MRA
MALTA RESOURCES AUTHORITY

Proposed Electricity Tariffs

Summary of Review Process and Conclusions

[12th December 2009]

INTRODUCTION

The Malta Resources Authority ('MRA' or the 'Authority') was requested to approve the proposed electricity retail tariffs ('the proposed tariffs' or 'the proposed tariff revision') put forward by Enemalta Corporation ('Enemalta' or the 'Corporation') in the final updated KPMG report dated 10th December 2009 (the 'KPMG Report' or the 'Model') attached herewith as Appendix 1.

The proposed tariffs have been put forward by Enemalta in light of the significant increase in oil prices that occurred in the international market place subsequent to the tariff revision which came into effect in April 2009 ('the April 2009 tariff revision').

The proposed January 2010 tariff revision takes the following into account:

a) The impact of increased international oil prices on Enemalta's fuel costs for the 12 months to 31st December 2010;
b) The Corporation's latest projected cost base for the 12 months to 31st December 2010;
c) The impact which lower levels of consumptions (compared to those prevailing prior to the April 2009 tariff revision) will have on potential achievable revenue for the Corporation in 2010;
d) The adverse variance outside the Corporation's control, which occurred in the nine months to 31st December 2009, as a direct consequence of lower consumption resulting in lower fuel usage, changes in gas oil/fuel oil mix, as well as actual fuel costs for the nine months to 31st December 2009 being significantly higher than what was projected at the time of the April 2009 tariff as a result of the increase in international oil prices over the same period; and
e) Other variances between budgeted and actual costs for the period April to December 2009.

The Authority noted that, as it had done in the previous tariff revisions, Enemalta has unilaterally decided to exclude from the costs incorporated in the proposed tariff revision, the significant impact of both realized and unrealized losses that are expected to arise on the 'long-term' forward hedge agreements which were in place as at 31st December 2008.

REVIEW AND APPROVAL PROCESS

As part of its Review and Approval Process the Malta Resources Authority and its consultants:

a) Reviewed and tested the workings and results reflected in the KPMG Report;
b) Reviewed and assessed the principles used as the basis of the proposed tariff revision and reconciled these with what had been approved and agreed to in May 2009 as part of the April 2009 tariff revision; and

c) Reviewed and analytically tested the information, assumptions and data used as a basis for the preparation of the KPMG Report.

FUNDAMENTAL PRINCIPLES AND OBJECTIVES

The Fundamental Principles and Objectives used as a basis of the current tariff revision have remained unchanged since the April 2009 tariff revision and may be summarised as follows:

Legality

The processes and methodologies adopted must conform to applicable legislation, regulations and directives, including the legal obligation imposed on Enemalta not to operate at a loss.

Sustainability and Profitability

The proposed tariffs should enable Enemalta to reverse its historical loss making position and achieve an acceptable rate of return on both its current and future capital employed, which would enable it to service its existing debt obligations and sustain an acceptable fixed asset replacement and upgrade policy.

Non-discrimination

The proposed tariffs must not unjustifiably discriminate between comparable groups of consumers and avoid potential cross-subsidization within the different user groups.

Transparency

The entire tariff revision process should be transparent with consumers being provided with sufficient information to enable them to secure an acceptable understanding of how:

i. The proposed tariffs were computed by Enemalta; and
ii. The Malta Resources Authority's review and approval process.

FULL COST RECOVERY METHOD

Consistent with previous tariff revision exercises, the current tariff revision has been computed by Enemalta on the basis of a 'Full Cost Recovery' method.

The 'Full Cost Recovery' method assumes that the proposed tariffs will enable the Corporation to recover all its acceptable costs and earn a reasonable rate of return on its capital employed necessary to enable it to meet its current and future debt servicing obligations as and when they fall due. The 'Full Cost Recovery' method assumes that total variable retail tariffs should be equal to the sum of:

Fuel Costs
Wages
Overheads
Return on Capital Employed ('ROCE')

After making the appropriate deductions and / or add backs in respect of:

Cost of Inefficiencies
Public Service Obligation Recoveries
Fixed Income Charges
Other Services Revenue

The current tariff revision has been based on the Corporation's forecast for 2010 as adjusted for selected under recoveries which occurred in the nine month period to 31st December 2009.

The Authority noted that the Corporation's claimed Return on Capital Employed has not been included as an amount equivalent to its total projected total debt servicing obligation as was done in April 2009. Instead the Corporation has computed its ROCE by multiplying its Total Capital Employed by its Weighted Average Cost of Capital.

Although the Authority is not questioning the validity of this alternative method it believes that the change in approach should only be approved after a suitable public consultation process.

THE REVIEW PROCESS

The Authority's review process commenced after the submission of the initial draft report KPMG dated 6th November 2009. On the basis of this initial report the Corporation was requesting that variable target revenue be increased from Euro254.1 million to Euro333.30 million as summarised in the table hereunder:

	3rd NOV 2008	31st MAR 2009	16th NOV 2009
	Euro million	Euro million	Euro million
Fuel costs	223.00	159.30	206.80
Wages	34.40	29.80	31.00
Overheads	34.30	43.10	46.70
ROCE	24.40	29.70	34.30
Under recovery – 2009	-	-	21.50
Cost of inefficiencies	(3.10)	-	-
PSOs /street lighting	(7.80)	(7.80)	(7.00)
Target Revenue (annual basis)	**305.20**	**254.10**	**333.30**

Although in the review, Enemalta adhered to the approved principles in computing it's tariff revision claim, the Authority concluded that the total claim should be reduced by Euro7.29 million.

The Authority insisted that adjustments should be incorporated into the financials included in the model to reflect:

a) Certain under recoveries (both in cost and revenues) which occurred in 2009, which the Authority concluded should be borne by the Corporation; and
b) Certain costs included in the Corporation's projections for 2010, which the Authority concluded should also be borne by the Corporation.

The Authority also accepted in principle that the Corporation may seek a subsequent adjustment in the next tariff revision to take into account potential increases in:

a) Increased costs (over and above what has already been projected) associated with the reduction of the sulphur content in fuel oil; and
b) The possible over estimation of other revenue.

CONCLUSIONS

The Authority has carried out this exercise in accordance with law, which establishes that the tariffs must provide sufficient revenue to Enemalta in its financial year and that the methodology used is in accordance with the model which has been approved after public consultation.

The Authority is pleased to note that notwithstanding the fact that the Corporation did not necessarily concur with the conclusions reached by the Authority and continued to reject the Euro7.29 million reduction in proposed tariffs, the Corporation accepted to incorporate the said reduction into the proposed tariffs, thus enabling the Authority to approve the tariffs as revised

In the light of the review process and the decision taken by the Corporation to incorporate the requested adjustment the Authority believes that the proposed revised tariffs included in the updated report of the 10th December 2009 reflect an overall acceptable target revenue figure.

REUBEN BALZAN LL.D.
CHAIRMAN