Mitsubishi UFJ Securities

MUFG

RE: Call for inputs on the draft "Tool to calculate the weighted average cost of capital (WACC)"

Dear Members of the CDM Executive Board,

We are grateful to the Executive Board for launching a call for inputs from stakeholders on the draft "Tool to calculate the weighted average cost of capital (WACC)**"** and would like to submit our comment.

We are thankful to the Methodological Panel for developing the tool and appreciate the amount of time and effort that must be devoted to refine the tool so that it can be utilized for real business practice and decision making in developing countries. The current version of the tool does not appear to be as clear or concise as we believe is possible and we are concerned that it may lead to increased clarification requests. In particular we are concerned about the lack of rationale behind each step and the lack of consistency throughout the tool. We would like to suggest to the EB to revise the tool and to open another round of public comments with an improved version.

1. Lack of rationale

The overall methodology procedure to calculate the weighted average cost of capital (WACC) is divided into steps to determine each parameter of the WACC equation. As the tool is intended to be used by a wide audience, not only those in the financial field, we believe that the rationale behind each step should be clearly stated. Currently, the tool does not provide sufficient rationale to justify the options presented in each step. We suggest that the tool is revised to include the rationale so that the reader can clearly understand why each step is presented. For example:

- In Step 2, what is the rationale for separating case (II) into the two situations, (a) and (b)?

- In Step 4, why are the three options, A, B and C given and what is the rationale behind each equation and parameter used?

- Moreover, in the equations in Step 4, why is the coefficient, β, the covariance of a stock in relation to the rest of the stock market, not taken into consideration?

2. Lack of consistency

The tool is not consistent in its use of terms, clauses or in the general layout of the steps. We suggest that the tool be revised to remove these inconsistencies. The steps will become easier to read thereby enhancing the comprehension and application of the tool. We suggest the following approach:

2.1 Combine Step 1 and Step 2

Combine Step 1 and Step 2 into a single step with three cases, making the tool clearer and easier to follow:

Case (I);
Case (II) a; and
Case (II) b

This will simplify the clauses in each of the following steps. For example, instead of having to write: *"Case (I) in Step 1"* or *"Case (a) in Step 2"*, the cases can be clearly defined as: "Case (I)" and "Case (II) a".

2.2 Revise inconsistent clauses

Re-write the following clause to remove the inconsistency in the language:

"This option can be used if:

Case (II) in Step 1 applies; or
Case (I) in Step 1 applies and case (b) in Step 2 apply and the…"

The above two clauses seem to contain a redundancy. If Case (II) in Step 1 applies, then this clause covers case (b) in Step 2 so it is not necessary to include it as a separate clause and the wording is redundant. This same clause is present under the following options: Option 3B, Option 3C and Option 5B.

It is suggested that by combining Step 1 and Step 2, as suggested above, this will improve the wording of these clauses.

2.3 Revise inconsistency in the definition of term, PE_g

In Options 4A and 4B, the term *equity risk premium* is defined as either *"global equity risk premium"* or *"general equity risk premium"*. Both terms are given the same parameter, PE_g. It is suggested to define this parameter in general terms as: PE_i, where *i* can represent either global or general, PE_G, or PE_g, depending on the case.

It is further questioned as to why the term *"general"* is used instead of *"country specific"* when Option 4B refers to *"country specific equity return"*, not *"general equity return"*. We suggest revising the name of either the term, PE_g, or the option accordingly.

2.4 Revise inconsistent terms, GB_i and PE_g

The scope and applicability of the tool state that: *"Any investment analysis must be done in the same currency selected for the WACC calculation. All cash flows…must be standardized using a single currency or reasonable equivalent…"*

In Step 4, the average cost of equity financing is calculated using the terms GB_i, yield of a government bond issued by the host country and PE_g, equity risk premium (global or general). GB_i is defined either in USD terms or in the local currency of the CDM project host country. According to the cited source, PE_g is calculated in a USD base. If GB_i is determined in the local currency then it seems to be inconsistent with the above applicability condition to use a USD base for PE_g.

3. General Comments: Average cost of equity financing, k_e, Equity risk premium, PE_g

We would also like to suggest to the methodological panel further improvements to the step to determine the average cost of equity financing. The cited source to which the tool currently refers, *"The worldwide equity premium: A smaller puzzle"*, quotes a 4.7% global equity risk premium. This is taken as the equity risk premium of 17 developed countries (South Africa is the only developing country included in the list) and seems too conservative a figure to properly reflect the situation in CDM host countries.

Further, the general equity risk premium, used in the case of country specific equity return is determined as 4.1% from the equity risk premium of 16 developed countries excluding the USA and is taken from a US investor's stance. In terms of calculating a country specific equity return this seems an inappropriate and overly conservative figure.

We suggest that the tool apply an equity risk premium for countries where CDM projects are actually implemented: either a general equity risk premium for developing countries or a country specific equity risk premium that is reflective of the situation in each developing country.

We believe that that the current version of the "Tool to calculate the weighted average cost of capital (WACC)**"** can be further improved, making it applicable for real business practice and decision making in developing countries. Each step of the tool can be further clarified, providing greater rationale and current inconsistencies can be revised or removed. Improvements in the definition of terms and in the layout and flow of the steps will facilitate greater understanding and reduce any future clarification requests.

We would like to suggest to the EB to consider our comments when reviewing the tool and to open another round of public comments with an improved version to ensure that the tool encompasses the view of all relevant parties. Thank you for your consideration.

Sincerely yours,

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Clean Energy Finance Committee
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