<u>Weighted Average Cost of Capital Position Paper</u>
<u>Response from KEK</u>

21. 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.
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?
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 <u>do not</u> 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 <u>wholly unachievable</u> 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.

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.
- 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.

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.

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.
- 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.
- 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.

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 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.

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?

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 illicit a response from the Ministry of Economy and Finance on the legality, advisability and opportunity for KEK to avail of such funds.

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?

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?

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.
- 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.
- 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.
- 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.
- 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.
- 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?
- Please clarify what assumptions were used when determining that a credit rating between B and BB would be "reasonable "to expect for Kosovo?
- Please define what assumptions were used when defining a risk-free rate of 5.5% in Kosovo?

Comments:

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

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?

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?
- Are there any regulatory decisions in the region that we can view in regard to assumed ERP in the estimation of WACC?

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.

Beta

Comments:

- Table 4 (International Regulatory Decisions on Equity Betas) is of limited assistance due to the lack of a relevant regional comparison.
- 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.
- 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.
- 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.

3.5 'Small company' adjustment

Comment:

- The current value of KEK's fixed assets is €328M.

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?

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.

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.

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.

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.

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.