European Bank
for Reconstruction and Development

To: Members of the CDM Executive Board

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Subject: EBRD response to the EB call for public inputs at its 58th meeting regarding the draft revised "Guidelines on the assessment of investment analysis"

The European bank for Re construction and Development (EBRD) appreciates the opportunity to contribute to the consultations on investment analysis in the demonstration of additionality.

EBRD understands that the intention of the proposed revisions was to increase **transparency**, **integrity** and **reduce transaction costs** of the procedures laid out in the Additionality Tool.

The guidelines advice the **use of a benchmark approach in investment analysis instead of an investment comparison analysis** in cases "where the choice of the developer is to invest or not to invest." This affects most CDM project activities in such areas of renewable energy, energy efficiency and waste. Indirectly this approach is likely also to affect indirectly and assessments under Joint-Implementation as PDD consultants and accredited independent entities tend to apply CDM rules to the letter in assessing additionality of JI projects.

For those projects using the benchmark approach in investment analysis, the guidelines require the **use of standard market benchmarks in cases where the projects could be developed by others than the project participants**. This would apply in particular to renewable energy projects and any energy efficiency/clean energy projects implemented by energy efficiency services companies (ESCOs).

The guidance allows **company-specific benchmarks to be used for projects that can only be implemented by the project participant,** and leaves the decision to DOE to conclude whether company-specific or market-based benchmarks may be used for projects that could be implemented by others.

EBRD concerns

Our observation of the market suggests that the investment analysis has played a very useful role in establishing the awareness of the concept of additionality among market participants. At the same time it has become vulnerable to discretionary assumptions and arbitrary selection of information, and this has led to cumbersome and non-transparent debates between project participants and DOEs, based on these arbitrary and non-transparent arguments. These debates cost project participants a lot of time and money and do little to improve the environmental integrity of CDM. They prevent the development of a wider interest in the mechanism and thus effectively reduce low carbon investments. Similar practices are used in the assessment of JI projects, where the concept of

additionality is often following to the letter the methodologies and rules applied by the CDM community, with similar consequences.

We appreciate the efforts of EB to introduce more transparency into the assessment of additionality. We believe that benchmarks are in principle a useful tool to enhance transparency of investment analysis. However in the real world of developing countries the use of benchmarks can end up adding to, rather than rectifying the confusion.

Requiring **"market"** or **"company-specific" benchmarks** as proposed in the revised guidelines does not improve transparency or integrity because it does not reflect the realities of project investment and financing decisions for a number of reasons.

- **Establishing country-wide benchmarks covering all investments in broad groups of sectors is inappropriate in most developing countries**. Markets for sustainable energy projects in less advanced developing countries are typically in their infancy if they exist at all. Even in the more industrialized developing countries, these markets are often fragmented and heavily distorted. From EBRD experience with private sector project sponsors across markets and countries, we note that there is a very large range in investment criteria and approaches, which form the basis upon which investors decide whether to invest. A wide range of drivers are at play, including but not limited to financial return, access to finance, regulatory environment and accounting standards.

- **The values of the market benchmarks for the expected return on equity presented in the table in the Annex do not match observed levels and diversity of risks** in the EBRD countries of operation for the following reasons:

  i) project risk profiles are in reality very heterogeneous within the proposed three broad categories. Small energy efficiency projects are perceived by investors and financiers as much more risky than e.g. a green-field investment in new CCGT, but the annex bundles them together under one benchmark – this seems clearly inappropriate

  ii) the proposed country risk premia typically significantly understate country risk as perceived by investors and independent estimates of default spreads for sovereign debt – EBRD's extensive empirical experience is that the rates proposed are well below those required by investors, including EBRD

  iii) The range of suggested sector risk spreads appears far too small for most EBRD countries of operation, especially for certain project types in each category

- **The required financial data on the projects in the relevant market segment is normally not publicly available**; it would therefore not be possible to factor them into broader benchmarks. The Bank's experience with DOEs is that typically in initial phases they lack sufficient understanding of financial markets and their judgement is based on the easiest and least risky basis (namely published benchmarks), whereas there can be a very good rationale for project specific benchmarks. For example the Guidance in paragraph 16 assumes that a "*commercial lending rate in the host country*" can be identified – in practice there is a very wide range of commercial lending rates and these are highly sensitive to project specific conditions, including e.g. location and sponsor. Therefore, the DOE interpretation of project investment decisions based on macro-level market data are not likely to accurately reflect the project investment decisions based on micro-level project data.

- **Carbon price itself is less certain which makes the value of investment with carbon credits difficult to predict.** It is intrinsically difficult to determine if the project with carbon credits would exceed the investors' threshold. Given the mounting uncertainty about the future of carbon markets buyers tend to purchase at a market indexed price, whereby the eligibility risk (e.g. for import into ETS Phase III) is increasingly put on the seller. In other words a CDM seller could end up with no value for the emission reductions, even though the investment went ahead. The instrument as proposed is too static to take this very dynamic risk on board. This is a fundamental issue for any additionality analysis.

- **The proposed approach discriminates against structured financial solutions.** For example Guidance 16, that the cost of debt and equity should reflect that of "the legal entity owning the CDM project activity" would discriminate against project financing structures (where the "legal entity owning the CDM project activity" is a special-purpose vehicle (SPV)) as higher discount rates would be applied to such projects than to identical projects financed on a balance sheet of a sponsor. Requiring application of a WACC of a sponsor in an investment analysis would significantly distort the investment decisions and limit the overall volume of investments in sustainable energy in developing countries by restricting them to balance-sheet financed projects, which are rare in developing countries. In most EBRD countries of operation the expansion of renewable energy projects depends on foreign sponsors who provide equity, know how and technology, but who prefer to not take the risk of debt. Structured limited recourse finance is most transformational in the immature and risky markets, e.g. semi-equity instruments or project finance based on long term commodity transaction arrangements or parent or third party secured finance. Such financing structures are very much needed in difficult and complex markets where traditional corporate borrowing is limited to large companies with first tier brand names. Carbon finance mechanisms should be designed to promote rather than hinder no-, or limited recourse financial structures.

Guidance 17 assumes a **default debt: equity structure of 50:50** where the actual structure is not available. This again seems an unnecessarily broadbrush approach – in our experience this is a common ratio for small hydropower projects but for wind projects for example the financing structure is usually more aggressive, e.g. 70:30, and in specific markets where equity is hard to find these ratios apply also to other technologies). We suggest that reference be made to structures common for the specific type of project and market.

We agree with Guidance 5 that the assessment period should not be limited to the crediting period. However we believe that the **assessment period** should reflect the typical investment horizon and that the approach to the **fair value assumed at the end of the assessment period** should reflect the uncertainties inherent in many projects that are likely to need CDM revenues. For example it is common in renewable energy projects to attribute very little value to assets after the expiry of any feed-in tariff regime notwithstanding that the technical life of the assets may be significantly longer.

EBRD recommendations how to address transparency and integrity

EBRD proposes a three-pronged approach to assess additionality tailored to different market conditions and project sizes:

1. **In advanced countries and mature sectors the standard market benchmarks for equity rates of return may be used.** Such markets would need to have stable macro frameworks, competitive structures with many participants, access to deep and liquid capital markets that

have no financial access and forex conversion restrictions. The list of such mature markets should be published and reviewed periodically by EB.

The standard benchmark rates used to evaluate projects should not be company- or market-specific, but rather based on the risk profile of the project itself.

Where standard project based market benchmarks are applied in advanced developing countries several modifications to the proposed approaches could enhance realism of projections

a. Equity rates of return proposed in the annex would need to be revised upwards and the various spreads widened and diversified on the basis of country/sector risk profile assessment.

b. Granularity of the proposed groups would need to be increased to reflect different risk profiles of different sectors in each country and different project types/sizes (e.g. medium versus large; protected versus unprotected sectors, etc.).

c. Benchmarks should be used as default floor values for the discount rate that reflect the average real risks as reflected in national benchmarks (if published by host countries), financial parameters used by already-registered CDM projects, or other benchmarks which reflect common practice in economic/financial analysis. PDD consultants could use such floor values as a basis for calculating project-specific discount rates.

2. **For large projects in the distorted, less developed and highly fragmented markets** we suggest to continue allowing the use of **project-specific benchmark discount rates** in the investment analysis.

3. **For small and medium-scale[1] CDM projects proposed in the distorted, less developed and highly fragmented markets we propose to determine additionality *a priori* for selected CDM project activity categories by applying country/sector wide barriers and common practice analysis instead of project specific investment analysis**. This would constitute an extension of the indicative simplified baseline and monitoring methodologies. In particular:

   - EB could periodically (e.g. every 2-3 years commission an independent review of country/sector wide barriers that prevent certain CDM project activity categories from being a common practice.

   - Selected categories of CDM project activities that face systematic barriers and are not common practice in specific sectors and sub-sectors in individual countries would be considered *ipso facto* additional until the next review period.

   - Integrity concerns can be addressed by conservative assessment of barriers.

[1] Extending the thresholds from simplified modalities and procedures for small-scale CDM project activities we would propose the following size thresholds for small and medium size projects Type (i): Renewable energy project activities with a maximum output capacity equivalent of up to 60 megawatts (or an appropriate equivalent); Type (ii): Energy efficiency improvement project activities which reduce energy consumption, on the supply and/or demand side, by up to the equivalent of 60 gigawatthours per year; and Type (iii): Other project activities that both reduce anthropogenic emissions by sources and directly emit less than 60 kilotonnes of carbon dioxide equivalent annually

- Country/sector review of barriers and common practice could include assessment of actions of host countries to remove barriers through policies and measures. In the persistent absence of the host country actions to remove barriers the review can suspend additionality of affected types of CDM project activities.

- To mitigate the risk of pervasive windfall profits the EB could establish a maximum cut-off IRR, possibly differentiated by countries/ sectors / subsectors (e.g. at the level of the second highest percentile of the IRR range reported).

There are the following features of this approach:

- It would materially improve transparency and reduce transaction costs while at the same time align the additionality assessment with realistic consideration of market conditions. Barriers and common practice analysis at a sector level together would provide a realistic, transparent, cost-effective and difficult to manipulate approach to assessment of additionality.

- It would also address the issue of perverse incentives associated with investment analysis, namely incentives for project sponsors to decrease the financial attractiveness of their project and perverse incentives for the host country authorities not to introduce policies and measures that would make CDM eligible project activities financially viable.

- This approach proposes a mechanism to prevent notorious and excessive windfall profits. However, it would inevitably create some infra-marginal rents for certain percentage of project participants in certain markets. We believe that the risk to environmental integrity of the infra-marginal rents is small and limited in time. **Even projects with high returns can still be additional if they face documented barriers and are not yet a common practice.** In any technology/product diffusion process prime movers expect extra profits in return for extra risk they are taking, and without these, there will be no progress, i.e. without infra-marginal rents there is no market penetration. Furthermore, such a streamlined approach to additionality and high profits would scale up investments and therefore enhance competition for projects, which would have a lowering feed-back effect on profits.

To reiterate, our main concern is that the use of benchmarks is not appropriate for many CDM projects (and similarly JI projects) that are inevitably developed in environments where such benchmarks are either not available or misleading. We doubt that such an approach will contribute to sustainable development, low carbon economy restructuring, technology transfer or equitable regional distribution of the CDM and JI projects. EBRD is operating in the economies in transition that are falling far behind in carbon market participation. Here the flexible mechanisms have hardly contributed to leveraging investments and proposed approach would make participation in carbon markets virtually impossible for most participants except largest corporates with easy access to finance and operating in the most developed markets.

Instead we would request parties to consider a very different approach that would be able to leverage investments, technology transfer, increased participation in CDM/JI markets and equitable distribution of proceeds over the regions. The approach would be based on rules that are more transparent and predictable to investors and involve materially reduced transaction costs and discretion both on the side of project participants and DOEs. This is especially crucial for small and medium sized projects in distorted less developed markets. The approach that we propose gives a chance of making a real difference in the marketplace.

We would be happy to explain or discuss these points further.

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