F-CDM-RtB

CDM: FORM FOR SUBMISSION OF "LETTER TO THE BOARD" (Version 01.1)

(To be used only by the Project Participants and other Stakeholders for submitting Letter to the Board as per Modalities and Procedures for Direct Communication with Stakeholders)

Name of the stakeholder[1] submitting this form (individual/organisation):	CA.G.N.Jayaram, Chartered Accountant.
Address and Contact details of the individual submitting this Letter:	Address: 30,Bharathidasan Street,Teachers colony, Erode-638 011, TamilNadu, India Telephone number: +91424 2277101 E-mail Address: ram@icai.org
Title/Subject (give a short title or specify the subject of your submission)	Observations on CDM guidances to financial additionality
Please mention whether the Submitter of the Form is:	☐ Project participant ☐ Other Stakeholder, please specify CDM financial Additionality expert advising DOEs.
Specify whether you want the Letter to be treated as confidential[2]):	☐ To be treated as confidential ✓ ☐ To be publicly available (UNFCCC CDM web site)To be publicly available.

Purpose of the Letter to the Board:

Please use the space below to describe the purpose for submitting Letter to the Board.

(Please tick only one of the four types in each submission)

☐ **Type I:**

☐ **Request Clarification** ☐ **Revision of Existing Rules**

☐ Standards. Please specify reference

☐ Procedures. Please specify reference

✓ ☐ Guidance. Please specify reference Guidance to the investment analysis EB 51 and EB 62

☐ Forms. Please specify reference

☐ Others. Please specify reference

☐ **Type II: Request for Introduction of New Rules**

☐ **Type III: Provision of Information and Suggestions on Policy Issues**

[1] Note that DNAs and DOEs shall not use this form to submit letter to the Board.
[2] Note that the Board may decide to make this Letter and the Response publicly available

Please use the space below to describe in detail the issue that needs to be clarified/revised or on which the response is requested from the Board as highlighted above. In doing this please describe the exact reference source including the version (if any).

1. FAIR VALUE OF THE ASSETS AT THE END OF THE USEFUL LIFE OF THE ASSET- CONTRADICTION:

Guidance No.3- version 5 EB 62- *"if a shorter period is chosen, include the fair value of the assets …".*
This seems to suggest that if the maximum period of 20 years is taken, the fair value need not be included. Compare and contrast with Guidance No.4 version 5 EB 62- *"The fair value of any project activity assets at the end of the assessment period should be included as a cash inflow in the final year."*

Hence, paras 3 and 4 appear to be in clear contrast against each other. The Hon.CDM EB may come out with a clarification in this regard.

2. COST OF THE DEBT VIS A VIS DEBT EQUITY RATIO – CONFUSION

Guidance No.16 version 5 EB 62:
This states as
"In cases where the debt finance structure of the project is not yet available (e.g. a letter of intent for debt funding is not available), the cost of debt can be assumed as the commercial lending rate in the country or the yield of a 10 year bond….".

The debt finance structure has no relevance to the cost of the debt for any entity. The cost of the debt is the rate of interest for the debt in percentage terms and the debt finance structure means the debt equity ratio of the entity. The structure of debt finance is relevant only to the debt equity ratio of the entity. There appears to be a confusion as to the structure of debt finance and the cost of the debt which are two different phrases.

3. DEBT EQUITY RATIO AND THE COST OF DEBT AS PER VERSION 5 OF THE INVESTMENT ANALYSIS IN EB 62 :

The debt equity ratio guidance which was contained in para 11 of the version 3 of the investment analysis guideline in Annex 58 of EB 51 and some of the earlier guidances has been now omitted in the latest version 5
of the investment guidance. This could be due to inadvertence since the prescription of this ratio is very essential. This debt equity ratio is a very sensitive parameter which could have considerable effect on the calculations. Similarly, in the case of the assumption regarding the cost of the debt, the earlier guidances clearly specified the method in which this assumption has to be made. This has now been omitted in the latest
version 5. This is another important parameter more particularly if the equity IRR scenario. In the project IRR scenario also, this could impact in the form of taxation expense. Hence, a clear guiding note for assuming
these parameters are required.

4. ANAMOLY REGARDING THE FINANCIAL STATEMENTS PRESCRIBED:

Guidance No.17:
This para prescribes the method of determining the debt equity ratio for the purpose of calculating the benchmark where an internal benchmark is used. It states as follows:
"….The percentage should be determined based on the latest balance sheet provided under local fiscal/accounting standards and rules if: (a) the legal entity owning the assets of the project activity has balance sheets audited by a third party within two years prior to the submission of the CDM-PDD for validation; and (b) the accounting books of the legal entity reflect at least the total value of all the assets needed for the project activity…."

value of the assets needed for the project activity at all since none of the assets would have been purchased on that date. For this reason, this para may require a revision.

5. ANAMOLY REGARDING THE NOMINAL BENCHMARK OPTION:

In the para 7 of page 8 of Annex 5 of version 5 EB 62, the option of representing the benchmark in nominal values is provided. It states that *"In situations where an investment analysis is carried out in nominal terms, project participants can convert the real term values provided in the table below to nominal values by adding the inflation rate. The inflation rate shall be obtained from the inflation forecast of the central bank of the host country for the duration of the crediting period. If this information is not available, the target inflation rate of the central bank shall be used. If this information is also not available, then the average forecasted inflation rate for the host country published by the IMF (International Monetary Fund World Economic Outlook) or the World Bank for the next five years after the start of the project activity shall be used."*

The guidance provides the modality of determining the inflation rate only for the benchmark and leaves the value of inflation to be used for the IRR wide open. Under this scenario, the PPs could adopt any values for the calculation of the IRR and this could be a potential case of protracted reviews and disputes.Further, even for the benchmark, it has to be examined as to how appropriate it is to apply the inflation to the benchmark which is expressed in terms of percentage. Applying inflation to absolute figures is acceptable but how a figure which is already expressed as a percentage can be inflated has to be examined.

6. UNFAIR DISADVANTAGE TO SMALL CDM PROJECT DEVELOPERS:

In the para 16, it is suggested that the commercial lending rates have to be applied. There could be a large variation between the rates at which a small entity could borrow and the rates at which a organized corporate can secure the funds. This essentially depends on the credit rating of the entity owning the project. Financial Institutions and Banks are exposed to large risks if they lend to smaller entities and new ones than to large corporates where the risk perception is very low. This risk perception is compensated by increasing the spread in terms of percentage over and above the prime lending rate of the bank. This has to be also allowed in the calculations by verifying the credit rating of the entity and the spread percentage associated with that credit rating. This would present a fairer picture of the benchmark figure. This allowance has to be given even to benchmarks based on standard parameters since this benchmark is calculated with reference to other analogue entities. This argument would also hold good when the market return is calculated with reference to the returns on equity since all these are based on return perception of the investor with reference to large entities and corporates where the risk profile is smaller. Since small scale CDM projects are undertaken by micro and small entities, it is unfair to calculate the benchmark as we would do in case of large entities. By doing so, the benchmarks are set at artificially low rates which is an injustice to the small scale entities. These measures could deny a level playing ground for small entities. They could straight away eliminate these small entities from the CDM due to unrealistic benchmark calculations. The problem has also been aggravated by introduction of the default values for return on equity. This table specifies a value of 11.75 % for the equities. In India, at present, even the investment into term deposits of nationalized Banks which is considered literally risk free fetches an annualized return of 9 % - 9.5 %. The market returns obtained in the equity market by investment in major blue chip corporates have historically fetched substantial returns to the investors over the years. This being the case, the prescription of 11.75 % is quite paltry and unrealistic for unknown small sized firms.

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Please use the space below to any mention any suggestions or information that you want to provide to the Board. In doing this please describe the exact reference source including the version (if any).	
>> Suggestion for point No.1: In most parts of the world, land is an appreciating asset and other assets such as machineries are depreciating assets. Hence for arriving at the fair value, the land and the other assets including machineries have to be separately considered. The prescription may be that In case a shorter period than 20 years is considered: Land should be valued at a stipulated premium calculated by appreciating the value by 5 % for every year of age and the machineries to be valued at the 50 % of the book value. In case a period of 20 years is considered : Land should be valued at a higher premium (by applying the same formula ie., enhancing the value @ 5 % for every year and the machineries can be valued @ 10 % of the original value. The element of terminal taxation incident on the salvage value realization has also to be allowed if in accordance with the respective country's taxation laws. Suggestion for point No 2 : The phrase "structure of debt" may be eliminated here and this para may be made to apply only to the cost of the debt. The debt equity structure is anyhow dealt with by para 17 of the same guidance. Suggestion for point No 3 : The same guidance as appearing in the earlier versions in para 11 which was robust could be re-inserted to avoid any ambiguity in the investment analysis. Suggestion for point No 4 : The debt equity ratio can be derived from the entity's previous three audited financial statements on a weighted average basis would be a fair indicator of the future. In case there are no debts appearing in the financial statements the prescribed default ratio of 50 : 50 may be used. Suggestion for point No 6: I am sure this is not the intention of the Hon.CDM EB. In my considered opinion, this anomaly though unintentional requires immediate attention of the authorities and correction. Hon.CDM EB may introduce a size premium and liquidity premium which would enable small and tiny project developers who are unlisted to adopt a default premium to the benchmark calculations after determining the same through any accepted model such as CAPM. This move would render justice to such small project developers by recognizing the actual return expectation for investment into projects of their size.	
If necessary, list attached files containing relevant information (if any)	• [replace this bracket with text, the field will expand automatically with size of text]

Section below to be filled in by UNFCCC secretariat	
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History of document

Version	Date	Nature of revision
01.1	09 August 2011	Editorial revision.
01	04 August 2011	Initial publication date.
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