

Agenda item 3 (b)

Paragraph 27 of the annotated agenda

Revision to the “Guidelines on the assessment of investment analysis”

CDM EB 61

Bonn, Germany, 30 May to 3 June 2011



Revision to the “Guidelines on the assessment of investment analysis”

- CMP5 requested the Board to further work on the development of guidelines for demonstration and assessment of barriers and of **standardized methods to calculate financial parameters**
- The revision standardizes the determination of the “**weighted average cost of capital (WACC)**”, used as financial hurdle rate
- Meth panel assessed public comments and issues raised by the Board
- Main changes:
 - a) Look-up table with default values for the cost of equity is an **option** and not anymore mandatory
 - b) More explanations how the default values were derived (information note)

Revision to the “Guidelines on the assessment of investment analysis”

Background on financial benchmarks

- Financial benchmarks can be determined in many ways
 - Different models, time horizons, sector definitions => different results
 - CAPM model can be applied in different ways and markets outside US are too small for reliable application
- They aim to model investor decisions but there is no “best method” or “true” financial benchmark
- Key challenge: determine the cost of equity
 - No objective guidance available
 - Use of CAPM model leads to strongly varying results

Revision to the “Guidelines on the assessment of investment analysis”

Guidance on cost of equity

- Proposed approach: Look-up table with **default values** for the cost of equity per sector and country
 - Easy to use: may reduce transaction costs
 - Regular updates by the EB possible
 - Default values are a good proxy of a “minimum” expectation of return
 - Simplified approach following the CMP mandate to standardize
- Introduced next to existing approaches, such as
 - government/official approved benchmark
 - company internal benchmarks
- Impact assessment
 - Out of 24 projects, the outcome would only have changed in 1 case

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How were the default values determined?

Cost of equity =

Risk free rate	3.0%	US treasury bonds
+ Equity premium	6.5%	Arithmetic long-term mean of US equity return in relation to bond returns
+ Risk premium for the host country	0.6% - 7.5%	Moody’s ratings as proxy + comparisons with countries with similar gross national product per capita
+ Adjustment factor to reflect the risk of projects in different sectoral scopes	-0.5% - +1.0%	Adjustment factors recommended based on typical risk profile of the sectors

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How are sectors defined?

- Group 1**
1. Energy Industries
 2. Energy Distribution
 3. Energy Demand.
 13. Waste handling and disposal
- Group 2**
4. Manufacturing industries
 5. Chemical Industries
 6. Construction
 7. Transport.
 8. Mining/Mineral production.
 9. Metal production
 10. Fugitive Emissions from fuels
 11. Fugitive emissions from production and consumption of halocarbon, and sulphur hexafluoride.
 12. Solvent use.
- Group 3**
14. Afforestation and reforestation
 15. Agriculture

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Table of default values

	Group 1	Group 2	Group 3
Afghanistan	14.5	15.5	14
Albania	13	14	12.5
Algeria	12.9	13.9	12.4
Angola	13	14	12.5
Antigua and Barbuda	10.5	11.5	10
Argentina	14.5	15.5	14
Armenia	12.5	13.5	12
Azerbaijan	11.2	12.2	10.7
Bahamas	10.9	11.9	10.4
Bahrain	10.8	11.8	10.3
Bangladesh	12.75	13.75	12.25
Barbados	11.75	12.75	11.25
Belize	14.5	15.5	14

- Values in real terms (not nominal terms)

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Guidance on cost of equity

In summary

- The look-up table simplifies the determination of the cost of equity
- The use of the table is a voluntary option
- Country-specific situations are reflected
- It is recommended to regularly update the table
- An impact assessment was conducted
- Further improvements could be undertaken in the future based on the experiences gained and proposals by PPs

**THANK YOU
FOR
YOUR ATTENTION**

