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Malta Resources Authority

Review of proposed changes in electricity tariffs

4th May 2009

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1. Introduction and Scope of Review

Terms of reference

We were commissioned by the Malta Resources Authority ('MRA' or the 'Authority') to assist with it's review of Enemalta Corporation's ('Enemalta' or the 'Corporation') request for a revision of it's electricity tariffs.

Scope of work performed

It was agreed that our work would entail providing the MRA with additional analytical information and analysis which would enable it to:

1. Obtain a clear understanding of the approach and methodology adopted by the Corporation and its advisors in the formulation of the model used as a basis for the proposed tariff revision;
2. Obtain a clear understanding of the key assumptions and the sources of input variables applied in the model;
3. Obtain sufficient comfort regarding the accuracy and reliability of:
   a) The input variables; and
   b) The actual model ('the KPMG report' or the 'KPMG model') used for the purpose of the tariff revision computations; and
4. Identify key issues which should be addressed by the Authority.

Sources of information and key discussions

The review exercise focused primarily on the information contained in the following documents:

1. KPMG Report dated 3rd November 2008
2. KPMG Report dated 23rd March 2009
3. Audited Accounts of Enemalta Corporation for the year ended 30th September 2007
4. Management accounts of Enemalta Corporation
5. Financial Budgets of Enemalta Corporation
6. Billing and customer analysis prepared by MITC
7. Internal workings generated by Enemalta Corporation in response to specific queries raised by the engagement team

In arriving at our conclusions we also took into consideration the explanations and clarifications provided to us by:

- Members of Enemalta's senior management team;
- Engagement partner and staff from KPMG; and
- Members of the Malta Resources Authority team involved in the review process

Our engagement did not entail an audit of the information used as a basis for preparation of the tariff revision model and we do not express an opinion thereon.

2. Basis of Current Tariffs

The current electricity tariffs were computed on the basis of a targeted revenue figure of Euro 305.2 million computed as follows:

	3rd NOVEMBER 2008 REPORT	BASIS OF CALCULATION
FUEL COSTS	Euro 223m	Actual crude oil market prices between 1st - 24th October 2008 less a further reduction of Euro 30 million
+	+	
WAGES	Euro 34.4m	The unaudited management accounts for the year ended 30th September 2006 adjusted for an assumed increase in cost of 25%
+	+	
OVERHEADS	Euro 34.3m	The unaudited management accounts for the year ended 30th September 2006 adjusted for an assumed increase in cost of 22% (no inflation element was applied to depreciation)
+	+	
ROCE	Euro 24.4m	6.61% (EU Commision's benchmark in 2002 adjusted for the change in EURIBOR between 2002 and 2008) of the Corporation's assumed capital employed as reported in the unaudited management accounts for the year ended 30th September 2006
-	-	
COST OF INEFFICIENCIES	Euro 3.1m	Conclusions of the report prepared by Enemalta : "Analysis of work practices reports by MEU and Enemalta" which takes into consideration the reports prepared by the Management Efficiency Unit in September 2005
-	-	
PSOs	Euro 7.8m	Actual amount received from Government on a yearly basis
=	=	
TARGET REVENUE	**Euro 305.2m**	

VARIABLE	**Euro 276.8m**
FIXED	**Euro 25.4m**
INSTALLATION	**Euro 3m**

3. Reduced Target Revenue by Euro 51.1 million

Enemalta is now proposing to reduce its variable tariff's in line with a reduced target revenue figure of Euro 254.1 million, calculated as follows:

	3rd NOVEMBER 2008 REPORT	23rd MARCH 2009 REPORT	MOVEMENT	
FUEL COSTS	Euro 223m	Euro 159.3m	**- Euro 63.7m**	**-29%**
+	+	+		
WAGES	Euro 34.4m	Euro 29.8 m	**- Euro 4.6m**	**-13%**
+	+	+		
OVERHEADS	Euro 34.3m	Euro 43.1m	**+ Euro 8.8m**	**26%**
+	+	+		
ROCE	Euro 24.4m	Euro 29.7m	**+ Euro 5.3m**	**22%**
-	-	-		
COST OF INEFFICIENCIES	Euro 3.1m	nil	**+ Euro 3.1m**	**100%**
-	-	-		
PSOs	Euro 7.8m	Euro 7.8m	**nil**	**0%**
=	=	=		
TARGET REVENUE	**Euro 305.2m**	**Euro 254.1m**	**- Euro 51.1m**	**-17%**

4. Reduction in Projected Fuel Costs

Since the date of the 1st report prepared in November 2008 the Corporation's estimated annual cost of fuel consumption, based on forward market prices, is projected to decrease by Euro 63.7 million as follows:

3rd November 2008 Report

Total estimated cost of Euro 223 million

The above estimate was based on actual average crude oil market prices prevailing in the period between 1st – 24th October 2008 less a further reduction of Euro 30 million to take into account further reduction in oil prices between the said period and the date the report was issued.

23rd March 2009 Report

Total estimated cost of Euro 159.3 million

The above estimate was based on the estimated fuel cost for 2009 excluding any effect of hedge agreements in place and calculated as follows:

January - February 2009 - Actual market prices multiplied by actual consumption

March to December 2009 - industry forward prices multiplied by estimated consumption

5. Movement in Wages and Overheads

The most recent report includes an estimate for wages and overheads of Euro 72.9 million. The estimated costs are Euro 4.2 million higher than the original cost estimate included in the November 2008 report. The revised estimate has been based on more accurate and up-to-date financial information.

	3rd NOVEMBER 2008 REPORT	AUDITED ACCOUNTS FOR THE YEAR ENDED 30th SEPTEMBER 2007	23rd MARCH 2009 REPORT
WAGES	Euro 34.4m	Euro 28.6m	Euro 29.8 m
OVERHEADS			
Depreciation	Euro 24.1m	Euro 25.7m	Euro 27.7m
Other costs	Euro 10.2m	Euro 16m	Euro 15.4m
TOTAL	**Euro 68.7m**	**Euro 70.3m**	**Euro 72.9m**

6. Return on Capital Employed

Required ROCE has increased by Euro 5.3 million as a result of a change in basis which links ROCE to the Corporation's debt servicing obligations instead of a fixed percentage of historical capital employed.

3rd November 2008 Report

- ROCE of 6.61% computed on the basis of the EU Commission's benchmark set in 2002 (5.12%) as adjusted for the change in the EURIBOR 6-month rate between 2002 and 2008.

- The Corporation's assumed Capital Employed was calculated on the basis of total assets less trade creditors as reported in the unaudited management accounts for the year ended 30th September 2006.

23rd March 2009 Report

Based on the debt servicing obligations of Enemalta in 2009 estimated as follows:

- Euro 14.132 million representing the Corporation's estimated principal loan repayments;
- Euro 14.405 million representing the Corporation's estimated interest payments; and
- Euro 1.1 million representing the financing requirements of future investment plans.

7. Elimination of Cost of Inefficiencies

3rd November 2008 Report

Based on the conclusions of the report prepared by Enemalta : "Analysis of work practices reports by MEU and Enemalta" which takes into consideration the reports prepared by the Management Efficiency Unit in September 2005 , Enemalta excluded the cost of identified inefficiencies estimated at Euro3.1 million.

23rd March 2009 Report

No deductions from target revenue were made for operational inefficiencies since the Corporation does not deem these inefficiencies as being within its direct and discretionary control.

8. No Change in PSO Contribution of Euro 7.8 million

3rd November 2008 Report

An amount of Euro 7.8 million remitted annually by Government to Enemalta Corporation to cover the cost of street lighting and the other associated costs provided to Government has been deducted from the target revenue computations

23rd March 2009 Report

No change has been made from the position of the 3rd November 2008 Report and the same deduction has been made in the current tariff revision model

9. Reduced Target Revenue

In view of the overall reduced cost input into the tariff model and the higher level of projected fixed revenue, variable tariffs have been projected to decrease by Euro 54.2 million as follows:

	3rd NOVEMBER 2008 REPORT	23rd MARCH 2009 REPORT	MOVEMENT	
	(Euro millions)	(Euro millions)	(Euro millions)	%
TARGET REVENUE	305.2	254.1	-51.1	-17%
Variable	276.8	222.6	-54.2	-20%
Fixed	25.6	28.5	2.9	11%
Installation	3	2.9	-0.1	-3%

10. Fixed and Installation Tariffs

Residential / Domestic

No change have been made in the assumptions relating to **Fixed** and **Installation** revenue from the 3rd November 2008 Report.

The **Fixed** and **Installation** rates also remained unchanged.

Non-residential

The assumed ratio of single to triple phase accounts for the purpose of calculating **Fixed** revenue was revised from **90:10** to **63:37** as a result of a more updated profile of the non-residential accounts available at the time of issuance of the 23rd March 2009 Report.

No change in the assumptions relating to **Installation** revenue from the 3rd November 2008 Report.

The **Fixed** and **Installation** rates also remained unchanged.

10. Fixed Tariffs – Residential

	3rd November 2008 Euro (inc. 5% VAT)	23rd March 2009 Euro (inc. 5% VAT)	Change Euro (inc. 5% VAT)
Total	**16,305,744**	**16,433,300**	**127,556**

Type	3rd November 2008 Number of accounts		23rd March 2009 Number of accounts		Movement	Rate inc. 5% VAT (no change)	Change (Euro)
Single	188,143	**90%**	186,097	**89%**	-2,046	65	**-132,990**
Triple	20,905	**10%**	22,241	**11%**	1,336	195	**260,520**
Total	**209,048**		**208,338**		**-710**		**127,530**

10. Fixed Tariffs – Non-residential

	3rd November 2008 Euro	23rd March 2009 Euro	Change Euro
Total	**10,088,626**	**12,756,120**	**2,667,494**

Type	3rd November 2008 Number of accounts		23rd March 2009 Number of accounts		Movement	Rate (no change)	Change (Euro)
Single	37,797	**90%**	26,189	**63%**	-11,608	120	**-1,392,960**
Triple	4,200	**10%**	15,479	**37%**	11,279	360	**4,060,440**
Total	**41,997**		**41,668**		**-329**		**2,667,480**

11. Variable Tariffs

Residential / Domestic

- No change in the Eco-reduction mechanism parameters from the Legal Notice 338 of 2008.
- Variable tariffs for the NOP=0 category (now classified as domestic) remained unchanged from the 3rd November 2008 Report
- Decreases have been applied to all other residential categories

Non-residential

- Elimination of differential rates within the non-residential categories resulting in one set of variable tariffs for all consumer groups

11. Variable Tariffs – Domestic rates (NOP=0)

Variable tariffs for the NOP=0 category (now classified as domestic) remained unchanged from the 3rd November 2008 Report.

Cumulative consumption (kWh)	3rd November 2008 Tariff inc. 5% VAT (Euro)	23rd March 2009 Tariff inc. 5% VAT (Euro)	Movement (Euro)
2,000	16c1	16c1	**no change**
6,000	17c3	17c3	**no change**
10,000	18c9	18c9	**no change**
20,000	20c9	20c9	**no change**
> 20,000	23c2	23c2	**no change**

11. Variable Tariffs – Residential Rates

Variable tariffs for the other residential categories decreased when compared to the tariffs as per the 3rd November 2008 Report. The cost of the first 10,000 kWh consumed by any residential account have decreased by an average of 22.4%.

Cumulative consumption (kWh)	3rd November 2008 Tariff inc. 5% VAT (Euro)	23rd March 2009 Tariff inc. 5% VAT (Euro)	Movement (Euro)	
2,000	16c1	11c9	**-4.2c**	**-26%**
6,000	17c3	13c4	**-3.9c**	**-23%**
10,000	18c9	15c2	**-3.7c**	**-20%**
20,000	20c9	20c9	**no change**	
> 20,000	23c2	23c2	**no change**	

11. Variable Tariffs – Non-residential: Normal vs. Proposed Rates (kWh)

The variable tariffs for residential accounts which previously paid ‘normal rates’ have decreased across the board as a result of the elimination of the differential rates.

	3rd November 2008	23rd March 2009		
Cumulative consumption (kWh)	Normal rate kWh (Euro)	Single rate kWh (Euro)	Movement (Euro)	
2,000	14c7	10c4	**-4.3c**	**-29%**
6,000	15c5	11c2	**-4.3c**	**-28%**
10,000	16c8	12c5	**-4.3c**	**-26%**
20,000	18c3	14c0	**-4.3c**	**-23%**
60,000	20c	15c7	**-4.3c**	**-22%**
100,000	18c5	14c2	**-4.3c**	**-23%**
1,000,000	17c2	12c9	**-4.3c**	**-25%**
5,000,000	16c	11c2	**-4.8c**	**-30%**
> 5,000,000	13c4	8c6	**-4.8c**	**-36%**

11. Variable Tariffs – Non-residential : Reduced vs. Proposed Rates (kWh)

As a result of the elimination of the differential rates, the variable tariffs for non-residential accounts which previously benefited from the 'reduced rates' remained fairly constant, with marginal decreases per kWh registered in the higher consumption bands.

Cumulative consumption (kWh)	3rd November 2008 Reduced rate kWh (Euro)	23rd March 2009 Single rate kWh (Euro)	Movement (Euro)	
2,000	10c4	10c4	**no change**	
6,000	11c2	11c2	**no change**	
10,000	12c5	12c5	**no change**	
20,000	14c	14c0	**no change**	
60,000	15c7	15c7	**no change**	
100,000	14c2	14c2	**no change**	
1,000,000	12c9	12c9	**no change**	
5,000,000	11c7	11c2	**-0.5c**	**-4%**
> 5,000,000	9c1	8c6	**-0.5c**	**-5%**

11. Variable Tariffs – Non-residential : Normal vs. Proposed Rates (kVah)

The variable tariffs for residential accounts which previously paid ‘normal rates’ have decreased across the board as a result of the elimination of the differential rates.

Cumulative consumption (kVah)	3rd November 2008 Normal rate kVah (Euro)	23rd March 2009 Single rate kVah (Euro)	Movement (Euro)	
2,000	13c5	9c6	**-3.9c**	**-29%**
6,000	14c3	10c3	**-4c**	**-28%**
10,000	15c5	11c5	**-4c**	**-26%**
20,000	16c8	12c9	**-3.9c**	**-23%**
60,000	18c4	14c4	**-4c**	**-22%**
100,000	17c	13c1	**-3.9c**	**-23%**
1,000,000	15c8	11c9	**-3.9c**	**-25%**
5,000,000	14c7	10c3	**-4.4c**	**-30%**
> 5,000,000	12c3	7c9	**-4.4c**	**-36%**

11. Variable Tariffs – Non-residential : Reduced vs. Proposed Rates (kVah)

As a result of the elimination of the differential rates, the variable tariffs for non-residential accounts which previously benefited from the 'reduced rates' remained fairly constant with marginal decreases per kVah registered in the higher consumption bands.

	3rd November 2008	23rd March 2009		
Cumulative consumption (kVah)	**Reduced rate kVah (Euro)**	**Single rate kVah (Euro)**	**Movement (Euro)**	
2,000	9c6	9c6	**no change**	
6,000	10c3	10c3	**no change**	
10,000	11c5	11c5	**no change**	
20,000	12c9	12c9	**no change**	
60,000	14c4	14c4	**no change**	
100,000	13c1	13c1	**no change**	
1,000,000	11c9	11c9	**no change**	
5,000,000	10c8	10c3	**-0.5c**	**-5%**
> 5,000,000	8c4	7c9	**-0.5c**	**-6%**

12. Variances for the Period October 2008 - March 2009 (based on a 7% reduction in electricity consumption)

The adverse variances resulting from reduced consumption and higher wages and overheads offset the positive impact of the favourable variances attributable to the drop in fuel prices and the increased fixed revenue for the period October 2008 to March 2009 as follows:

	3rd NOVEMBER 2008 REPORT	ATTRIBUTABLE TO THE PERIOD OCTOBER 2008 - MARCH 2009		ACTUAL BETWEEN OCTOBER 2008 - MARCH 2009		EFFECT ON ACTUAL REVENUE
FUEL COSTS	Euro 223m	Euro 105m	Based on Mwh generated	Euro 92m	Based on actual consumption	**+ Euro 13m**
WAGES & OVERHEADS	Euro 68.7m	Euro 34.4	50% (6 months)	Euro 35.6m	Based on updated budget estimates	**- Euro 1.2m**
VARIABLE REVENUE	Euro 277m	Euro 130.7m	Based on Mwh generated	Euro 117.6m	Based on estimated reduced consumption	**- Euro 13.1m**
FIXED REVENUE	Euro 25.6m	Euro 12.8m	50% (6 months)	Euro 14.3m	Based on updated customer profile	**+ Euro 1.5m**
TOTAL						**+ Euro 0.2m**

13. Summary of Key Matters

COST OF INEFFICIENCIES	No deductions from target revenue were made for operational inefficiencies since the Corporation does not deem these inefficiencies as being within its direct and discretionary control. The reduction in the 3rd November Report amounted to Euro 3.1 million.
ROCE	The ROCE in the 3rd November 2008 Report was calculated at 6.61% (EU Commision's benchmark in 2002 adjusted for the change in EURIBOR between 2002 and 2008) of the Corporation's assumed capital employed as reported in the unaudited management accounts for the year ended 30th September 2006 whereas the ROCE in the 23rd March 2009 Report was based on the estimated debt servicing on obligations of Enemalta in 2009.
PROJECTED FUEL COSTS	Enemalta's projected cost of fuel was estimated at approximately *Euro 5.66 million* lower than what resulted from their detailed workings. Enemalta has agreed to absorb the full impact of this decision and pass on the benefit to consumers in the form of reduced rates.
HEDGE AGREEMENTS	Enemalta is party to a number of hedge agreements, which during the last 12 months, as a result of the volatility in the oil market, are resulting in hedging losses. These losses, whether realised or unrealised have been completely omitted from the tariffs as per the 23rd March 2009 Report.