



January 12th 2011

Chairman and Members of the CDM Executive Board  
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**Subject: Call for public inputs: “Draft revision to the guidelines on the assessment of investment analysis”**

Dear Mr. Mahlung and Honourable Members of the CDM Executive Board

The Global Wind Energy Council welcomes the opportunity to comment on the draft revision to the guidelines on the assessment of investment analysis. Upon examining the draft guidelines we have the following input and recommendations to put forward.

**Default values for the expected return on equity**

According to a recent IGES<sup>1</sup> study, 50% of registered projects use the benchmark analysis. For some types of projects, for example wind energy projects, the percentage is much higher, demonstrating the importance of appropriate and consistent benchmarks in the determination of additionality.

Appendix A of the draft guidelines describes the derivation of default expected returns on equity. However it is not clear how the listed values have been derived.

We recognise that the development of pre-defined default benchmark rates may be useful specifically for cases where suitable benchmarks are not available for use by the project proponents, but the existence of these default benchmarks should not prevent project proponents from using other investment benchmarks in cases where there is enough market information to estimate the said benchmarks. In cases where data is insufficient, the guidelines should provide the criteria for the selection and applicability of appropriate methodologies and sources to be used in the development of these benchmarks.

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<sup>1</sup> Towards CDM Reform, IGES, June 2010.  
[http://enviroscope.iges.or.jp/modules/envirolib/upload/2798/attach/towards\\_cdm\\_reform.pdf](http://enviroscope.iges.or.jp/modules/envirolib/upload/2798/attach/towards_cdm_reform.pdf)

The values reflected in the table in Appendix A across sectors (1-3) are currently pre-determined. However experience shows that country and project type risk will vary frequently, showing significant volatility. Hence a static, fixed table may not be the best way to reflect typical returns on equity for projects, unless a methodology and timeline for updates is provided at the same time.

Although the Guideline offers some indication of the methodology for the calculation of prescribed benchmark rates, it is not clear how the rates have been arrived at. Based on the numbers listed in the appendix and not having seen the underlying data and calculation methods, the percentages shown appear to be very low compared to current numbers seen in the market. This could lead to masking of risk and could unreasonably penalise many CDM projects, especially renewable energy.

The methodology for arriving at the “risk premium for the host country” is not explained clearly. Even using the country rating by Moody’s as a proxy for this risk, the translation of this indicator into the other is unclear. Taking a reasonably stable developing country like India as an example:

- If the risk-free rate of return of 3% and the equity risk premium of 6.5% are subtracted from the total value assigned to Group 1 (11.75%), we are left with 2.25%, which corresponds to the risk premium for the host country *and* the adjustment factor to reflect the risk of projects due to sectoral scope.
- It is unclear for example how India’s Moody’s sovereign rating of Ba1 (*local currency, as of July 2010*) translates to the risk premium for the host country.
- This risk premium seems insufficient to account for the host country and sectoral scope risk. The OECD country risk for India, for example, which is already used in many CDM projects and which is considered quite conservative in the market, is 3%<sup>2</sup>.

Paragraph 5 of Appendix A recognises three different project categories according to the sectoral scopes used under the CDM: Group 1, 2 and 3, and all project types within a Group are assigned the same value for expected return on equity. It is unreasonable to assume that project- specific risks cannot adequately be reflected with such broad categorisation. Hence we believe these three categories are not enough to classify expected returns for project activities, as not all projects within a category have the same risk.

- As an example, in the energy sector, renewable energy projects (like wind) carry more risk than conventional energy projects, and therefore it is reasonable that the expected return on equity required for an investment in an innovative renewable energy technology will be higher.
- Further even amongst projects based on renewable energy, there are differences in risk. Other issues, such as technology maturity, which also varies from one project type to another and even within the same project type depending on the technology used, also affect the sectoral risk. Hence there should be scope for such deviations to be taken into account while calculating the adjustment factor for reflecting this aspect of the project risk.

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<sup>2</sup> <http://www.oecd.org/trade/xcred/crc/>

Additionally, the expected return on equity calculation appears to ignore the fact that projects also carry with them a liquidity risk, which increases along with the expected lifetime of the project, as the project developers are involved in a project for that duration, and there is no liquidity for them. A risk premium to reflect this should be added as an element in the calculation of the expected return on equity, or it should be included as part of the adjustment factor to reflect the risk of projects in different sectors.

**Recommendation:**

1. The guidelines should continue to include default values of expected rate of returns. However, rather than being mandatory, the guidelines should specify that the use of the default values is optional i.e. to be used when there is a demonstrable need for them to be used.
2. The calculation for the expected return on equity should be transparent, flexible, and must adequately reflect the reality of what is expected by the market in different sectors and markets. Hence the guidelines should identify criteria for the selection of appropriate sources and methods based on parameters that would allow for uptake of benchmarking standards relevant to project typology or market maturity.
3. The guidelines should include a methodology to update the default values listed in the table in Annex A.
4. Further the treatment of inflation is not clear in the draft guidelines. The guideline should include a worked example showing how inflation should be treated.

**Expenditures occurred prior to the decision to proceed with the investment in the project**

Para 6 of the draft guidelines states that “any expenditures occurred prior to the decision to proceed with the investment in the project will not impact the final investment decision as such expenses sunk costs which remain unaffected by the decision to proceed or not with a project activity”. We have concerns about this rationale. There is no set expectation around projects about sunk costs and they can impact different types of projects in different ways. In the wind energy sector, for example, it plays a significant role, due to the nature of wind project development; these projects typically have certain expenditures which must be realized before the investment decision, such as resources assessments and land permits.

**Recommendation:**

The guidelines should differentiate between “expenditure” and “expensed amount” as expenditures may relate to buying permits or land or equipment in advance to be able to do the project, whereas the latter refers to something that has been (and should be) written off as part of expenses in a Profit & Loss account. The former must definitely be considered for investment analysis and, though the expenditure may already have been made, it cannot be regarded as a “sunk” cost since it will be carried as an “Asset” in the Balance Sheet for capitalization at a later date. If this is also the intent of the UNFCCC, it should be clarified to avoid confusion. Needless to say, these figures will be audited during the validation process.

We once again welcome the opportunity to be able to input into the draft guidelines and believe our recommendations will help to improve the tool for investment analysis. We look forward to reviewing the next version of the guidelines on the assessment of investment analysis.

Kind regards,

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