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Weighted Average Cost of Capital Position Paper
Response from KEK

31. August 2006

General Comments

KEK has read and considered the position paper in detail and has both specific and general comments.

In general KEK has found the paper to be well structured and balanced. However:

1. There is a lack of relevant comparisons and data on which to base such an important decision. In particular the lack of any quoted figures or examples from other countries in the Balkans or South Eastern European region is a distinct weakness. Data, tables and examples quoting well worn examples from developed regulatory regimes in Australia, the UK and the Scandinavian countries are hardly relevant to the post conflict, post communist economy that is the emerging nation of Kosovo. This surprises KEK as it has been diligent in offering to provide a wide range of readily available local data from Kosovo to the consultant.
   No such offer has been made to the consultant – although it is possible that there is confusion between the various consultancies. We would welcome any evidence that KEK JSC may wish to provide on local conditions.
2. There is a notable lack of discussion on what is an attempt by the consultant to disallow a recovery of a rate of return to KEK for Pre- 1999 assets and donor funded assets. These represent the vast majority of all KEK assets. An esoteric and academic discussion on the exact basis for the calculation of WACC for an extremely limited, minimal set of assets is hardly relevant to a utility and industry in crisis. Much more interesting for KEK, its shareholders, management, employees and the industry generally would be the setting out of the logic, if any, behind the position which seems to be hinted at in the first paragraph of the covering letter and in various other places in the substantive document. Is it the intention of the consultants to recommend the exclusion of anything other than "*assets financed on a commercial basis*" from the rate base? And if so on what basis?
   This approach follows the tariff methodology issued by ERO and previously the subject of public consultation, including inputs from KEK JSC. It should be noted that KEK JSC does not, at present, incur financing costs related to existing assets. ERO has committed to allowing recovery of such costs should they arise at a later date.
3. It appears that the position paper was not formulated to address the separation of KOSTT from KEK. It would seem that the consultant has availed of a short cut, treating all KEK and KOSTT issues as common for mere convenience. KEK

rejects this approach and suggests that individual consideration of both companies is necessary. While we concur that they operate in a similar environment KEK and KOSTT do not face similar risks as explained further below. KEK cannot accept that because this study would appear to have been incorrectly specified or formulated that it should be treated identically to KOSTT on this extremely important issue and calls for a separate consideration of the issues.

4. While KEK would share the consultants ambition that it should strive to achieve a 60% gearing ratio this is wholly unachievable in the current circumstances of KEK, the electric industry in the Balkans and specifically the financial situation of the broader Kosovar economy. The chances of going from 0% to 60% gearing for KEK are unrealistic in the extreme and we would venture that this assumption threatens to invalidate the basis for the methodology.
   The gearing assumption relates to the financing of new investment and not KEK JSC's average gearing. This follows from the principle that a return is only earned on new assets and not existing donor-financed or 'gifted' assets.

Specific Comments
KEK has many specific comments and questions it wishes to share with the ERO. It is happy to make the vast majority of these comment public but requests that those comments, should be made public in full and unedited.

Comments and Questions for public consumption

1. *Covering Letter:*

Comments:

- KEK asserts that its allowed regulated asset base should include all donor funded assets and pre-1999 assets. If these are to be removed from the regulated asset base KEK wishes to have a separate discussion of this extremely material item within the industry.
  <u>This discussion was held at the time of consultation on the tariff methodology. KEK JSC appears to be reopening a decision already made by ERO.</u>
- We would like to draw your attention to the fact that the proper title for the incorporated entity is KEK JSC. Please ensure that all future correspondence contains the correct appellation.
  <u>Noted.</u>

2. *Disclaimer:*

Comment:

- The European Agency for Reconstruction is partaking in this review with a dual role. That of both donor organization for the industry and financier of the study itself. KEK JSC recommends that any comments received by the ERO from EAR and published should be specific as to their nature. That is, is it as sponsor of the study or as a donor organization? This would assist in avoiding any potential conflict of interest.
  <u>Noted.</u>

3. *Introduction*

Questions:

- We would like to understand if this is a note or a position paper? Please clarify as there seems to be some confusion between the cover letter and the document.
  <u>The paper was prepared by the consultants as a note to ERO. It has subsequently been published as a position paper.</u>
- Paragraph 3 refers to "*methodological issues*" being ignored or simplified. Please clarify and assist us by listing those particular issues that the author has chosen to ignore and those ones which have been merely simplified.
  <u>An example list is included on page 7 of the note.</u>
- Is it the opinion of the author and/or the ERO that the "*huge uncertainties"* referred to in line 4/5 of paragraph 3 translates into a higher risk for a company such as KEK JSC operating in the Kosovar environment? Please elaborate.
  <u>The uncertainties captured in the Kosovar environment are reflected in the country risk premia attributed to Kosovo.</u>

Comments:

- We would like to underline that in our view it is entirely incorrect to attribute the same assumptions on WACC to both KEK and KOSTT. A need exists for a separate study of both entities.

We would be interested to hear from KEK JSC as to how they consider the assumptions should differ between KOSTT and themselves.

- We concur with the assertion that "*many uncertainties remain*" and would state that this obviously effects the risk attributable to KEK, its investments and the necessary rate of return those investments should rightfully attract.
  Please see response above.

4. *Assumptions*

Question:

- Why is this methodology proposed when it does not currently apply to KEK and cannot apply in the medium term as there exists no possibility of introducing commercial financing until at least 2008 (please see KEK Financial recovery Plan) and even then in limited amounts?
  As part of its price review, ERO will be required to make decisions on likely future financing of KEK JSC investments. This note does not prejudge the issue of what level of commercial financing can reasonably be expected.

Comment:

- With respect to the comment that KEK can access foreign capital markets we would point out that there exist no plans to do so and very limited opportunities given the ill defined status of Kosovo. Furthermore we request that the ERO specifically elicit a response from the Ministry of Economy and Finance on the legality, advisability and opportunity for KEK to avail of such funds.
  The assumption made is that final status will be resolved within the period covered by this price review. Given the small size of the Kosovar capital market, a prohibition on KEK JSC seeking foreign financing would seem to imply a continued reliance on donor and Government funding. We understand that this is not Government policy and that donors have so far not been forthcoming with commitments to meet KEK JSC's investment programme. A copy of this note/position paper has been provided to the Ministry of Economy and Finance for their comments.

3. Calculating WACC

Questions:

- Can you please define what r_d or r_e; are? Are we correct to assume that this is the same r_d and r_e as referred to and eventually defined on page 3 and page 6?
  This is correct.

Comments:

- We concur that there is no single 'right' number for the various components and that these components are merely estimates.

3.1 Gearing

Questions:

- How can the assumption listed in paragraph 1 (that is effectively no gearing) be inappropriate if this is the reality at present?

- How can KEK JSC be expected to follow such a financing policy if it is unable to obtain financial loans?

<u>Please see response above.</u>

Comments:

- We confirm we rely on donor and KCB grant funding but we disagree with the assertion that KEK JSC lacks inherited debt because this remains unclear and we expect this to be resolved as an issue during status talks.

<u>Please see response above.</u>

- We agree that, as stated in the company Financial Recovery Plan, we expect to rely on donor funding and KCB for investments in the medium term. Indeed KEK JSC has been at the forefront of advocating a donor conference to raise such funds.

<u>Can KEK JSC confirm whether any commitments have yet been made by either Government or donors to providing such funds?</u>

- Table 1(*Evidence on Gearing*). It would be appreciated if more examples from the region could be made available as a measure of comparison closer to the Kosovar reality. It is unhelpful and misleading to quote examples from the southern hemisphere and nothing from the Balkans.

<u>We agree that evidence from the Balkans would be a valuable addition. However, we note that such evidence is difficult to obtain as many regulators do not publish their decisions in detail. We attach a short summary of other regulatory decisions in the region. If KEK JSC has further evidence that it would wish to provide, this would be welcomed.</u>

- Please note that if KEK JSC was to apply for a credit rating it is highly unlikely to achieve anything close to BBB. Again this is not a fair comparison.

<u>The gearing shown is a target for new investment, not an indication of what KEK JSC's current gearing is or should be and what its credit rating would be at this time.</u>

- The chances of KEK achieving a 60% gearing ratio are limited given its present financial condition and its existing ratio of zero.
- KEK' does not envision building any new generation in the near future.
- KEK agrees that the generation and supply businesses are more risky. Factors such as the age and state of its generation plant and the low collection percentage in Supply make these businesses definitely more risky. In addition the lack of access that Supply Division faces in major enclaves North of The Ibar (representing in excess of 10% of the consumer load in Kosovo) is an additional risk factor. Furthermore the lack of spare physical generation capacity means that in the event of an unscheduled outage Supply Division is immediately exposed to the necessity to import power at elevated prices.
- We would like you to note that KEK even at present <u>does not</u> have an effective monopoly in generation , with both Lumbardh and Iber Lepenc (who you have copied on this 'position' paper) presently generating in Kosovo.

  <u>KEK JSC's generating capacity represents approximately 90% of operating capacity within Kosovo, and both Lumbardh and Iber Lepence sell exclusively to KEK JSC at prices defined in contracts. We also note</u>

that both hydro-plants are by their nature "must run" plants. This appears to be an effective monopoly with little competitive threat to KEK JSC's dominance.

- Furthermore KEK does not have an effective monopoly in supply with an illegal entity (i.e. the so called ElectroKosmet) presently attempting to operate, bill and collect on the distribution network in parts of Kosovo.
- We agree that new generation and supply is likely to be undertaken by private investors and will be unregulated.

3.2. Return on Debt

Risk-free rate

Questions:

- Please define what the Kosovo government credit rating is at present?

We are not aware that the Kosovo Government is currently rated.

- Please clarify what assumptions were used when determining that a credit rating between B and BB would be "reasonable "to expect for Kosovo?

This is based on an assessment that Kosovo would be expected to be rated above a country which has defaulted on its international debt (Argentina) and which does not benefit from the extensive donor support that Kosovo has and is likely to continue to have, but would be rated below countries with reasonably strong economies such as the Ukraine.

- Please define what assumptions were used when defining a risk-free rate of 5.5% in Kosovo?

As stated in the note, this follows from the assumption on Kosovo's possible credit rating lying approximately halfway between the average yield for the Ukraine and Turkey and that of Argentina. The value has been rounded to the nearest 0.5% representing the degree of uncertainty over any estimates of WACC.

Comments:

- We concur with your statement that "Even if final status is rapidly resolved Political and Economic risk is likely to remain high"

Debt risk premium

Comment:

- KEK would be more at ease with a comparison directly from the region particular in the Former Yugoslav republics. KEK also agrees with the assumption that debt risk premium should be at the higher end of that scale.

3.3 Return on equity

Question:

- Could you please list which of the many possible real life market phenomena that the CAPM is, in your view, unable to explain in practice?

  These include:

- **Small Firm Effect: Smaller frms have higher expected returns than predicted by the CAPM.**
- **Value Effect: Firms with low ratios of book value to market value have higher expected returns.**
- **Neglected Firm Effect: Firms with low institutional holdings have higher returns.**
- **Overreaction: Stocks which are down in one time period tend to rebound in the next (and vice versa).**
- **January Effect: The return in January is consistently larger (by up to 8%) than returns for all other months.**
- **Monday Effect: The return from Friday close to Monday close is negative.**

Equity Risk Premium

Questions:

- Can you please provide us with further information and the sources of the quoted various debates that are relevant to the Kosovo reality as promised in the last paragraph of page 7?
  A good starting point is E Dimson, P Marsh and M Staunton (April 2006), The Worldwide Equity Premium: A Smaller Puzzle (downloadable from http://www.helsinki.fi/iehc2006/papers1/Dimson.pdf#search=%22triumph%20of%20the%20optimists%20officer%22). This contains a number of references to further reading if additional insight is required.
- Are there any regulatory decisions in the region that we can view in regard to assumed ERP in the estimation of WACC?
  Please see attached summary.

Comments:

- There appears to be little real basis in the calculation of the ERP due to the lack of a functioning stock market in Kosovo.
  This is a common problem, not confined to Kosovo. The use of proxies is common regulatory practice. We welcome any alternative proposals on an appropriate methodology to calculate the required equity return for KEK JSC.

Beta

Comments:

- Table 4 (International Regulatory Decisions on Equity Betas) is of limited assistance due to the lack of a relevant regional comparison.
  Please see previous responses.
- Again, we would like to record that KEK is not a monopoly in the market but there is at least 2 companies generating in the market.
  Please see response above.
- A common equity beta for KEK and KOSTT should not be assumed.
- Only 8% of our demand is associated with industry. This represents an artificial situation in Kosovo where industrial demand is suppressed but even so we do not accept that revenues are potentially more volatile than

GDP growth; we believe there is a strong link between these as demonstrated worldwide.
<u>The paper argues that the sensitivity arises from the impact that one large customer can have on electricity demand compared to their impact on the wider economy—precisely because of the small share of industrial demand in GDP.</u>

- We believe a more thorough study of the existing privatization process should be carried out in order to have a more realistic projection of the impact of volatility of electric demand on GDP.
<u>This comment is unclear.</u>

3.5 'Small company' adjustment

Comment:

- The current value of KEK's fixed assets is €328M.
<u>Noted.</u>

5. Comparison with other estimates

Question:

- There appears to be an inherent contradiction with your calculation of a 10.8% WACC. Please clarify? Are you suggesting that KEK operates in a less risky environment that Banks in Kosovo?
<u>The appropriate comparison is between the assumed real return on equity for KEK JSC and the real return on equity estimated by the IMF for banks in Kosovo. The former is 13.5-16.0% and the latter lies between 16.7% and depending on whether Eurozone inflation of approximately 2.0% or Kosovar inflation of approximately is applied. This implies that KEK JSC is slightly less risk than banks, a conclusion that takes account of KEK JSC's implicit Government guarantee.</u>

Comments:

- We concur with the comment that the estimate appears conservative compared with the return on equity earned by banks.

6. The role of government

Comments:

- It is KEK's view that the Ministry of Economy and Finance will be entitled to a rate of return on assets when KEK recovers financially and certainly no policy has been put forward by them so far in this regard suggesting that they would forego such a dividend. Indeed we would suggest that this is highly unlikely even in the situation where a utility had the most benign governmental relationship.
<u>This is a matter for Governent policy. As noted above, ERO has committed to allowing recovery of actual financing costs (including any return required by MFE) on existing assets as and when these are incurred. It is also appropriate to note that Government will need to balance its desire for such a return against the implications for electricity tariffs.</u>

7. Conclusions

a) A common WACC should apply to both KEK and KOSTT, as they are deemed to operate in a similar environment and face similar risks.

Comments:

- Yes, we both operate in Kosovo.
- No, we do not face similar risks, we have higher risks than KOSTT.
  <u>We would welcome further detail on KEK JSC's arguments underlying this statement.</u>

b) The real (i.e. deducting inflation) cost of debt for KEK and KOSTT is 7.9 – 8.4%.
Questions:

- Is it 7.9% or 8.4%? The uncertainty obvious in the author's calculations mirrors the reality of a high risk environment where most assumptions can become rapidly invalidated. Furthermore we would suggest that even if KEK could secure debt financing, the cost is likely to be much greater because of the associated risk to the borrower.
  <u>Does this imply that KEK JSC's view is that actual rather than an assumed financing cost should be passed through on all assets? Or does KEK JSC believe a different figure is warranted and, if so, what is this?</u>

c) The real cost of commercial equity for KEK and KOSTT is 13.5 – 16.0% before tax.
Comments:

- Again, the range is wide, and the credibility of the assumptions on which the calculation is based are questionable.

d) A gearing (debt to capital ratio) of 60% is appropriate for the future financial structure of KEK and KOSTT.
Comments:

- This is clearly not achievable in present circumstances and should not be set as a target for KEK.
  <u>Please see previous responses.</u>

e) The estimated real pre-tax WACC for KEK and KOSTT lies in a range of 10.1 – 11.4% with a mid-point of 10.8%.
Comments:

- KEK suggests that further work, particularly comparisons based in the region, needs to be undertaken before such a conclusion and definite figure can be recommended to the ERO.
  <u>Please see response above requesting KEK JSC's alternative proposals.</u>

<u>Attachment – Example Balkans WACC decisions</u>

Bulgaria (distribution network)

- Rate of return = pre-tax, risk-adjusted, real WACC
- Capital structure (gearing ratio):
  - replicates actual capital structure in first regulatory period
  - after that, gradual move to target gearing ratio
- First regulatory period :
  - Return on equity = 16%
  - Cost of debt set close to actual interest rate on existing loan agreements
  - **Minimum WACC = 12%**

Slovenia (Networks)

- Rate of return = pre-tax, real WACC
- Results of initial calculations:

    - Average cost of debt 4.5% real
    - Return on equity of 11.8% real
    - This gave a WACC > 9% real – too high – hence;
- First regulatory period, taking into account need to limit price increases for network and to obtain political acceptance, **WACC set = 5.1%**

Romania

- Rate of return = pre-tax, risk-adjusted, real WACC
- First regulatory period - WACC set at **12% real**
- Second regulatory period – WACC set at **10% real**
- Third regulatory period onwards, ANRE will calculate the WACC on the basis of :
    - Cost of equity, estimated by applying CAPM, looking at empirical values of other regulator for countries with similar risk.
    - cost of debt,
    - gearing ratio