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Chairman and Members of the CDM Executive Board
UNFCCC Secretariat
Martin-Luther-King-Strasse 8
D-53153 Bonn
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20 April 2012

RE. Review of request for registration of project 4722 (Recovery and Utilization of Associated Gas to Optimize Power Generation at PETROAMAZONAS Block 15 Facilities)

Dear Chairman and Honorable Members of the CDM Executive Board:

We are writing on behalf of the authorized participants to project 4722.

After careful review of the project documentation and the applicable CDM rules and requirements, we believe that there are no grounds to further withhold the registration of the proposed project activity. Enclosed with this letter is a Memorandum which details the specifics of our legal review.

Given the significance of the project and our own assessment, we respectfully request a meeting with you in Bonn at your earliest possible convenience prior to the EB taking any further decision in relation to the project registration (we therefore also ask you to move the project registration from EB67 to EB68 to allow for discussion with you). Following discussions with the DNAs of Finland and Ecuador after EB66 we understand that they are observing the situation and have expressed their support for using a meeting as the next step in the process to resolve this matter.

Yours sincerely,

Dechert LLP

1 Enclosure

Dechert LLP

MEMORANDUM

DATE 19 April 2012

FROM René Gonne, Wim Vandenberghe (Dechert LLP, Brussels)

RE CDM registration of project 4722, Recovery and Utilization of Associated Gas to Optimize Power Generation at PETROAMAZONAS Block 15 Facilities ("the Project") – additionality criterium

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Summary:

The purpose of this memorandum is to assess the merits of the concerns expressed by the EB during its meetings (EB 65 and EB 66)[1] when assessing and reviewing the request for registration of the Project. In particular, concerns have been expressed about the financial additionality of the Project in view of the fact that the investment analysis in the PDD (and in subsequent clarifications from the DOE and PPs) does not value the potential savings of crude oil by using associated gas (transformation of flared gas) to generate on-site electricity.

As outlined below, it is our opinion that the PPs and DOE have correctly chosen and applied the benchmark analysis as part of the required investment analysis. There is however debate within the EB about the exercise in practice of the additionality criterium to the Project and suggestions are therefore made to include the 'economic benefits' of crude oil savings as project revenues in an investment comparison manner. Even if the additionality test is applied in such a manner, then it appears that the Project is equally additional under CDM rules.

In conclusion: the PPs and DOE are able to show the financial additionality of the Project through both a benchmark and investment comparison analysis with inclusion of revenues from crude oil savings. There is no further requirement or legal ground that would oppose to the eligibility of the registration of the Project. In registering the project, the CDM rules are applied correctly by the EB as well as by the PPs and DOE.

The PPs and DOE have to apply the latest rules which are in force when requesting registration of the proposed project. It is expressly stated that the DOE "*shall comply with the latest version of the 'Guidance on the Assessment of Investment Analysis*" (see par. 110 VVM v1.2; "Investment Analysis Guidelines"). The PPs and DOE therefore correctly used version 3.1 of the "Guidelines on the assessment of investment analysis" (versions 4 and 5 were also taken into account following their adoption).

The rules laid down in the Investment Analysis Guidelines prescribe that the use of a benchmark analysis is not appropriate if there is no choice but to make the investment, in order to supply the same or substitute products or services, and that an investment

[1] EB65: "*the Board could not agree on the interpretation of the additionality tool*".
EB66: "*With regard to request for registration for project activity "Recovery and Utilization of Associated Gas to Optimize Power Generation at PETROAMAZONAS Block 15 Facilities" (4722) submitted by the DOE (DNV), the Board was not able to reach a decision. The Board decided to continue its deliberations on the request at its sixty-seventh meeting*".

comparison must then be provided for (§19). Conversely, a benchmark analysis is appropriate in the case at hand as the baseline (i.e. flaring of gas at the production site) does not request an investment. In other words, the Project as such was not required to guarantee power demand but was entirely implemented to reduce overall emissions and generate income through the CDM. No investment was needed to cover power demand as Petroamazonas already had invested in and installed power generation equipment which is sufficient to cover all needs.[2]

Following the application of the rules laid down in the Methodological Tool "Tool for the demonstration and assessment of additionality" (v.5.2) ("Additionality Tool"), the ecnomic attractiveness of the Project activity was assessed by presenting a financial analysis comparing the Project IRR to a benchmark (the underlying documentation in the PPD is consistent with the methodology set out in "Approved Baseline and monitoring methodology AM0009"; "Approved Methodology").

In doing so, revenues from potential savings of crude oil resulting from the Project activity were not as such included as project revenues as potential savings of crude oil have no cost saving / benefit value for Petroamazonas. The rationale for this position taken by the PPs (and validated by the DOE) is that Petroamazonas can use crude oil for power generation at no cost and is not eligible for any revenues from crude oil not used for power generation (this was documented by reference to the applicable laws of the State of Ecuador and to the operating licence and by-laws of Petroamazonas).[3] This is in line with the Approved Methodology, in particular the last bullet point on page 6/13 (the substitution of crude oil for power generation does not constitute a cost saving if it is not a cost in the first place). Taking into account this specific regulatory situation in Ecuador also complies with the Additionality Tool (see page 6 at point (5) under 'sub-step 2b: Option III. Apply benchmark analysis'). The Project activity of switching from crude oil to associated gas for power generation at brown-field oil exploration is then additional in accordance with applicable rules and requirements (which the PPs and DOE have to fully apply).

The EB seems to give a different reading of the additionality criterium as laid down in the Additionality Tool and Approved Methodology by limiting recourse being made by the PPs to country specific circumstances (i.e. Petroamazonas cannot assume any potential revenues from crude oil savings under the laws of Ecuador) and also by apparently requesting that an Investment Comparison Analysis is made rather than a Benchmark Analysis.[4]

Such a request would seem to be without legal foundation or outside the EB's authority.

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[2] This power generation equipment is required even under the proposed Project as back-up generation capacity given the uncertainty of associated gas (in terms of volumes and composition) and given the fact that gas volumes will deplete over time. For that reason, the investment analysis can not take into account potential revenues from a sale of the equipment as a project revenue.

[3] So this is not a situation for example which is analogue to an artificial transfer pricing between companies belonging to the same corporate group as in this case there is no transfer price paid by Petroamazonas to the State for the crude oil used for power generation.

[4] See review form dated 14 July 2011: "*the DOE shall further substantiate the validation of the identified baseline, in particular, how the DOE has justified the elimination of alternatives G4, G7, G8 and P3 as per the AM0009 v4 (page 6) given that these alternatives have not been eliminated based on either prohibitive barriers or investment comparison analyses as required by the methodology…*".

The Approved Methodology, however, creates the impression of a dual test (benchmark + investment comparison) as on the one hand it states that with the Benchmark Analysis the baseline (no investment needed) is a viable alternative whereby on the other hand it requests to compare the project with other investment alternatives (geared towards an Investment Comparison Analysis).

Such an application of the Investment Comparison Analysis firstly means that a cost benefit estimation and comparison should be made by reproducing market conditions at the level of Petromazonas (this is in line with the Additionality Tool and Approved Methodology which require the use of market parameters). Secondly, one has to decide which alternative(s) is (are) suitable as comparators. It appears that the only suitable comparator for the Project activity and its additionality would be an "oil enhancement production" project (as the proposed project enhances crude oil production by using less crude oil for power generation).[5] This comparator has been tentatively referred to by the DOE in response to questions from the EB.[6]

In other words, a comparison should be made between (i) the project activity on the hand and (ii) the alternative activity on the other hand:

> (i) the Project which indirectly leads to a crude oil volume/production enhancement (associated gas will be used to generate electricity on-site instead of using existing crude oil power generation equipment);
>
> (ii) the project which would happen in the absence of the Project: i.e. use the project funds as indicated in the PDD (approx. 80 million USD) to proceed with 'business as usual' (BAU), i.e. drilling new wells to explore and produce more crude oil. This alternative would result in additional crude oil production which would exceed by far the savings of the crude oil consumption in the proposed CDM project.

This comparison should be substantiated by the PPs with data in order to show that the project activity indeed falls outside the above mentioned BAU baseline and thus is additional. In order to thus fully assess the profitability of the one activity over the other, all the input parameters should be included as per the Additionality Tool (i.e. relevant market costs and revenues).

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[5] Comparing the project with power generation projects would not be correct as such comparison is only relevant when dealing with a greenfield project (before any investment is made) or in the event of having to increase the overall power generation capacity due to increased oil production activities. None of these two scenarios is applicable in the project at hand.

[6] *"DNV's further investigation showed that while PETROAMAZONAS EP has no direct economic benefits from saving in crude oils, the crude oil production rate is one of the main key performance indicator for PETROAMAZONAS EP. However, DNV's calculation showed that the crude oil savings achieved as a result of the project at Eden Yuturi, Panacocha and Block 31, only represent 2-3% of the total crude oil production at Eden Yuturi, Panacocha and Block 31. The savings are thus rather insignificant and it is in DNV's opinion reasonable to assume that it is not likely that the project would be implemented only to improve the key performance of crude oil production.* ***Moreover, to increase crude oil production, the project would have to compete with other investment opportunities, such as investing into further drilling and exploration***." (Response DOE and revised Validation Report dated 11 August 2011).