Input on the draft revised "Guidelines on the assessment of investment analysis"

The Methodologies Panel is applauded for its efforts to address this difficult subject.

We believe that further clarification on some of the key elements of Appendix A will enhance the Guidelines' conceptual validity and practical usefulness.

1 Cost of equity vs. project risk premium

The four factors the Appendix enumerates in its first paragraph belong to two different groups. Factors (a), (b) and (c) constitute what is typically referred to as the cost of equity whereas factor (d) deals with a project risk premium. While both are essential in arriving at a suitable benchmark, it is important for the following reasons to treat the project risk premium represented by factor (d) differently from the cost of equity to be derived from (a), (b) and (c).

1) The project risk premium must largely depend on experts' subjective judgment, defying the approach taken for the cost of equity to calculate it based on empirical data.

2) The project risk premium is not confined to the return on equity. It is equally pertinent when the selected benchmark is predicated on a cost of debt or the WACC .

The foregoing observations point to the vital need to distinguish factor (d) from factors (a), (b) and (c), to establish a reliable default value for the project risk premium on the basis of systematically obtained input from a large number of experts. The relevance of experts' input will be ensured by clarifying that CDM project activities by definition are marked by:

- insufficient profitability (before CER revenue),
- implementation without being mandated by law or regulations and
- employment of a technology not commonly used in the region

The establishment of the default project risk premium (e.g. 3%) will be on the understanding that a higher project risk premium can be adopted if substantiated for a particular project activity and that the value is applicable to a benchmark linked to the cost of debt of the WACC .

2 A host country's risk premium vs. the premium it requires for equity investment

The approach advocated in Appendix A relies on US data for factors (a) and (b). It is only in factor (c) that the specific situation of the host country is taken into account.

In considering factor (c), it is crucial to differentiate the debt market and the equity market. When a host country is delivering stellar economic performance, the country's risk premium, the primary concern of the debt market, is small. But a soaring equity market that normally accompanies economic prosperity lifts equity investors' expectations, leading them to demand a substantial premium over the returns of the US equity market manifested by (a)+(b).

In this regard, the use of Moody's rating for factor (c) is misguided. The rating measures a country's riskiness from the viewpoint of debt service capacity and offers it as a guide to debt instrument investors. In the above example, the risk premium Moody's rating assesses will be too small to adequately reflect the equity investors' expectation regarding the premium over the US equity performance. Selection of some other reference more closely aligned with equity investment is recommended.

3 US dollar-based return vs. local currency-based return

The equity for most CDM project activities at present is provided by host country investors, not by Annex I country investors who act as buyers of CERs. A vast majority of these local equity investors make decisions in terms of their own (host country) currency. Hence, a return on equity benchmark applicable to investments denominated in the host country's currency is essential.

The framework presented in Appendix A is ill-equipped to deal with this reality. Factors (a) and (b) are clearly based on US dollar-based data. Moody's rating reflects the risk premium to be added to the yield of a country's US dollar-denominated debt instrument. Thus, the combination of (a), (b) and (c) results in a US dollar-based return expectation that fails to be useful for the major part of CDM equity funding today. There is a pressing need to expand Appendix A and relate it to equity return expectation for investments made in the host country's currency.

We hope that the above comments will be helpful in improving the Guideline.

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