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Ymer Fejzullahu
Chairman of ERO Board

KOMPANIA KOSOVARE PËR DISTRIBUIM DHE FURNIZIM ME ENERGJI ELEKTRIKE S.H.A.
KOSOVO ELECTRICITY DISTRIBUTION AND SUPPLY COMPANY J.S.C.
KOSOVSKO PREDUZEĆE ZA DISTRIBUCIJU I SNABDEVANJE ELEKTRIČNOM ENERGIJOM D.O.

KEDS - S.H.A.

Nr. 64 Dt. 29.07.2022
HQ 1

Alpin Dogan
Chief Executive Officer
KEDS J.s.c

29 July 2022

SUBJECT: The Third Periodic Review for the regulatory period 2023-2027

Dear Mr. Fejzullahu,

The Energy Regulatory Office (ERO) has initiated the third periodic review for the regulatory period 2023-2027 on 26 May 2022 to set the Maximum Allowed Revenue (MAR) for the Distribution System Operator (DSO) for the period 1 April 2023 to 31 March 2027.

In accordance with the requirements of the Initiation Document for the Third Periodic Review, DSO has prepared the Proposal for the input values such as:

- Weighted Average Cost of Capital,
- Allowed level of losses and losses sharing factor

Electricity crises, increase of prices and inflation is expected to negatively affect the upcoming years, therefore in order to avoid any risk that could damage the financial stability and sustainability, as well efficient operation of the DSO, we request from ERO to consider the DSO's proposal

Due to the great importance of this process, DSO is open and ready for further discussions whenever necessary.

Sincerely,


Alpin Dogan
Chief Executive Officer, KEDS J.s.c

Appendix

Proposal on Weighted Average Cost of Capital

Proposal of DSO for Loss reduction target 2023-2027



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Proposal for the Weighted Average Cost of Capital (WACC) for the third regulatory period 2023-2027

July 2002



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1. Introduction

The Energy Regulator Office (ERO) based on the responsibilities given by the Law on the Energy Regulator as well as in accordance with the Rule on Distribution system operator Revenues has started the third periodic review for multi-year tariffs (MYT3) to set the Maximum Allowed Income (MAR) of licenses OST/OT and DSO for period 1 April 2023 to 31 March 2027.

Part of the third periodic review is the determination of the input values as main parameters, which are used to calculate the maximum allowed revenues of the DSO. One of the input values that is used to calculate the maximum allowed revenues for DSO is the Weighted Average Cost of Capital (WACC).

DSO in this document has presented the proposal for the weighted average cost of capital for the regulatory period 2023-2027, the value of which will ensure continuity and financial stability for the Distribution System Operator, as required by applicable legislation.

2. Methodology

The weighted average cost of capital (WACC) is the discount rate that represents the investor's preferred rate of return, which is generally considered to be the investor's opportunity cost of capital. The size of a discount rate is related to the perceived risk of the investment. The concept of risk includes an investment situation that lies somewhere between complete certainty of monetary return (no risk), and complete uncertainty of monetary return (infinite risk). When an investor compares two investments, where each has the same expected monetary return, an investor would prefer an investment with lower risk. Therefore, the higher the risk, the higher the expected return.

The WACC calculation methodology is based on the DSO Revenue Rule, according to which the method of calculation is determined based on the following formula.

$$WACC = (1 - g) * (rE) / (1 - t) + g * (rD)$$

Where:

- **WACC** - the Weighted Average Cost of Capital
- **g** - Gearing (debt:debt+equity ratio)
- **rE** - real cost of equity (expressed as a %)
- **rD** - real cost debt (expressed as a %)
- **t** - Kosovo corporate income tax rate

According to the DSO Pricing Rule:

The gearing (g) shall be a value proposed by the DSO licensee and determined by the Regulator between 0 and 1, and shall represent the share of debt in total financing. The value shall be determined based on



a balanced consideration of the current financing mix of the DSO and the financing mix that might be expected to be achievable now and in future taking account of the financing mix of similar utilities internationally.

The cost of equity (rE) shall be a value proposed by Distribution System Services (“DSO”) and determined by the Regulator, taking into account the similarities with the local and international companies with similar scope and calculated using the Capital Asset Pricing Model (CAPM) with the adjacent formul.

$$rE_i = r_f + \beta_i * ERP_m$$

Where:

- **r_f** - risk-free rate
- **ERP_m** - *equity risk premium*
- **β_i** - covariance between the returns on the individual equity asset and those of the market as a whole (the equity beta)

The risk-free rate (r_f) shall represent the cost of non-concessionary sovereign debt in Kosovo, in real terms, and shall be proposed by the DSO licensee and determined by the Regulator using evidence on the cost of non-concessionary sovereign debt for Kosovo and/or, where this is unavailable or insufficient, the cost of non-concessionary sovereign debt for countries considered to have a similar credit status to Kosovo.

The equity risk premium (ERP_m) shall be proposed by the DSO licensee and determined by the Regulator using evidence on the equity risk premium internationally.

The beta (β_i) shall be proposed by the DSO licensee and determined by the Regulator using evidence on the beta applicable to similar utilities internationally.

The cost of debt (r_D) shall be the average interest rate of existing long-term loans (exceeding one year) to the DSO, expressed in real terms and weighted according to the value in Euros of each loan.

The DSO shall be required to procure commercial (non-concessionary) loans through a competitive process, or to demonstrate to the satisfaction of the Regulator that the interest rate of those loans not procured through a competitive process is equal to or less than the prevailing market interest rate at the time the loan agreement was signed.

Where the Regulator considers that the interest rate of a loan not procured competitively exceeds the prevailing market interest rate then the difference of the loan above the interest rate shall be adjusted and excluded from the calculation of the cost of debt.

Where the Regulator considers there are insufficient existing loans to provide a reasonable estimate of the actual cost of future debt financing to the DSO, the Regulator may make an adjustment to the actual cost of debt calculated as above. This adjustment shall be made based on:

- I. An assessment of the prevailing market interest rate for loans to businesses of similar size, risk and credit status as the DSO.
- II. An assessment of the expected interest rate applied to any future concessional loans to the DSO.



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- III. An assessment of the expected mix of commercial (non-concessional) and concessional loans in the debt of the DSO over the coming Regulatory Period.

Weighted Average Cost of Capital is used as the appropriate measure of the minimum return investors require to invest in a business. It is a measure of the normal profit level a business needs to be able to attract finance in a competitive market. The WACC is a widely accepted methodology to calculate the cost of capital, understood by both the finance community and the industry, and already used by many regulators.

In order to take as a basis the size of the company compared to other companies in the international market, which is comparatively a smaller company, the size risk premium has been added to the cost of capital, in accordance with the WACC calculation theory.



3. Gearing

The estimation of the financial structure of the company must consider the financial ratio of comparable companies which operate in the electricity distribution service, have similar activities, as well as optimizing this structure so as to reduce the cost of capital. The approach implicitly assumes that the peer group jointly represents an efficient investor.

Since the estimated WACC is to be applied in the Regulatory Asset Base (“RAB”), we deem appropriate to use the Adjusted Net Debt in our calculation. We concluded in the Adjusted Net Debt by deducting from Total Debt, Cash & Cash Equivalents and Lease Liabilities.

In order to derive a range of Cost of Equity and to properly assess the impact of capital structure, we consider a minimum and a maximum value of debt/equity.

The minimum debt/equity ratio is provided by Capital IQ as of 11 July 2022, based on an average of 5 years data in line with Beta calculations.

The maximum debt/equity ratio is based on CEER Report on Regulatory Frameworks for European Energy Networks 2021. We deemed appropriate considering the average debt/equity of four countries (Albania, North Macedonia, Montenegro, Slovakia) based on available data.

Gearing Ratio			
	Average of D/E	Average of D/C	Average of E/C
Selected Electric Power Distribution Comparable Companies	57.8%	36.62%	63.38%
Selected countries D/E ratio based on CEER	66.7%	40.00%	60.00%

Source: Deloitte Analysis

In the above table, it is presented the debt to equity ratio of different samples, in line with Beta calculation, respectively:

1. Selected European public traded Electric Power Distribution companies;
2. Selected countries average D/E ratio based on CEER;

As a conclusion the Gearing ratio of the sector ranges between 36.62% to 40.00%.



4. Methodology for calculating Cost of equity

The cost of equity represents the return on a comparable alternative investment to the investment in the subject company and must have similar characteristics to the stream of payments from the company with respect to maturity, risk and taxation. Alternative returns are normally determined on the basis of returns in the capital markets for equity investments in companies (in the form of a share portfolio). These returns can be observed in the market and can be divided in principle into a risk-free rate and a risk premium required by shareholders in return for accepting business and financial risk. The risk premiums correspond to specifics of Kosovo market and/or company and size risk.

This is the approach most commonly used by investors to estimate cost of equity expressing the expected return on equity.

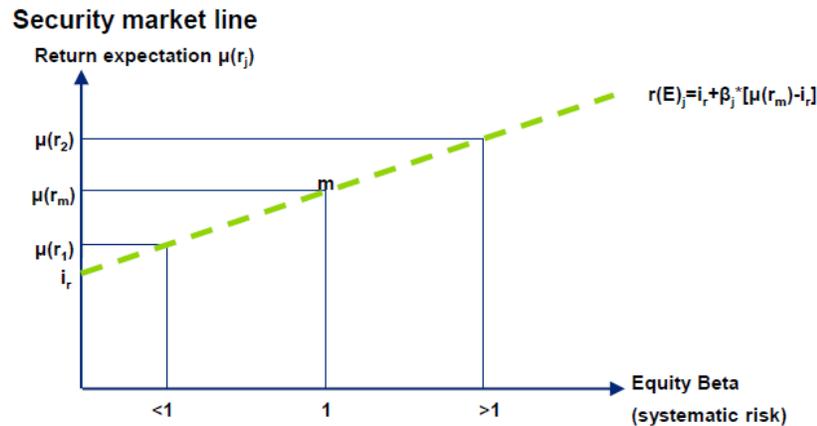
In view of determining the cost of equity of a company, we refer to one method reflecting the considerations on several markets and business features indicated by the results of the researches and analysis conducted on comparable companies operating in international markets. Theoretical capital market models have been developed in the economic science in order to estimate the cost of equity, of which the most significant is the Capital Asset Pricing Model (CAPM). The fundamental assumption of the CAPM is that there is a linear relationship between the risk attaching to a security and the expected return for that security. The model measures the risk of the security using its normalized covariance, known as the beta coefficient.

The cost of equity of a company can be estimated using the CAPM on basis of the following formula:

$$r(E)_j = ir + \beta_j * [\mu(rm) - ir]$$

Where:

- **r(E)_j** - equity providers' required rate of return for the leveraged company
- **ir** - return on a risk-free investment (equal to risk-free rate)
- **β_j** - the beta
- **μ(rm)** - expected return on the market portfolio



4.1. Cost of equity - German Risk-free rate

Conceptually, the risk-free rate represents the return that the investor can achieve at the estimation date from an investment in risk-free securities with a similar maturity. In a theoretical ideal case, this is the return on a portfolio of securities whose risk of default and correlation with the returns on other investments is equal to zero.

Furthermore, given the absence of traded (liquid) long-term government bonds in Kosovo, the Risk-Free Rate is based on the rate of the German bond, denominated in EUR, corresponding to Kosovo currency. The risk-free rate based on German Government bond approach reflects better the present market circumstances because of long maturities of the bonds, liquidity of the bonds and large number of bonds traded.

Further adjustments are performed to reflect the Kosovo business environment compared to the German one, such as the country risk premium.

German Government bonds used for the risk-free rate have a maturity of 20 years, given that most likely this is the minimum time horizon of the capital expenditures applied in energy industry.

In view of the recent turbulence on the capital markets and the resulting volatile performances of prices and indices, we deemed it appropriate to use a range of values to account for the volatility.

We used as a minimum the average yield of the last three months preceding 11 July 2022 of 1.40% and as a maximum the yield as of 11 July 2022 of 1.48%. A longer historical period to average risk-free rate would not be appropriate because the sharp increase of inflation is here to stay during the next period tariff application.

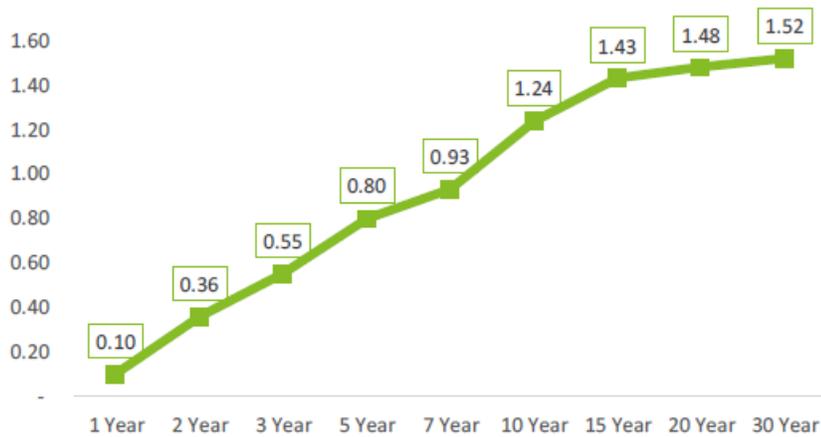
An adjustment on the selected risk-free rate has been applied, deducting from minimum RFR the average CDS (Credit Default Swap) for Germany of the last three months preceding 11 July 2022 of 0.23% and



deducting from maximum RFR the CDS as of 11 July 2022 equal to 0.26%, in order to generate an adjusted risk-free rate, excluding CDS effect.

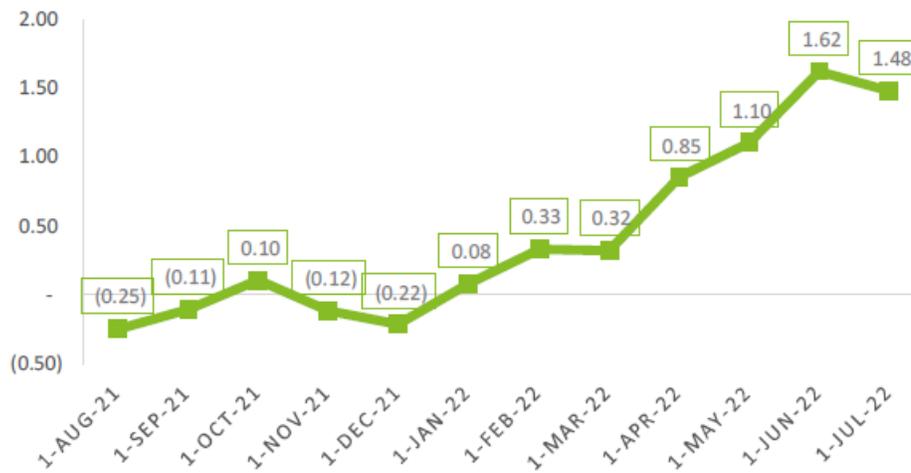
Therefore, the German risk-free rate used range from a minimum of 1.17% to a maximum of 1.22%.

German Government Bond Yield as of 11 July 2022



Source: CapIQ

Last 12 months 20 Years German Government Bond



Source: CapIQ



4.2. Cost of equity - Kosovo Risk-free rate

Germany displays the lowest risk in Europe, implying that any investor might choose to invest in an alternative European country governmental bond by considering the additional risk of the country. Based on this rationale, the risk-free rate of another European country can be calculated by adding the specific country risk premium to the German risk-free rate.

The country risk premium for Kosovo was calculated based on Damodaran country risk premium estimations, which derive from converting the respective sovereign ratings default spreads of each country into a country risk premium.

Kosovo does not have a ranking from rating agencies, therefore it is not possible to estimate a direct country risk for it. In order to bypass this difficulty we considered all countries neighboring Kosovo (Albania, Bosnia and Herzegovina, North Macedonia, Montenegro and Serbia), assuming that Kosovo has similar political, economic and financial issues compared to these countries. We considered the average sovereign ratings default spread of these countries a minimum, which resulted in 5.30%. As a maximum, we considered the average sovereign ratings default spread of Albania, Bosnia and Herzegovina and Montenegro as these countries are deemed to be more comparable with Kosovo.

Damodaran Country Risk Premium

Country	Moody's rating	Rating-based Default Spread	Country Risk Premium
Albania	<i>B1</i>	5.40%	6.29%
Bosnia and Herzegovina	<i>B3</i>	7.80%	9.09%
Macedonia	<i>Ba3</i>	4.31%	5.03%
Montenegro	<i>B1</i>	5.40%	6.29%
Serbia	<i>Ba2</i>	3.61%	4.21%
Average		5.30%	6.18%
Average B1-B3		6.20%	7.23%

Source: Damodaran, 2022

The default spread reflects the bond markets, which are proven to be less risky than equity markets. Damodaran calculates the relative volatility multiplier (1.17x) using the ratio of the S&P Emerging Market Equity Index standard deviation to the BAML Emerging Public Bond index standard deviation.

Therefore, the resulting country risk premium for Kosovo is 7.23%. Kosovo risk free-rate has been calculated by adding to the German risk-free rate the estimated country risk of Kosovo is estimated as 8.45%.



Description	Value
German Risk Free Rate	1.48%
CDS for Germany as of 11 July 2022	0.26%
German Risk Free Rate adjusted for CDS	1.22%
Rating-based Default Spread (as per regional countries)	6.20%
Adj. for additional risk spread	1.17x
Adj. Country Risk Premium	7.23%
Kosovo Risk Free Rate	8.45%

Source: Deloitte Analysis

4.3. Cost of equity - Equity Risk Premium

The higher level of risk associated with an investment in a company compared with risk-free securities is reflected in the equity risk premium. It is calculated as the difference between the expected return on the market portfolio, which represents the hypothetical portfolio of a fully diversified investor and the risk-free return. While the market portfolio as such is not available on the capital market, it can be conveniently equated with major indices (e.g. S&P 500).

The equity risk premium does not compensate for the total risk associated with a security, but only covers the systematic risk (market risk). Systematic risk is the part of the total risk of a security that cannot be avoided by diversification. The level of systematic risk is affected e.g. by the risk-free rate, economic forecasts or taxation policies by countries.

The Arithmetic Average ERP for 1926 – 2020 as per 2021 SBBI Yearbook; Duff & Phelps results at 7.25%. In order to reverse historical S&P 500 P/E appreciation Deloitte calculates P/E Adjustment of 0.78% representing the Annual growth in S&P 500 Index P/E. The Modified Historical ERP results at 6.47%.

Furthermore, as per latest Deloitte calculation, Implied Return on Market results at 9.65%-10.32%. The range of Implied Return on Market is adjusted for Risk-Free Rate (the yield of the 20-Year Treasury Constant Maturity bond) resulting at Implied Equity Risk Premium of 6.27% - 6.94%.

Based on the above-mentioned, as per the latest Deloitte Advisory consensus(30 June 2022), ERP results at 6.25%.

Equity Risk Premium	Value
Equity Risk Premium as of 30 June 2022	6.25%

Source: Deloitte Methodology

We used the equity risk premium of 6.25% in our WACC calculation.



4.4. Cost of equity - Beta coefficient

An important consideration in determining the cost of equity for a specific company is the assessment of the risk profile of the company in comparison with the market as a whole. This assessment is expressed by the beta coefficient. The beta coefficient represents the extent to which the return on a particular security changes when there is a change in the return on the market portfolio. The beta coefficient is therefore a measure of the systematic risk of a particular security and is expressed in mathematical terms as a normalized covariance.

In general, a company must be quoted on a stock exchange in order for the risk premium to be calculated using the CAPM. In the absence of observable returns, such as for private companies, it is not possible to calculate a beta coefficient directly from the market. However, the beta coefficient can be estimated for unquoted companies by using a sector average or the average beta of a selected peer group of comparable companies. For this purpose, we have selected the sample of peer companies presented in the Appendix 1 to derive the beta coefficient.

When using the published beta coefficients of comparable companies, it should be stated the comprised systematic risk attached to the respective comparable companies, or the sector average. The systematic risks may possibly include both operating risks and financial risks. Therefore, the comparable companies beta is adjusted for the financial (Debt/Equity) and operational risk (corporate tax).

Peer group selection process

For the purpose of our research, our primary resource was the database provided by Capital IQ (S&P), offering high quality information on both public and private capital markets along with applications of market and companies researches, screening and real-time market data. The individual search parameters were set cumulatively as follows:

Classification: We identified the long list pool of comparable companies throughout the criteria of industry classification of “Electric Power Distribution”, on the basis of the Capital IQ. Additionally, to the industry criteria, we limited the screening of comparable companies, selecting those operating in the European market, in order to reflect resemblance with the subject Company operating market. Furthermore, we refined the screening to reflect public companies data, with the intention of attaining an extensive quality of information.

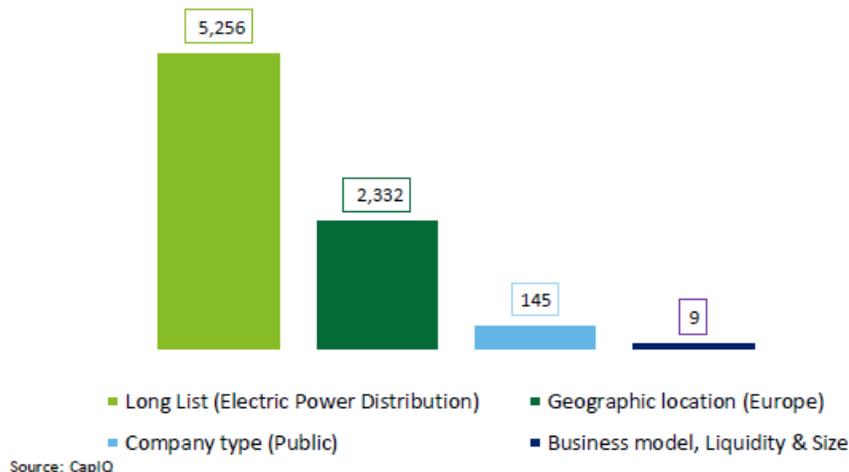
Business Model: As a second step in the peer group selection process, the business model of the companies included in the long list were reviewed and compared to the Company, then it was further considered.

Stock trading liquidity: Out of the group of public traded companies were selected those with sufficient liquidity of the share traded.

The final group of comparable companies is composed of 9 European public traded Electric Power Distribution companies as shown Appendix 1.



Comparables Companies screening



With the purpose of attaining the beta to be used as an input for the calculation of the Company's Weighted Average Cost of Capital, we have considered as a minimum the average unlevered beta resulting from the selected comparable companies, equaling 0.56x.

Additionally, the Council of European Energy Regulators "CEER" publishes every year the methodology and calculation of WACC for each European country. The data is provided by Energy Regulator Authorities of the respective countries. Based on the latest report published in January 2022 by CEER through "Report on Regulatory Frameworks for European Energy Networks 2021", we considered as a maximum the average of the unlevered beta of four countries considering the available data, respectively Albania, North Macedonia, Montenegro and Slovakia, which resulted at 0.62x.

In view of the recent turbulence on the capital markets and the resulting volatile performances of prices and indices, we deemed it more appropriate to use long-term average beta coefficients (5 years) rather than current betas in order to counteract the distortions that have arisen recently and to enable sustainable future betas to be estimated.

The unlevered beta has to be calculated using the debt/equity ratio and the Corporation Tax rate. The corporate tax rate in Kosovo is 10%.

In conclusion, the beta used for WACC calculation purposes is estimated at 1.

4.5. Cost of equity - Other specific premiums

In accordance with the CAPM model, other relevant adjustments should be considered when calculating the Weighted Average Cost of Capital. Along the lines of deliberations of market and country features where the subject Company develops its activity, other contemplations regarding the business should be taken into consideration in order to reflect the related impacts on the cost of equity. Therefore, in line



with the CAPM method, adjustments for size premium and company -specific risk premium are to be considered as explained below :

Size Premium - accounts for the additional risk inherited in the returns of small company stocks . As small companies operate within a specified sector, compared to other guideline companies, it is appropriate to apply a size premium for micro - cap to their cost of equity.

The size premium, as abovementioned, is based on a sample of companies operating in United States, which given the size and the trends of the market do not completely correspond to the size of companies operating in Kosovo. Therefore, considering the small size of the Company subject to analysis compared to US market, however given the importance of the company in the context of Kosovo market (KEDS is the only licensed Energy Distribution company), we deemed reasonable to classify it as micro to low-cap.

Therefore, the size premium used in the calculation of this cost of capital ranges between 1.50 % 3.25 %.

Rank	Market Capitalization in USD mln		Value Size Premium
	From	To	
Medium Capitalisation 3-5	2,446	13,178	0.75%
Low Capitalisation 6-8	449	2,445	1.50%
Micro Capitalisation 9-10	2	446	3.25%
1	29,026	1,966,079	0.00%
2	13,179	28,808	0.50%
3	6,715	13,178	0.75%
4	3,830	6,711	0.75%
5	2,446	3,829	1.00%
6	1,592	2,445	1.25%
7	912	1,589	1.50%
8	449	911	2.00%
9	189	446	2.25%
10	2	189	5.00%
10a	84	189	3.25%
10w	125	189	2.50%
10x	84	125	4.50%
10b	2	84	8.00%
10y	37	84	6.25%
10z	2	37	11.00%

Source: Deloitte Methodology



5. Methodology for calculating the Pre-tax Cost of Debt

Unlike the cost of equity, the required return on debt can be directly observed in the market. In view of the cost of debt for the Company, we have considered a Reference Interest Rate (1Year EURIBOR) and applied Debt Risk Premium (Corporate credit spreads) based on credit rating.

For Reference Interest Rate we used as a minimum the average 1Year EURIBOR of the last three months preceding 11 July 2022 of 0.7% and as a maximum the 1Y EURIBOR as of 11 July 2022 of 1.0%.

Kosovo does not have a credit ranking from rating agencies, therefore it is not possible to estimate a direct credit rating for it. In order to bypass this difficulty we considered countries neighboring Kosovo (Albania, Bosnia and Herzegovina, North Macedonia, Montenegro), assuming that Kosovo has similar political, economic and financial issues compared to these countries.

Country	Moody's rating	S&P's rating
Albania	<i>B1</i>	<i>B+</i>
Bosnia and Herzegovina	<i>B3</i>	<i>B</i>
North Macedonia	<i>Ba3</i>	<i>BB-</i>
Montenegro	<i>B1</i>	<i>B</i>
Serbia	<i>Ba2</i>	<i>BB+</i>
Average		<i>B</i>

Source: Trading Economics

Considering the credit rating we have calculated corporate credit spreads for BB-, B+ and B rankings based on St. Louis Fed data.

For Debt Risk Premium we used as a minimum the average corporate credit spreads for BB-, B+ and B ratings of the last three months. Consequently, the selected cost of debt (pre-tax) ranges from 6.5% to 7.4%.

Description	Value
Reference rate	1%
Debt risk premium	6.5%
Cost of debt (Pre-Tax)	7.4%

Source: Deloitte Analysis



6. Proposal of WACC

Based on the above analysis, the weighted average cost of capital before tax is estimated at 15.35%. This also presents the request of the Distribution System Operator for WACC for the third regulatory period 2023-2027:

Definition	Value
Risk – free rate	8.45%
Gearing	36.62%
Premium of small company	3.25%
Cost of debt	7.40%
Premium risk	6.25%
Beta	1
Cost of equity (post –tax)	17.95%
Corporate tax rate	10.00%
Cost of equity (pre-tax)	19.94%
WACC real (Pre-tax)	15.35%

In conditions where DSO has not yet recovered from the COVID pandemic and when electricity prices in international markets will continue to be very high, setting unrealistic targets will jeopardize the financial stability of DSO, which has already been weakened by the impact of the crisis global energy.

It is a well-known fact that the economic crisis, price increases and inflation are expected to have a negative impact in the coming years, and to avoid any risk that would damage the financial stability and proper operation of DSO, ERO is required to set realistic goals for the period 2023 -2027 and increased attention is required during the evaluation of the DSO proposal.



7. Appendix - A1 Company screening

The selected pool of comparable companies consisted of 9 European public traded Electric Power Distribution companies.

	Company Name	Country	Ration of Debt/Equity	Unleveraged Beta
IBSE:ENJSA	Enerjisa Enerji A.S.	Turkey	79.3%	0.47
BME:IBE	Iberdrola, S.A.	Spain	57.4%	0.35
LSE:SSE	SSE plc	United Kingdom	43.4%	0.36
WSE:PGE	PGE Polska Grupa Energetyczna S.A.	Poland	3.2%	1.15
WBAG:VER	VERBUND AG	Austria	5.9%	0.93
ENXTLS:EDP	EDP - Energias de Portugal, S.A.	Portugal	84.3%	0.29
BME:ELE	Endesa, S.A.	Spain	66.9%	0.36
WSE:ENA	ENEA S.A.	Poland	48.9%	0.67
BIT:ENEL	Enel SpA	Italy	130.6%	0.44
Average			57.8%	0.56

Source: Capital IQ