

CDM Business Issues: Describing a Project for Buyers

Written for
UNIDO's Preparatory Assistance to 10 Francophone African
Countries on the Clean Development Mechanism (CDM)

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Background

The CDM is a market-based mechanism, intended to result in the production and sale of virtual certificates that document and credit emissions reductions and/or avoided emissions (Certified Emission Reductions, CERs), through projects implemented in developing countries. Participation in this market is regulated by the United Nations and restricted to entities (sellers and buyers) in countries that are Parties to the Kyoto Protocol.

The CDM has been implemented through a protracted – and some would say painful – process of what is commonly referred to as “learning-by-doing.” As a result of this approach to developing the mechanism, the primary international focus to date has been on developing a regulatory framework that ensures the environmental integrity of the mechanism. Much of the training available to individuals and organizations in developing countries that are interested in becoming actors on the CDM market has reflected that focus, and has centered on the rules and procedures used to regulate the use of the mechanism: the regulatory framework. Issues covered include project eligibility, the UNFCCC project cycle, design/selection of baseline and monitoring methodologies, additionality, project documentation, host country approvals, validation, and requirements imposed by large buyers such as the World Bank. More recently – as experience has increased through bold efforts to actually establish and act in the nascent international carbon market – a gradual process of shifting attention from regulatory to market issues has been underway. This shift was reflected in the topics covered under the UNIDO CDM Capacity Building Workshop for Francophone African Countries, in September 2005.

This paper provides an overview of one of the market-oriented issues presented as part of that workshop: describing a project for buyers. The art of project marketing/sales is currently underdeveloped in the carbon market: learning-by-doing is in full swing and there are a lot of lessons that remain to be learned. My intent here is not to provide a guidebook for negotiating the inherent twists and turns of the project sales process. For

many of those who enter the fray today the ride is certain to be bumpy (but potentially profitable none-the-less). My hope is, rather, to describe the market from different perspectives and, in the process, point to a number of potential hurdles that can be avoided by the well prepared. But first, to put this in context, it is necessary to say a few words about the market for CERs.

There is a lot of discussion today regarding the size of the market and which is greater: supply or demand for CERs. It is likely to take years before market balances become clear. What is clear today is that the market is characterized by imperfections that have consistently tilted the scale in favor of the buyer. The CER market today is clearly buyer driven (*i.e.*, buyer controlled). Until recently, it was not

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expected that projects could even be developed without a buyer. So-called unilateral projects were not expected to be eligible for registration. This has not turned out to be the case. The market, however, is still under considerable buyer control. This is in large part a reflection of the imbalance in institutional muscle available to the players on each side. While the buyer-side is represented almost solely by national governments, the

seller side is represented primarily by small- to medium-sized private companies. Similarly, while the buyer-side has been able to collaborate and share resources, through the World Bank operating in their interests, no similar institutional resource has surfaced to serve businesses on the selling side.¹ This has resulted in buyer control of both the terms of sales and the sales price. This control, however, is artificial: an artifact, actually, of the process of market development. It is not likely to survive, if the CDM does. Being aware of the imbalance of control and its artificiality can help sellers interested in playing on the CDM market today, by providing a different shade of glasses through which CDM project development and CER sales can be viewed. Donning those glasses can help project proponents (owners/sellers) in making key decisions regarding CER sales, and in preparing for them in the process of project development.

Looking for Buyers

The CDM is intended to lead to the sale of CERs. Every project proponent wants to feel confident that there will be a buyer for his/her CERs, and that the price negotiated eventually for the sale will make the effort worthwhile (*i.e.*, profitable). Any doubt with regard to either of those issues represents an investment risk. Under given market conditions, the extent of investment risk stemming from uncertainty regarding product sales depends in large part on production certainty and production cost: how certain are you that the investment will result in the anticipated quantity of CERs being produced, and what will be the total production cost per CER (including regulatory transaction costs²)?³ As in any product-oriented sales situation, the better you know your project/product and the market segment targeted for its sale the lower your risk.

¹ The cartel-like behavior in price setting (reflected by the stable and opaque price of 5USD/tonne applied to the majority of government and World Bank CER purchases made in 2003-2004) is an example of such collaboration on the buyer side of the market.

² CDM project economics comparisons often focus on the cost of the investment in a physical measure (such as the cost of purchasing, installing and operating a turbine). Total project costs also include costs related to marketing, project development, financing and regulatory transaction costs. Regulatory transaction costs include the cost of: producing project documentation for the CDM Executive Board; seeking host-country approval; enlisting the services of a designated operational entity (DOE) for project validation; a registration fee; meeting monitoring requirements; enlisting the services of a DOE for project

If your perception of sales risk is extremely low (*i.e.*, you are certain that your project will produce the anticipated quantity of CERs and that there will be a buyer who will pay a price that makes your project profitable), implement your project (get ready to produce CERs!) first and look for a buyer or a broker later. If not, it would be useful now to learn more about the CDM market and start thinking about how to describe a project for buyers.

When is it time to attempt a sale?

Every CDM project should have a project business plan, and the business plan should define strategies for developing and selling the product (CERs). To what extent one is prepared to take on investment risk alone, or, conversely, how much one hopes to share that risk with a buyer, is a key question for sellers. For most sellers it is soothing to know that there is a buyer that is willing (and maybe even committed) to purchase a project's CERs for the seller's desired price (or more!). The higher the seller's perception of investment risk, the more urgent it is to reduce that risk by obtaining the commitment of a buyer, to the purchase and a price at least, and potentially to other terms such as the sharing of project development costs and the provision of support in the form of access to expertise.

Expectation regarding carbon market development and CER sales prices – relative to a project's CER production cost – is another key question for sellers. Following the launching of the EU ETS, the CER market price development trend in 2005 was generally upward. Sellers that signed sales contracts early are getting nasty wake-up calls these days from brokers offering twice the early negotiated price or more. What's more, a spot market is developing and buyers and sellers alike may be moving away from agreements that lock in 100% of the anticipated CER production for the full life of a project. Where the carbon market on the whole is going is unknown. Where prices are going is even more unclear, and there is plenty of room for speculation. So, to determine when to attempt a sale, a seller needs to know how much income the CER sales need to generate to cover project costs, how much profit is hoped for, how much risk the investor can bear and how much help is desired or needed from the buyer. If production costs approach the current market price and the investor is risk averse, it can make sense to attempt to close a deal early. If project costs are low and/or the investor is prepared to take on significant risk, it can be better to wait. One thing is clear. CERs that look real – *i.e.*, sales from projects that are

- What is your perception of project investment risk?
- How much help do you want/need?
- How high a price are you hoping for?

verification and certification; and payment of the “share of proceeds” to cover administrative expenses of the UNFCCC and for meeting costs of adaptation.

³ Other key determinants of product sales risk include: the long-term viability of the CDM itself and its sister mechanism the European Union's Emissions Trading Scheme (EU ETS); whether or not the Parties to the Kyoto Protocol (KP) will ratify a second KP commitment period and/or something similar that includes significant mitigation commitments post 2012; whether or not new large business interests will enter and dominate the market on the production/sales side; and whether or not large quantities of cheap CERs from, for example, HFC oxidation and methane recovery will be dumped on the market. These types of risk determinants are important, but beyond the scope of this paper.

registered or close to registration and ready to generate CERs – demand a higher sales price than CERs that look more like ideas.⁴

What do you need to know about a buyer?

As noted above, the majority of CER sales to date have been to national governments and banks and other agents representing national governments. The number of private-sector buyers/sales has been limited and is likely to stay comparatively small through the first KP commitment period. Private-sector interest is not likely to grow significantly before clear signals are evident regarding the longevity of the CDM and, more importantly, the EU ETS.

Negotiating a CER sale with a public-sector buyer is a protracted process that has been known to take more than a year. Far from all negotiations result in sales. Even an initial expression of interest can take months to obtain from a buyer. Furthermore, buyers commonly require that the sales pitch is made using pre-determined (by the buyer) filled in forms. This situation results in costs – real and opportunity – on the part of the seller. Having to start over late in the game can be expensive as well as frustrating.

The risk of that kind of unfortunate outcome can be reduced through knowledge about the buyers on the market. Before getting too far into the process of attempting a sale with a particular buyer, a seller should find out as much about them as possible. A buyer fact-finding-mission should be carried out, with the aim of determining whether or not the buyer is likely to meet the seller's needs. The most obvious first question is whether or

- What are their priorities?
- What is their timetable?
- What are their policies regarding costs?
- What are their policies regarding price?

not there is a good match between your project and the buyer's priorities. What types of projects are they looking for (mitigation category, region, scale) and what are their preferences (sector, gases, type of seller, project costs)? Most public-sector buyers are interested in projects from specific regions and project categories (or may exclude specific regions/countries and/or project categories). They also usually have a set budget to spend, a timetable for delivering CER purchase contracts, and an idea about how many projects they want in their portfolios.

Typical buyer selection criteria are listed in Table 1. Some of these criteria are discussed in more detail below. A buyer is likely to make a greater effort to acquire, and be willing to offer more for, a project that is a good match for their portfolio.

Another important piece of information is what the buyer's time-table looks like (how fast/slow). Are they interested in closing sales quickly? Are they working against a deadline? Have they finalized similar purchases and, if so, how long did it take and why? An ice cold buyer that gives a clear and fast "no" is much better than a lukewarm one that takes a long time to deliver the same answer. If you find a buyer that would likely be interested in your type of project and has a timetable that matches your own, the next thing you will want to know is what policies the buyer employs regarding

⁴ CERs that look real are also of interest to brokers, providing an additional sales option to project proponents.

purchase price, and, potentially, the sharing of costs.⁵ At the end of the day, it is the sales price relative to costs that determines profits.

Table 1. Buyers' typical first-order project selection criteria

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| <ul style="list-style-type: none">• Project type• Sustainable development aspects• Host-country support• Additionality aspects (baseline credibility)• Project size (How many CERs)?• Financial aspects• Documentation |
|--|

As mentioned above, CER sales prices historically have been set solely by buyers, and have been relatively stable, arbitrary and opaque. More often than not a flat rate of roughly 5USD/tonne has been applied.⁶ However, such pre-market behavior is changing as the carbon market begins to take shape. Larger price variations and the application of differentiating criteria can be anticipated. Perhaps more importantly, sellers appear less willing to accept long-term sales contracts at fixed rates, which is likely to cause buyers to re-think their purchasing strategies and policies. Here again, knowing that a potential buyer has a purchasing strategy (with regard to price) that is likely to match your needs – be they for a lower but stable price or flexibility and the possibility to squeeze your investment for all it is worth – is important information at this stage of the game.

Some buyers have been willing to share or absorb project development and implementation costs. The types of costs covered have included fees for (northern) development consultant expertise, validation fees, monitoring expenses, etc. To the cash-strapped project proponent such offers can appear generous and desirable, as an indirect form of project financing. However, such agreements should be made with great care. Are they offered at the expense of a lower sales price? Are they in fact a loan, to be repaid in CERs upon project implementation?⁷ How significant are they with respect to the total project development and implementation costs and income-generating potential? Do they warrant the lock-in to a single buyer that they commonly require?

Some of the questions raised above will be addressed in a buyer's call for proposals. Others you should ask about, preferably *before* submitting a proposal.⁸ In the process, you will gain another important piece of information. You will discover how transparent the buyer's purchasing policies and procedures are. A transparent buyer will be an easier partner in a business transaction than an opaque one.

⁵ One might expect this question to come first. However, in today's market without huge price variances at any given point in time, price is less likely to be a barrier to a deal than mismatches in priorities and timetables.

⁶ In at least one case a large buyer differentiated between project types.

⁷ This type of indirect loan procedure has been practiced by the World Bank's Prototype Carbon Fund (PCF). Project development costs have been paid upfront by the PCF but must be repaid once CER delivery gets underway.

⁸ Other sellers are an additional potential source of this type of information. Buyers are commonly identified as "Project Participants" in CDM Project Design Documents, posted for all registered projects on the UNFCCC website (<http://cdm.unfccc.int/>), which also list the project proponent's (seller's) contact information.

What does a buyer want/need to know?

Buyers ask a lot of questions, so be prepared to fill in forms. When doing so, the most important thing to keep in mind is that *all* buyers are looking for the same thing: bankable CDM projects. A bankable CDM project is a project with a strong proponent (seller) that will run the project smoothly and deliver the full anticipated quantity of CERs on schedule. They want certainty. No muss, no fuss. That means projects that will *not* run into financial difficulty; raise protest from local or international stakeholders; be difficult to get through the regulatory process; fail or stumble technically; or lead to contractual default on the part of the seller.

Everyone is
looking for
Bankable CDM
Projects

Beyond the initial portfolio-matching questions introduced above (Is it the right type of project for the buyer's portfolio, expected to deliver the right quantity of CERs at the right time and for the right price?), all questions relate to satisfying buyer's need for certainty. Concerns can be categorized in two groups: concerns about the seller and the business environment, and concerns about the project itself.

Over time, buyers have shown increased interest in ensuring that the project proponent is a viable business partner. This is reflected in the increasing amount of information requested early on, related to the financial (Table 2) and legal stature of the seller's company. The information is requested in an attempt to glean out the projects with committed owners that have strong business track records. Typical questions relate to: the type of company and how it is owned and operated (Who are you?); whether or not the company is solid (How do you behave and what is the state of your finances?); whether or not the company has sufficient internal expertise/capacity to implement the project; and who is responsible for what (if there are partners or external consultants involved).

Table 2. Financial information requests describing the seller

<p>For each Project Participant Years 2002 - 2004:</p> <ul style="list-style-type: none">- Own capital- Balance- Profit/loss- Operational results- Net results- Ratios: liquidity, solvability, profitability <p>Are the annual accounts audited? If yes, by whom?</p> <p>Provide:</p> <ul style="list-style-type: none">- Annual reports- Annual accounts- Balance sheets for the past three years- Profit and loss accounts for the past three years

The Belgians have recently attempted to identify and eliminate proposals from sellers/owners with poor legal records (Table 3). Buyers are also interested in projects supported by a strong public-sector infrastructure. A proponent's efforts can be facilitated or hampered by the capacity of the host country to administer CDM projects. Hence, questions may arise regarding the host country's Designated National Authority. Similarly, buyers will want and need some indication as to whether or not the proposed project is likely to meet the host country's criteria for determining whether or not a project contributes to sustainable development.

Table 3. Excerpts from the Belgian Federal JI/CDM Tender, May 2005.

<p>"Any Candidate may be excluded ... who:</p> <ul style="list-style-type: none"> • Is the subject of proceedings for a declaration of bankruptcy... • Has been convicted of an offence concerning his professional conduct... • Has not fulfilled obligations relating to the payment of social security contributions... • Has not fulfilled obligations relating to the payment of taxes... • Has been guilty of grave professional misconduct... • Is guilty of serious misrepresentation in supplying or failing to supply the information required under the provisions of this Call for Expression of Interest on the criteria for qualitative selection."

From the beginning, buyers have asked for assurances that the project itself will fly. Sellers have tended to start with a focus on technical aspects of the project: describing the actual measures that will be implemented. Buyers are more interested in knowing that the seller has the expertise to ensure that a project is technically viable than they are in detailed engineering diagrams. Most buyers – and especially buyers from the public sector – are also concerned with the environmental and social sustainability of projects. Some buyers may request information in this regard exceeding that of the CDM regulatory requirements. For example, buyers may seek information indicating that projects source local biomass (used as fuel or as industrial/manufacturing inputs) in an environmentally and socially sustainable manner. All buyers look for assurances that the projects they include in their portfolios are economically viable (yet additional: *i.e.*, not such great investments that they would be made without income from selling CERs. See additionality discussion below.). Learning by doing has taught experienced buyers to also ensure early on that a project is financially viable, *i.e.*, that the financial resources will be available to the seller to make the initial investment (how are you going to pay for it?). Buyers also ask sellers to identify and describe potential barriers and/or risks to successful implementation of the project.

Discussions of barriers, risks and economic viability are not complete without a thorough illumination of a project's viability with regard to additionality. Defining additionality and acceptable procedures for determining whether or not a project is additional has been a major bone of contention in the process of developing the CDM. The additionality concept, as applied by the CDM Executive Board, is intended to ensure the environmental legitimacy of projects. The aim has been to ensure that changes (emission reductions) that take place through project implementation are different from what would have taken place without the CDM (*i.e.*, in the business-as-usual or baseline case). Due to the confusions that arose in attempting to explain this concept, and the

Is your project additional?

numerous failed attempts to apply it in practical terms in baseline methodology proposals, the CDM Executive Board developed and approved an “Additionality Tool” that may be incorporated in baseline methodologies to assess and demonstrate whether or not a project is additional.⁹ In short, the Additionality Tool offers two lines of reasoning for demonstrating additionality: 1) an investment analysis indicating that the project may not be the most economically or financially attractive course of action; and 2) a barrier analysis that identifies barriers that prevent the project from being implemented but do not prevent the implementation of an identified alternative to the project. These two lines of reasoning are complemented by a common practice analysis aimed to ensure that the proposed project is not of a type (e.g., technology or practice) that is already widely diffused in the relevant sector and region. The CDM Executive Board has been rigorous in its attempts to ensure that CDM projects are additional. For this reason, even if the proposed project is in a relatively early stage of development, buyers attempt to ensure that projects being considered for their portfolios will pass an additionality test.

For projects that are not already registered, buyers will want to know how far into the development process the project has come (Are there applicable approved baseline and monitoring methodologies? Is there a complete draft PDD?), and to have an indication of the planned implementation timetable (When will you start delivering CERs?). Finally, buyers are often interested in knowing whether or not you have submitted your proposal to other buyers.

What does a potential buyer *not* need to know?

As indicated in the discussion above, buyers want to know just enough to reassure them that sellers are reliable and projects are viable. They want to enter into purchasing agreements that are going to deliver and are not going to result in conflicts or other problems along the way. Most buyers are not interested in detailed engineering specifications. Most buyers will not demand or show interest in the details of project economics or anything else that could be considered a trade secret.¹⁰ Most buyers will not express interest in where you source the technology you intend to install. And most buyers will not request information regarding the relationship (legal/economic) between the project proponent (seller) and the project developer(s) or other external consultants/experts.

Describing a project for buyers: filling out forms

Tendering forms are the first point of entry into a buyer’s CER acquisition portfolio.

Filling them out should not be treated as a technical exercise. Written well, responses on tendering forms play an integral role in an effective sales approach. They get

Have your marketing department take a look.

attention. They catch the buyer’s interest and provide assurance

that the seller is reliable and the project is solid. They don’t leave gaps or awaken questions and raised eyebrows. For this reason, the task of filling out forms should not be left solely to technicians, but should be the purview of strategists and marketing

⁹ See ACM0002, Tool for Demonstration and Assessment of Additionality, downloadable from: <http://cdm.unfccc.int/methodologies/PAmethodologies/approved.html>

¹⁰ However, at the tendering stage many buyers will want to see the *results* of an initial financial analysis, including an estimate of the total investment cost, the internal rate of return, etc.

experts. Is your proposal well thought out? Is your description clear, concise and comprehensible? Is your evidence convincing?

Finally, many of the conditions that will effect your negotiating position later on in the sales process will become clear as you prepare to approach a buyer. Filling out forms provides an opportunity to force yourself to do your homework in advance. Some of the questions you should begin to ask yourself about your negotiating position include:

- How strong is your company?
- How far along is your project in the development cycle? (methodology, registration)
- How expensive is the investment?
- How risky is the investment?
- How is the investment being financed?
- How eager is the buyer and why?
- What is the status of the market?

As you gather and present information, think through your negotiating position, so you won't be caught off guard.