believes that the applicability of these default values is limited because project developers either need historic values or up-to-date values. The draft guidance provides no means of accessing either of these qualities. Para 3 does not explain from where the "long-term historical returns on equity in the US market" are derived nor what type of equity investments it includes. It is important that the applied indicator reflects reasonably the required return on equity for an investment <u>into a single project.</u> Para 4 also does not specify how the country specific <u>equity risk premiums</u> have been derived from the US figures. The differences of investment conditions between countries should be taken account somehow in the equity risk premiums. However, it is important to note that <u>country credit risk ratings are not a relevant indicator for explaining differences in equity risk premium between countries.</u> Using country risk ratings to derive host country specific "risk free" rates from the returns of US bonds is justified, but deriving the "risk free" rates directly from the returns of the host country bonds would be preferred and should be allowed in the cases of host countries where such data is available. Also, average stock market return is not a relevant benchmark to the risk premium of an equity investment to a single project due to the following reasons:

- Portfolio effect:
  - An investment to a portfolio is less risky than an investment to an individual asset in the portfolio.
- Liquidity:
  - Stock market: Exit is possible at any moment
  - Single project: Short term exit is typically impossible
- Implementation risk and operation history
  - Stock market: Listed companies are in operation and have operation history
  - Single project: project has not been build and have no operation history

IETA proposes that along with the default values in Appendix 1, the guidance should provide a transparent description of how the values are calculated accompanied by the input values for the various parameters. Project participants may then alter these values to suit the conditions at the time of the decision to invest or if circumstances have changed, subject to validation by the DOE.

4. In Appendix A, Para 5, it is not explained how the *"adjustment factor to reflect the risks of projects in different sectoral scopes"* is defined. Also, the sectoral scopes defined are too coarse. There are very significant differences in capital costs and risk profiles within the categories. Again, we suggest that the sector specific risks are listed in Annex 1 and project participants are invited to define more appropriate values for their specific sub-sector if necessary. Also other differences between project types than "sectoral scopes" should be taken account. E.g. required return from a project based on new experimental technology is significantly higher than from a project that is based on mature technology having good operational record despite of the "sectoral scope".

5. The language in para 15 is a little ambiguous as to whether the default values shall be used or may be used if nothing else is available. It should be clear that the default values are for use when no alternative values are available and that they are not for to be used as a cap on the cost of capital for the sake of conservativeness.

6. The treatment of inflation is not clear.

7. In accordance with the guidance the benchmark values are expressed "in real terms". More specific guidance should be given how to use such benchmark. Can it be e.g. converted to nominal terms by adding a relevant inflation to the figure or is it necessary to convert all the benchmarked investment calculations into "real terms".

IETA greatly appreciates the opportunity to provide our input on this issue. Please do not hesitate to contact IETA's Policy Leader for Flexible Mechanisms, Kim Carnahan, at carnahan@ieta.org should you have any questions regarding this letter.

Sincerely,

Henry Derwent
President and CEO, IETA