14 April 2010

The Chairman and the Members of the CDM Executive Board
c/o UNFCCC Secretariat
P. O. Box 260124
D-53153 Bonn
Germany

Dear Madam/Sir,

RE: Comments on "Draft tool to determine weighted average cost of capital (WACC)"

We welcome efforts made by the CDM Executive Board to standardize calculation of WACC as required in the investment comparison analysis or benchmark analysis for determining additionality of a CDM project. With reference to this call for public input, the following response Is being submitted:

General: the structure of the tool is confusing. The Step I categorization of situations does not take into account the nature of the project legal entity. For example, it does not mention how a public entity either a government department, public sector company or a joint stock company should estimate its WACC.

1. Definitions: (i) Debt needs to be defined in the context of company balance sheet and project financing plan. Only long term debt is relevant. The rate of interest as stated in the loan agreement for fixed rate and the prevailing bank rate for floating rate are relevant. (ii) Equity definition asset minus liabilities is incorrect.
2. Step 2: Not clearly understood. The accounting books of the legal entity that undertakes the project will eventually reflect the value of project assets, except in case the entity is a Build-Operate-Transfer contractor. However, in that case, the awarding entity is the project owner. Situation (b) of this step and its subsequent applicability in the tool are redundant since by the definition of Legal entity on page 1, all project assets have to be on its accounting books. For case II, weighted average cost of debt is the only option.
3. For case I, the tool should consider as many variants of the legal entity as possible. These include, public entity like local government organization, public sector entity such as organizations wholly owned by the local/provincial/national government, joint stock companies with government and private stakes and private companies which are either closely or widely held by public.
4. Under Step 3: For debt financing from a parent company, the cost of debt (and even equity) should be the WACC of the parent company. If this is not to be disclosed for confidentiality reasons, it should be assumed to be zero% as a conservative value.
5. With regard to Option 3A of determining the average cost of debt financing (K_d) on Page 4, it is prescribed that "the parameter K_d should be calculated as the weighted average cost of debt funding of the legal entity owning the project activity". Given that a business operation often has both interest-bearing debts and non-interest-bearing debts, it would be necessary to clarify in this section whether all non-interest-bearing debts shall be excluded from the consideration. Inclusion of non-interest-bearing

debts into the calculation of average cost of debt financing would underestimate the result.

6. Many times, companies, especially small ones who have no access to debt resort to leasing of project assets. While this is a cash issue reflected in company's profit and loss account, guidance or clarification on how to take account of operating lease and/or financing lease would also be helpful.

7. Option 4A: Using average global expected equity return to calculate average cost of equity may not be appropriate to markets that are not fully integrated with global financial market. This is the most likely situation in many of the host countries. Moreover, using a default value of 4.7% for global equity risk premium may not be appropriate.

8. In general, the cost of equity calculation has been suggested from an external or global perspective. In both Options 4A and 4B, a global perspective is evident in relying on international source for calculation of country default spread. In countries where the stock market is established, various analysts have advocated the use of Capital Assets Pricing Model (CAPM), which has not been considered at all in the tool. Moreover, it is not correct to say that the country risk is reflected in its government bond (GB). GB yields may not be an appropriate indicator of the country risk.

9. In case of option 4C, the entity's documents alone cannot be relied upon. They must be backed by either certificate by an independent analyst like a credit rating agency or a banker of the entity. Moreover, the entity should provide logic in deciding the WACC which it applied in the immediate past 3 years along with necessary supporting data.

10. With regard to Option 5A, the tool should clearly mention that book value of the debt and equity as they appear in company's balance sheet should be used.

11. In Option 5B, using a default of 50:50 is not correct. Instead, the norm of debt:-equity ratio accepted by majority of infrastructure financing institutions in the host country (e.g. 70:30) should be used as a default.

We hope that the EB will consider these inputs while finalizing the draft Tool.

Sincerely yours,

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