



Adam Smith
INTERNATIONAL

A plan for the electricity sector in the
Dominican Republic

A report to the President, Dominican
Republic

17 July 2006

A plan for the electricity sector in the Dominican Republic

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A plan for the electricity sector in the Dominican Republic

1 Introduction and background

Following a request from President Fernandez, Adam Smith International has prepared two new reports from its analysis of the electricity sector in the Dominican Republic¹. The first was a report setting out in an analytical form the arguments we made in a series of presentations between 13 and 14 June. This was issued on 23 June 2006.

This document is the second report. It is based on a plan and sector performance model that ASI have built for use by the key agencies in the sector. The report covers only the key issues and assumptions. Summaries of the plan and performance model are at Attachments 1 and 2. The plan and the performance model are the tools that can be used to drive the actions and performance of the sector, and are available in full in electronic versions. Actions and performance milestones have been allocated according to the roles of the agencies as defined by the President in his speech of 14 June 2006.

Copies of this report will be presented to the President, Ing. Radhames Segura, Sr. Francisco Mendez and Sr. Ruben Montas as heads of the other State agencies with key responsibilities in the recuperation of the sector.

In addition Ing. Radhames Segura invited John Heath of ASI to attend and speak at a planning workshop held for senior CDEEE managers on the theme of 'CDEEE as the Holding Company'². The speech and presentation are available in both Spanish and English. English copies are attached to this report as Attachments 3 and 4.

This assignment has been carried out under the contract between CDEEE and Adam Smith International.

2 Principal points

- Over two weeks ASI has prepared a high level plan for the sector. The plan has been accepted by stakeholders, although some State agencies feel the need for Presidential approval of the plan, given its ambitious nature.
- In particular CNE would welcome further confirmation of its authority on policy issues.
- As policy authority CNE will need strong support from the whole industry, and external support may be necessary in order to strengthen its capability.
- The main role in arranging the financing of the distributors falls to CDEEE, as the state Holding Company.
- The plan assumes delivery of the new coal plant within contractual timescales, but there are concerns in the sector regarding the risks of this project. Our performance data incorporates the CDEEE estimates of the costs of generation from the coal plant, and not the projections of the distributors.
- Re-negotiation of the generator contracts requires a negotiating strategy based on contractual issues as much as on technical analysis. The plan builds in a phase for information sharing, which will include an

¹ The request was made from HE President Lionel Fernandez to Ivan Adams of Adam Smith International at an international electricity conference in Santo Domingo on 14 June 2006.

² 7 – 8 July 2006

understanding of the overall plan for the viability of the sector. A negotiation strategist may be useful to the CDEEE team to help trigger and deliver this task.

- As ASI has previously pointed out, the success of the communications plan depends on political and community leaders being speaking with one voice and reinforcing critical messages.
- The overall electricity industry has witnessed the speed with which CDEEE has sought to adapt to reflect its role as a Holding Company. This continual change will be a major exercise, involving the development of commercial and business skills as well as legal and administrative changes.
- The profile of service and financial performance over the period to 2010 is set out Attachment 2, with the years 2007 and 2010 highlighted. This is provisional and the data will need to be refined under the leadership of the Superintendencia.
- Delivery of a viable sector, and of sufficient improvements by December 2007, depends on immediate action on a range of issues, and especially:
 - A national, customer-based anti-theft strategy (CNE)
 - A national communications programme based on this strategy (CNE)
 - A clear electricity offer to the poor: tariff, advice and collection services, quality of service, energy efficiency measures and advice (CNE)
 - A funding policy and plan for investment in the currently non-viable distribution sector (CNE/CDEEE)
 - Removal of legal and regulatory barriers to effective cash flow performance in distributors (CNE/SIE/Judiciary)
 - Implementation of improved collection, service, anti-theft and asset renewal programmes in distributors (Distributors)
 - Creation of a robust tariff framework for the period to 2010, including quality of service measures (SIE).
- Medium-term performance related actions, already in progress or starting now, are:
 - Re-negotiation of generator contracts (CDEEE)
 - Delivery of coal capacity (CDEEE)
 - Delivery of transmission development projects (ETED)
 - Delivery of hydro capacity (EGEHID)
 - Delivery of renewables plant (CDEEE)
 - PRA pilot projects, leading on to review of pro-poor policies and new long term pro-poor policy (CNE)
 - SIE strengthening (SIE)
 - Review of cross subsidies in tariffs (CNE). The plan indicates that this will become a critical issue in the successful development of a long term policy framework for the sector. Other policies will depend on this task, and could be delayed by failure to deliver the policy and its implementation.

- The plan covers the whole period to 2010, and therefore covers the longer term issues:
 - The role of CDEEE as principal buyer (CDEEE/CNE)
 - Policy issues on hydro capacity and funding (CNE)
 - Policy issues on renewables capacity (CNE)
 - Updated energy efficiency and demand side policies and programmes (CNE)
 - Regulatory reviews of transmission and distribution (SIE)
 - Market design for a viable sector (CNE)
 - Industry structure policy (CNE)
 - Security of supply from 2010 (CNE)
 - Capacity planning from 2010 (CNE)
 - Competition policy for the sector (CNE/SIE). There will be short term issues to resolve in this area, given the risks to the integrity of the electricity system.
- The programme of actions will prove very challenging for the policy leader (CNE), the regulator (SIE) and the distributors in particular. The challenges for CDEEE lie more in the areas of commercial and project delivery risk.
- Political risk is not discussed as a limiting factor in this report. The principal political risk is a failure to deliver improvements by December 2007, and that target date has driven the timetable in the plan.
- ASI has made no study of the more specific commercial issues between organisations in the sector, and makes no comment on these issues.
- Any concerns that agencies cannot deliver their tasks must be resolved quickly - ideally by the end of July.
- If more challenging performance targets are required, then individual agencies must be asked to respond with proposals on how they can accelerate or intensify their activities and on what they would require from other agencies to deliver the better performance.

3 Process used for the plan and model

John Heath met with stakeholders between 3 and 13 July in order to discuss the actions required from each agency in order to meet the following goals set out by the President:

- A vision of a viable electricity sector within 3 to 4 years.
- A mission to transform the sector in that time, and to make real and identifiable progress by December 2007.

The meetings were primarily with the agencies of the State – CNE as policy owner, CDEEE as Holding Company, Superintendencia as regulator – and with the distribution companies, the sub-sector where the performance of the whole sector can be assessed. In addition a meeting was held with a group of generators because it is essential that all parts of the sector support and contribute to the plan even if they are not directly responsible for actions within the plan.

The plan utilises standard planning software, OpenWorkbench, which is available free from the website www.openworkbench.org. Therefore it uses standard terminology for planning: phases, tasks and milestones. The plan has ‘phases’ linked to each policy and project area identified in the previous work undertaken by ASI. Each ‘phase’ includes the identified ‘tasks’ (actions) needed if the mission is to be achieved. Performance target ‘milestones’ have been set for each year end to December 2010, and ‘milestones’ have also been set for other identified outputs from the tasks in each phase.

The plan starts from those phases and tasks that are most urgent if identifiable progress is to be made by December 2007. However, in line with ASI’s previous presentations, the longer term policy and regulatory issues have also been incorporated so that these can be resolved ahead of the targeted viability of the sector. Certain stakeholders discussed the need to resolve these other policy issues at an earlier stage, or even to review now certain existing policies. The plan does not reflect these concerns because that would take the focus away from the most urgent actions. In some cases pressure for action will have to be resisted so that the more urgent tasks are not put at risk.

In order to assess how critical the timing is for certain tasks, ‘dependencies’ have been built into the plan where they can be readily identified. These are for guidance only at this stage as there has not been sufficient time to discuss these in detail.

The plan is at a high level, and it specifically excludes any internal management actions by individual agencies as these are not relevant to all stakeholders. It has been prepared as a matter of urgency and it will need adjustment in the detail as better information becomes available. To that extent the plan is provisional, and not a ‘baseline’. However, the basic timing of the ‘phases’, especially in the short term, cannot be moved substantially if the December 2007 target is to be reached. Every day is critical.

The performance model is a simple spreadsheet utilising high level data from the distribution companies. The distributors have prepared this data quickly to meet the urgent timetable. Nevertheless the data should form the basis for agreeing the final performance targets. With some refinement it can also be used to help create a four-year tariff framework controlled by the Superintendencia. The data was collected on a commercially confidential basis, and therefore individual numbers for each distributor are not included in this report.

4 Assumptions and issues

4.1 The Plan

- In the short term the actions are more detailed. This is normal in planning.
- Major work programmes have not been broken down. However, these will take most resources. The actions by distributors have been treated in this way.
- **Policy actions assume no resource constraints. In fact policy making capability will be severely stretched, and it will be essential to work out how to provide assistance.**
- Most ‘phases’ in the plan have single agencies as their responsible owner. However, these agencies will need to deal with the other stakeholders, and not work in isolation. In certain cases, responsibility transfers from ‘policy maker’ to activity owner for implementation once a policy has been agreed. An example is the need to review legal processes.

- The existing position regarding diversification, capacity planning and security of supply, as determined previously by CDEEE has been accepted for the purpose of the plan. **ASI has not made any study of the expansion plan or the coal, hydro and renewable plant proposals and offers no opinion regarding the feasibility, the commercial aspects or the risks relating to these specific plans and projects.** For the purpose of the plan prepared by ASI these are treated as a ‘given’.
- CDEEE and the Instituto de Energia of UASD have provided information regarding the CDEEE position on the re-negotiation of the generator contracts. ASI has not undertaken a study of the data, and has not discussed the data with any party. **ASI believes that this is a matter for commercial discussions between the parties and it offers no opinion on the commercial issues.** The plan sets out a process for the re-negotiation which includes a phase for further information gathering and sharing within the context of the progress towards a sector with viable cash flows. ASI believes that the re-negotiation process cannot take place without that context and without a shared understanding of the prospects for positive cash flows in the future.

The summary of the plan with phases and milestones is given at Attachment 1. The detailed plan with all tasks included is given at Attachment 5.

4.2 *The performance model*

4.2.1 Principles in building the performance model

- Targets are taken from data provided by distributors, except for average electricity purchase costs, where the data was provided by CDEEE and the target is owned by CDEEE. This is subject to changes in assumptions set out in section 4.2.2.
- The model assumes current energy cost levels and **that electricity costs are “passed through” to customers in a revenue-based tariff framework.** This is a standard approach to reducing risk for distributors that are unable to absorb or manage risk.
- Inflation assumptions are as made by distributors and CDEEE.
- Further harmonisation of the assumptions will be necessary in order to develop the tariff framework.
- For two of the distributors the performance data represents the first opportunity of their management to produce a four year plan. Those distributors have produced the longer term data at short notice.
- The model assumes that funds will be found for asset renewal over the four year period, starting from September 2006. **The funds are treated as an investment that will need to be paid for by customers through the regulatory tariff framework.** A 20 year life and a return of 11% nominal have been used for this calculation. The residual value of the investment can therefore be clearly calculated at any point, representing the value of the remaining future cash flows from the asset. This approach can assist in providing confidence to investors that their money will be recovered.
- PRA subsidies are treated as income, with the balance of sales to PRA areas as losses.

- The non-regulated sector has been excluded on the grounds that it is effectively self financing and would be a pass through of both income and costs.

4.2.2 Key assumptions

The key assumptions in the model presented are as follows:

- 1) Tariff levels are pegged at the current level, but are allowed to rise with domestic inflation. This would equate to the Dominican Republic facing similar electricity prices to other Caribbean islands dependent on imported oil and gas, but higher prices than those with a diversified fuel base, until operation of the new coal plant.
- 2) Electricity production costs also increase with inflation through the combination of oil price, gas price and exchange rate changes. Any excess due to higher energy prices or a weaker exchange rate would need to be covered by tariff increases.
- 3) From the commencement of operations of the new coal plant the model switches to using the electricity cost provided by CDEEE (from 2009).
- 4) Distribution value added costs reflect the assumptions of the companies regarding increased costs in handling the rapid increase in regularised connections and customers. They include an assumption on financing costs of working capital, and a return and depreciation on the new capital provided for renewal of the distribution network.
- 5) Tariff levels in 2009 and 2010 are based on meeting the revenue need of the sector to enable viability, not on a technical tariff. The difference will need to be addressed in the tariff framework to be implemented by SIE. This difference is normal in all jurisdictions, and many now base tariff controls on revenue needs assessments as a means of managing distributor risks effectively.

4.2.3 Conclusions from the performance model

- Initial modelling using the CDEEE assumptions on energy costs resulted in the subsidy being maintained at existing levels until 2009. This is because improvements in distribution performance are offset by the high oil price assumptions in the CDEEE data. Given Government statements on the level of subsidy and the need to see it fall, it is considered that this is unacceptable, and some form of indexation in tariffs is necessary if oil and gas prices rise further. Therefore the assumptions set out in section 4.2.2 have been used.
- The actions of distributors would result in subsidies falling by a little more than US\$100m each year. Only with the operation of the new coal plant can subsidies be eliminated in the period, and that would be in 2009 with the CDEEE figures. Support for the poor could then be provided by cross subsidies between customers in the sector. Delays in that plant, or different financial outcomes, would result in continuing subsidies. The coal plant delivery is critical for this reason, and for prices to customers, and it is suggested that the plan is reinforced with interim milestones for the coal plant, so that controls and contingency plans can be set up.
- Distributor performance falls short of that needed to deliver viability without the coal plant being operational. Viability without the coal plant would be achieved at a losses figure down to 15% at then end of 2010 from the 17% assumed, and collections up to 95% from the 92% assumed.

- The performance has substantial service level targets linked to the delivery of better financial performance. The most significant of these is the doubling in the number of regularised customers of the distribution customers in the four years. This represents a major target for social and economic development
- In addition the performance targets include improvements in supply availability to 100% by the end of 2010, and a level of network refurbishment of 12% of the network over the planning period. These targets represent the beginning of a process towards international standards of asset and performance management in the distribution sector.
- Refinement of the model should lead to an earlier achievement of viability even without the coal plant, and to a steeper reduction in the profile of subsidies.
- More scenarios and discussion are needed in order to come up with a firm tariffs policy in the light of likely outturns on upstream energy prices. This discussion should be led by SIE, and include CDEEE and the distributors.

5 Control of the plan and the model

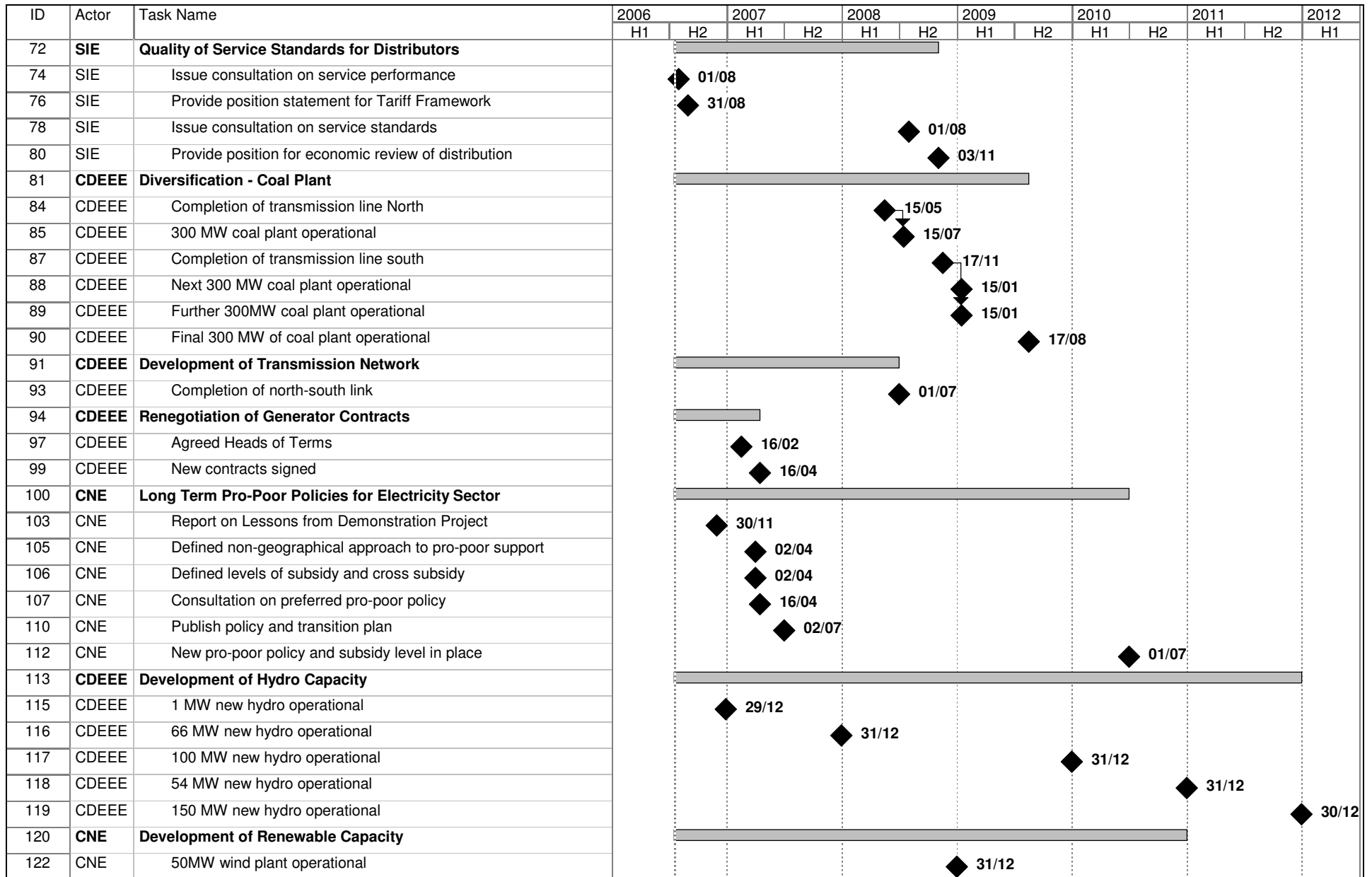
No plan is fixed for its duration; at best it can be 'baselined', variations monitored, and adjustments made where they are justified. If this first plan is acceptable, then it will need to be adopted by the appropriate agency. ASI would suggest that this should be the policy maker. The agency will need appropriate operational and political support in the development and management of the plan.

The model, and more importantly the data within it, will naturally fall under the control of the Superintendencia, as it can lead into the tariff framework phase of the plan. In this way the role of the Superintendencia could begin its role as 'guardian of the vision'.

Attachment 1 – Summary of the Plan

ID	Actor	Task Name	2006		2007		2008		2009		2010		2011		2012
			H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1
1	CNE	Anti-theft strategy													
3	CNE	Published Strategy													
4	CNE	Develop pro-poor offer													
8	CNE	Finalise pro-poor offer													
9	CNE	Removal of Legal Barriers													
13	CNE	Clear congress with legislation													
17	Judiciar	Implement new processes													
18	CNE	Removal of Regulatory Barriers													
21	CNE	Clear SIE Board with changes													
23	CNE	Implement new processes													
24	CNE	Communications													
25	CNE	Agree opening communications message													
27	CNE	Agree second stage message													
29	CNE	Agree second stage communications campaign													
31	CNE	Funding Framework for Distribution Investments													
34	CNE	Issue policy on funding													
35	CDEEE	Funding of Distribution Investment													
39	CDEEE	Input to Policy review on distribution funding													
41	CDEEE	Approval of funding plan													
42	Distrib	Distribution Anti-Theft and Improved Collection													
44	Distrib	Upgrade completed													
50	Distrib	Target performance													
51	Distrib	Target performance													
52	Distrib	Target performance													
53	Distrib	Target performance													
54	SIE	Tariff Framework													
59	SIE	Preferred Baseline of Costs Tariffs and Subsidies													
61	SIE	Issue consultation													
64	SIE	Issue second consultation													
67	SIE	Board approval													
68	SIE	Issue framework													
70	SIE	Implement framework													

Project: HLP Date: Tue 18/07/06	Task		Milestone		External Tasks	
	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	



Project: HLP Date: Tue 18/07/06	Task		Milestone	◆	External Tasks	
	Split		Summary		External Milestone	◆
	Progress		Project Summary		Deadline	↓

ID	Actor	Task Name	2006		2007		2008		2009		2010		2011		2012
			H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1
123	CNE	84MW biomass plant operational										◆			
124	CNE	105MW wind plant operationa;													◆
125	SIE	SIE Strengthening													
128	SIE	Propose new structure			◆										
131	SIE	Propose changes to legislation			◆										
134	SIE	Clear congress with change to legislation					◆								
141	CNE	Cross Subsidies in Tariffs - Policy Review													
143	CNE	Consultation on cross subsidies					◆								
145	CNE	Issue Cross Subsidy Policy					◆								
146	CDEEE	CDEEE Principal Buyer Role													
151	CDEEE	Issue tendering programme (with DS)					◆								
152	CDEEE	Generation cost performance target						◆							
153	CDEEE	Generation cost performance target							◆						
154	CDEEE	Generation cost performance target								◆					
155	CDEEE	Generation cost performance target									◆				
157	CDEEE	Issue position paper on power contracting roles in DR					◆								
158	CNE	Hydro Capacity Policy Issues													
162	CNE	Issue proposals for treatment of hydro					◆								
164	CNE	Agreed approach to hydro within electricity market													
165	CNE	Approved policy on hydro costs, funding, income, subsidy													
166	CNE	Renewable Capacity Policy Issues													
168	CNE	Issue proposals for rules for renewables					◆								
170	CNE	Approved policy on renewables within electricity market						◆							
171	CNE	Energy Efficiency and Demand Side Policies													
174	CNE	Consultation on new programme					◆								
176	CNE	Issue new policy and programme						◆							
178	SIE	Future Economic Reviews by SIE													
183	SIE	Transmission Quality of Service Proposed					◆								
184	SIE	Transmission Economic Framework Determined													
186	SIE	Next Tariff Framework Determined													◆
188	SIE	Analysis of existing tariffs against technical benchmarks						◆							
189	SIE	Programme of tariff modifications													◆

Project: HLP Date: Tue 18/07/06	Task		Milestone		External Tasks	
	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	

ID	Actor	Task Name	2006		2007		2008		2009		2010		2011		2012
			H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1
191	CNE	Market Design													
194	CNE	Issue consultation and request for views					◆	02/07							
196	CNE	Issue further consultation					◆	01/10							
199	CNE	Issue new policy					◆	01/01							
200	CNE	Clear legal changes in Congress					◆	31/03							
202	CNE	New market operational							◆	01/07					
203	CNE	Industry Structure													
205	CNE	Issue consultation paper					◆	01/07							
207	CNE	Issue further consultation					◆	01/10							
210	CNE	Issue new policy					◆	01/01							
211	CNE	Clear legal changes in Congress					◆	31/03							
213	CNE	New structure operational							◆	01/07					
214	CNE	Security of Supply													
216	CNE	Issue consultation paper							◆	01/07					
218	CNE	Issue further consultation							◆	01/10					
220	CNE	Issue new policy							◆	01/01					
221	CNE	Capacity Planning													
224	CNE	Issue of report for consultation							◆	01/08					
226	CNE	Issue new plan and policy								◆	02/02				
227	CNE	Competition Policy													
229	CNE	Publish timetable for policy review			◆	01/09									
230	CNE	Clarification of existing policy			◆	01/09									
232	CNE	Issue consultation						◆	01/01						
234	CNE	Issue new policy						◆	01/04						

Project: HLP Date: Tue 18/07/06	Task		Milestone	◆	External Tasks	
	Split		Summary		External Milestone	◆
	Progress		Project Summary		Deadline	

Attachment 2 – Summary of the Performance Targets

A plan for the electricity sector in the Dominican republic

Base Scenario

Performance Summary


Year		2008	2007	as at 31/12/2007	2008	2009	2010	as at 31/12/2010
Measure								
Average Tariff	US\$/kWh	20.0	21.6	22.1	22.7	14.0	13.8	13.8
Average Cost of Generation	US\$/kWh	14.0	15.1	15.5	15.9	7.8	8.2	8.2
Availability of Supply		79%	81%	84%	88%	91%	98%	100%*
Subsidy annual	US\$m	499	376		280	0	0	
Subsidy in month	US\$m			27				0
Electrical Losses		39%	32%	29%	27%	23%	19%	17%
Collection Recovery Index		52%	61%	65%	68%	71%	75%	77%
Customer Numbers				1,171,215				1,781,635
New Customers Regularised		0	204,324		203,637	233,090	173,692	
Increase in Customer Base				21%				84%
Billed Turnover	US\$m	982	1372		1736	1161	1322	
Proportion of network refurbished				2.8%				12.1%**
Gwh paid for	GWh	4664	5903		7374	8290	9561	
Growth in collected demand			27%		25%	12%	15%	105%
GWh produced	GWh	9039	9607		10808	11736	12811	
Growth in produced demand			6%		13%	9%	9%	42%

Notes

See assumptions from text of report


* based on two distributors' data only

** based on one distributor's data only

 based on reduced generation cost per CDEEE

 critical points

Attachment 3 – Presentation to CDEEE Holding Company Planning Workshop

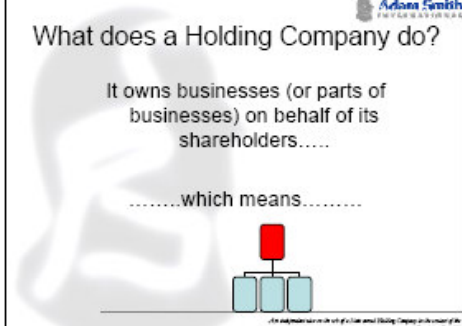


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An independent view on the role of a State owned Holding Company in the context of the Dominican Republic

John Heath

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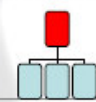


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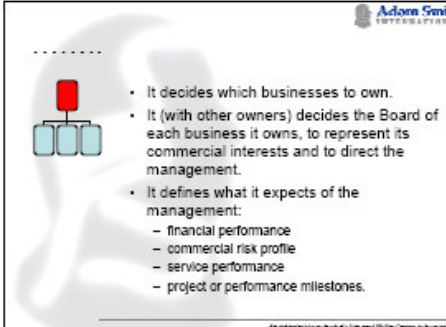
What does a Holding Company do?

It owns businesses (or parts of businesses) on behalf of its shareholders.....


.....which means.....



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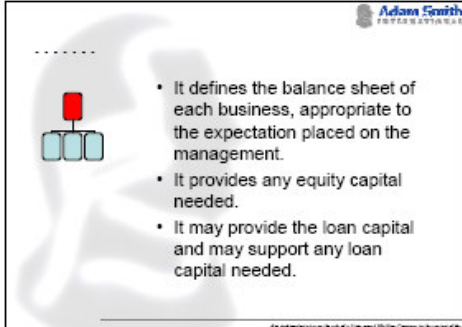


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


- It decides which businesses to own.
- It (with other owners) decides the Board of each business it owns, to represent its commercial interests and to direct the management.
- It defines what it expects of the management:
 - financial performance
 - commercial risk profile
 - service performance
 - project or performance milestones.

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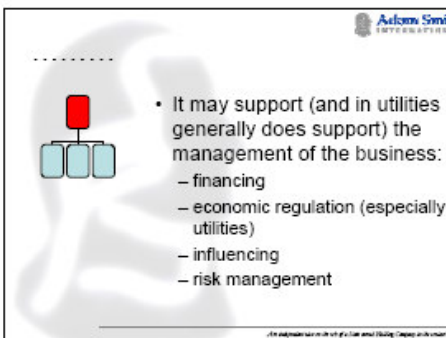


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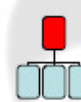


- It defines the balance sheet of each business, appropriate to the expectation placed on the management.
- It provides any equity capital needed.
- It may provide the loan capital and may support any loan capital needed.

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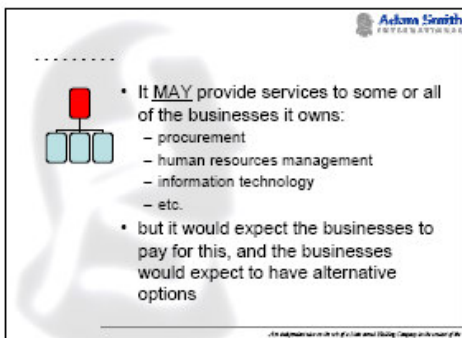


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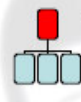


- It may support (and in utilities generally does support) the management of the business:
 - financing
 - economic regulation (especially utilities)
 - influencing
 - risk management

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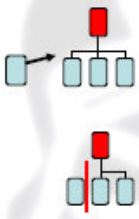
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- It MAY provide services to some or all of the businesses it owns:
 - procurement
 - human resources management
 - information technology
 - etc.
- but it would expect the businesses to pay for this, and the businesses would expect to have alternative options

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.....and



- It chooses which businesses to buy.....
-and which to sell.

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Are State owned holding companies different?


PRIVATE SECTOR	PUBLIC SECTOR
<ul style="list-style-type: none"> • Constrained by general commercial law • Constrained by shareholders through constitution and Board direction • Indirectly constrained by Government policies – social, competition etc. 	<ul style="list-style-type: none"> • Constrained by general commercial law • Constrained by shareholders through constitution and Board direction • May be constrained by specific law • Directly constrained by Government/shareholder policies – financial, social etc. • May be politically constrained

A constrained owner may cease to be a good owner.

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What if it cannot fund or support one of its businesses because of shareholder constraints?

- It should find an owner who is not constrained....



➤it should sell the business.

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This logic

that a business should have the owner best suited to its needs, and that an owner should own the businesses that it can best serve

should apply whether the Holding Company has public or private shareholders.

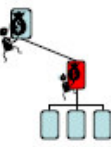
Therefore

1. Public or private (or shared) ownership should be a matter of commercial logic, not politics
2. It would be unwise for a State owned Holding Company to be constrained by specific law because it may need to sell a business at a later time

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What must a Holding Company deliver and how and why does it get paid?

- Holding Companies
 - by investing capital,
 - managing risk and
 - incentivising its businesses
- Deliver returns to the shareholder that
 - meet or beat the shareholder's cost of capital plus
 - the operating costs of the Holding Company.

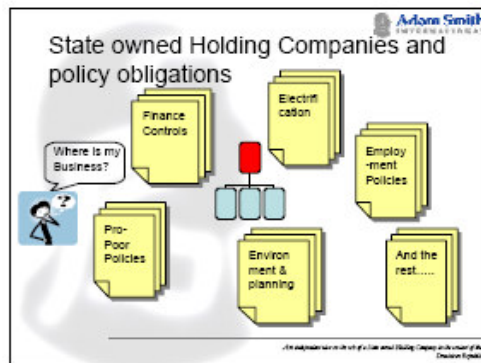


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Other ways of getting paid as a Holding Company

- The Holding Company can be paid for its services
- This improves its return, and offsets its operating costs
- BUT do the businesses get best value?
- OR are they being deprived of resources?

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However, perhaps private and public are not so different....

- Obligations are fine as long as you are paid for taking them on
- Or they are imposed evenly on the market competitors, public and private
- Perhaps they can be delivered more economically than forecast, giving benefit to shareholders, public or private

Observations on CDEEE and its Businesses.....

- Most are asset intensive, and funding and investment recovery risks are key Holding Company issues
- CDEEE must have a clear understanding on how it can obtain funding, and how it can help its businesses recover that money, for example through regulation
- Its businesses are higher risk than they should be – how can the Holding Company bring down its enormous risk profile without burdening the National Treasury for years to come?

CDEEE as Central Buyer

- It provides a key service to distribution businesses – a central buyer of electricity that can take greater risk than the individual companies.
- Is this not a hidden business in its own right, rather than just a Committee?
- As a business could it be equipped with the best skills for contract negotiation – and re-negotiation?
- How should this be owned, managed and controlled?...and recover its costs?

What about “Theft is the Key”? What is the role of the Holding Company?

- Finding the funds for the asset renewal programme in distribution
- Ensuring the investment can earn a return and be recovered
- Helping reduce the risk to its business portfolio by supporting the policy needs of distributors
- Defending its businesses against influential customers who do not pay for their power
- Leadership within its own workforce, and those of its businesses

An independent view on the role of a State owned Holding Company in the context of the Dominican Republic

That is our independent opinion

We hope it can help you

Thankyou

Attachment 4 – Text of Speech to CDEEE Holding Company Planning Workshop

CDEEE CONFERENCE ON HOLDING COMPANY ROLE

TEXT OF PRESENTATION BY JOHN HEATH, ADAM SMITH INTERNATIONAL

An independent view on the role of a State owned Holding Company in the context of the Dominican Republic

The concept of a Holding Company is common in modern utilities, as many utilities are in fact owned by larger businesses that find it appropriate to include utilities in their business portfolio. These Holding Companies may themselves be utility specialists, such as RWE from Germany. However, increasingly financial holding companies with assets in pension and insurance funds have become owners, especially in the distribution sector. So it is worth asking: What does a Holding Company do?

The simplest answer is that a Holding Company is an organisation set up by its shareholders to own businesses, either in full or a part of them. A Holding Company may just keep to its strict definition of “holding” shares, or it can be defined as carrying out an ownership role for businesses. These businesses themselves do not have to be fully separate commercial entities. Therefore it is best to see a Holding Company role as “ownership”, and it is evident that ownership is a skill in its own right. This is especially true of utilities because they require substantial investments in assets, and those investments can only be recovered over long periods. This means that the right owners must be able to take a long term view, be capable of funding large investments, and must be able to bring stability to their businesses.

So what does this mean? What do Holding Companies actually do? Of course this varies from the simplest financial ownership based on the simplest requirement – where is the return on my investment? – through to more sophisticated owners who look to link their businesses together in some way, perhaps through a common expertise, or a common customer base. What all Holding Companies are clear on is that they do not interfere in operational management, unless absolutely necessary in the short term because of failures to meet business targets. For example Canal Emirates Power left the commercial and physical operations of the Binghamton generating station to their General Manager, and when they wanted to exit that business they simply sold it with its management to TransAlta Utilities of Calgary.

The first decision of a Holding Company is: what businesses shall we own? This question should be answered in terms of what businesses give the Holding Company the returns and risk profiles that it wants, and where our specific assets and competence can bring extra value to businesses. Why buy a business that needs investment if your resources are already allocated elsewhere? Why buy a poorly performing business unless you know how to put in better management to achieve efficiency gains?

Once you have your business what do you do next? The Board of a commercial company represents its shareholders in setting the direction for the business management. The next big decision of a Holding Company is that of deciding who should be on the Board. The important point here is that a responsible Holding Company appoints individuals who can represent its commercial interests, and that can include individuals with management, financial, commercial, regulatory or political expertise, for example. These are general commercial competences, not purely technical skills. Political expertise in this context is valuable for the ability to influence policy makers with reasoned argument, let me be clear on this. It is in fact a commercial skill.

With the Board in place the owner must be clear on what it wants from the management of the business. This is perhaps the most critical issue in the ownership of businesses. The outcome

must reflect the owner's own requirements of course, especially in terms of financial performance, but it must reflect also what the business management believes it can achieve, less a little. After all, without incentives managers will only do the minimum necessary.

The direction of the management will not cover directly operational issues, unless there are known significant operational risks that are high priority. A high priority example from your current position is the question of tackling the issue of theft, which is destroying the viability of the whole sector, and could easily destroy CDEEE as a Holding Company. Every business owner is totally dependant on current and reasonably certain future cash flows.

Every owner starts with financial expectations. After all, they have put in the money, the capital, the investment, and they want to recover that money, and to earn a return consistent with the risk that they have taken. That even applies to Government, because they do not have infinite resources, and their resources are taken from the population that they serve. They should beware the risk of wasting the resources of the people by diverting them from other funding priorities.

That word "risk" appears frequently. Owners have to understand risk, have to know what risk they are taking, have to know what risks they can absorb, what risks they can manage. This Government has reached the limit on what risk it can absorb from the electricity sector and from the distribution sector in particular, and it has set a timetable for reducing the subsidies. The risk profile, defined as appropriate for the business that is owned, is a key performance measure for any owner.

Examples of risks in the utility sector include the level of service performance. It may surprise you to know that the share prices of utilities fall more if they are seen to be failing in their delivery of service to their customers than if they report a quantified financial failure of some form, such as the write-off of an investment. Owners of utilities take a great interest in the service performance of utilities, be that keeping the lights on or being prompt and accurate in billing and collection.

Also utilities undertake substantial projects, ranging from the construction of generating stations through to asset replacement programmes in transmission and distribution on to customer service projects, often involving changes in information technology. While managers carry the immediate risk of project delay and failure, only owners, Holding Companies and their shareholders, carry the ultimate risk. Nobody will take that risk from them.

I apologise now for my next point, but my background is financial. A balance sheet represents the value of a business, which is the discounted value of its reasonably assured future cash flows, not its investment in assets, and then it attributes that value into a financial structure based on what the shareholding is worth, and what it is sensible for a business to borrow given its current cash flows, its investment needs and its future prospects. It is essential to recognise that the right balance sheet structure is dependant on what the owners expected of their business. If the owners want a level of financial performance that is based on an investment, then they must put in place a balance sheet that will enable the investment to be financed. If necessary that will mean putting in an equity investment, but in the clear expectation that managers deliver a market return or better on that investment.

Given the cash flow problems of the sector, I am not sure what the real balance sheet of CDEEE itself could look like, let alone how it can structure the balance sheets of its businesses. However, with coherent business plans from the distribution businesses owned or part owned by CDEEE it should be possible to change that position.

An owner can also facilitate or even provide loan capital to a business. In an ideal world the balance sheet of a business should enable it to borrow its own needs, but more risky situations call for parent guarantees of loans, or even direct provision of these loans by the owner. State owners may be able to provide loans at lower interest rates than the businesses can obtain from

commercial banks, but it is important to recognise that there are limits on Government borrowing from multilateral agencies or commercial lenders. At some point such funds are rationed, and I have known Finance Ministries insist on their loans to businesses owned by the State being at commercial rates, because of the hidden cost of the sovereign guarantee in constraining Government borrowings.

Not all Holding Companies offer significant support to their businesses, because support costs the owners resources and money. Some indeed offer nothing except an equity input, and simply expect a financial return in dividends or other business value. For utilities the level of support offered by owners is generally real, because the investment is in assets that can only recover their value over long time periods. Therefore any assistance with financing will help in beating performance expectations. In addition, many factors can change over time, and in particular for utilities the level of revenues allowed by regulators can be especially critical and risky in the impact on returns. So many US investors into the UK lost money by failing to understand or manage the regulatory risk. The British could “laugh our way to the bank”. I hope that this phrase can be translated. Regulatory risk should be the most important risk faced by transmission and distribution utilities, and any generators with monopoly or dominant positions. It impacts on the owner more than on the manager, because it can hit the business value, rather than the operational performance. It is an interesting question for you at CDEEE: can you add value to the businesses you own by your skills at managing the regulatory interface?

Governments and policies change over time. So perhaps an owner needs to offer its utility businesses a skill in influencing future policies. So much of this support is in fact about the owner being the right entity to absorb, and much more importantly, to manage risk. Some of you may have heard me say it before, risk, risk, risk.

In my experience a minority of Holding Companies have seen their added value not in the skills I have just spoken about, but in their ability to offer services to their businesses. Procurement and information technology are the most typical examples, but I have also seen owners look at sharing human resources skills and management. One known success in this approach is the sharing of a brand, and one example that you may know is Virgin. Even that skill has not stopped Virgin selling off Virgin branded businesses, and franchising out the brand name to the new owners. I believe that they have done that with the Virgin brand of electricity in the UK, which changed from being a joint venture with an established electricity business to being a franchised brand of that company. I have not seen any brand development within the Dominican electricity sector, so that cannot be relevant here.

Where Holding Companies do offer these services, there should be a clear expectation that the businesses will pay for the services. After all they should cost less or be of higher quality than what the businesses can find elsewhere. And that is interesting, because this deal works two ways. If the businesses are expected to buy the owner’s services, then they will want quite rightly to negotiate the quality and price of those services – and they will want to use alternatives if that helps them meet the expectations of the owners. That tension is, to say the least, interesting. It also results in improved efficiency and service on the part of the owner. Owners must be efficient, not just the businesses they own.

My next point is simple, but easily overlooked. A Holding Company can choose which businesses it owns, which it wishes to buy, and of course which it wishes to sell, or even, let us be honest, which it wishes to close down because it cannot find a buyer. Now, that is truly a responsibility.

There is perhaps an assumption that there are major differences between business owners in the private and public sectors. Let us look at this analytically. Any owner of commercial businesses should comply with the general and any specific commercial law of the country, and should operate within the constitution of the company itself, and within the policies set under the direction of its own Board. Anything else would be corrupt, and for a state owned Holding

Company that would be especially corrupt. Generally State owned companies are set up under specific laws that introduce additional constraints compared with the general law or the constitution of the company. This is normally done for political rather than commercial reasons, because the law is seen as offering greater protection to political interests than either a company's constitution or Government policies. It is certainly harder to change a law compared with changing a company's constitution or Government policy.

However, the world is full of instances where short term policies become fixed in law, and then prove unnecessary constraints on Government and business when it becomes evident that the policies need to change. I can think of a Ukrainian law that sets out precisely how electricity tariffs are to be calculated, even though that methodology cannot handle many of the changes in the market since the law was passed. I have heard of the level of fines being set in legislation, and becoming outdated quickly because of inflation. Some caution and common sense is therefore necessary in drafting specific laws for State owned companies.

As far as Government policies are concerned it is perhaps obvious that State owned companies should comply with these policies, but of course private companies are also affected even if the policies are not always backed up in legislation. They may have other incentives for compliance. In addition it is probably true that private sector companies are constrained by political activities, but not as much as public sector companies. In some countries, for example certain states in Australia, public Holding Companies are remarkably unconstrained by politics. The level of constraint will vary from culture to culture. I leave you to judge what that level would be in the Dominican Republic.

This issue of constraints is important because they may prevent a Holding Company from acting effectively to bring about efficient performance and the expected results from the businesses that it owns. Poor performance from a business in turn will bring problems for the owner. Where an owner is so constrained that it cannot serve a business properly, then its only recourse is to find an owner who is not constrained in the same way. That means that it should sell the business.

This analysis leads to one general conclusion, and two significant consequences: the conclusion is that a business should have the owner best suited to its needs, and an owner should own the businesses it can best serve. The first consequence is that public or private ownership (or a mixture of the two) should be a matter of commercial logic, not political dogma. The second more specific consequence is that State owned Holding Companies should be wary of being constrained from making logical business decisions in the future through inflexible constraints built into the specific law governing its existence.

If a business needs the right owner, then the questions must arise: how does the Holding Company get paid for its contribution of capital, risk management and other inputs, and what must it deliver to its shareholder? The answer here is unashamedly financial, because the Holding Company acts to protect and enhance the value of its shareholder's investment. It must incentivize and help its businesses to deliver more than the cost of its shareholder's capital, and that extra amount is what it can use to meet its own operating costs. In case you think that this is just Yankee capitalism, can I just remind you that financial performance is locked in with the management of commercial risk, and that failure to provide customers with the services they need at the right price is the biggest single risk in any business, and especially in utilities who provide services to all. The Holding Company can only deliver value if it incentivizes its businesses to meet the needs of the customers and if it invests to deliver service quality to customers of its businesses, because only customers can deliver the cash flow that pays for the investment.

Some Holding Companies look to pay their way by providing services to the range of companies that they own, on the grounds that this is the benefit they bring as owners. This has been particularly common in utilities that were newly privatised and had not mastered the skills of business ownership. I have heard that this might have been the Union Fenosa approach. The

danger is that this in fact just deprives the businesses of value by imposing costs and service levels that suit the owner, not the business. I undertook an assignment for a time with one such utility, which imposed rules on its businesses that they must use certain services such as the integrated information technology systems. I costed out the burden that this placed on the poor workman going out to do his job. He carried on his back overheads of 250% of his cost, while competitors could send their men out with only 80% of overhead. Even worse this Holding Company sold one of its businesses, and then had to inflict on the remaining businesses the cost of dismantling the integrated information systems. This Holding Company is one of a handful of utility Holding Companies in Europe and North America to have defaulted on its loans. It no longer exists.

I would like to turn now to the policy obligations that can fall to a State owned Holding Company. They can often be seen as the principal objectives of the company because of the precedence of the political debate and the desire to be seen to comply with Government policies. Sometimes it is perhaps easier, or more exciting, to be seen implementing policies than it is to be seen setting the performance criteria of a business. For a State owned Holding Company it is therefore very important to keep the main attention on the business of owning businesses. As policy obligations come along, then they can be accepted, but on a commercial basis, that is, with a clear understanding on what needs to be achieved under the policy, what it will cost, and how the cost can be recovered. And who knows, perhaps the obligations can be delivered at lower than expected cost by the businesses, allowing a higher return for the shareholders. Where the Government is the shareholder that means resources become available for another policy objective. There seems to me to be merit in this approach, as the commercial objective of beating the budget can deliver value where the administrative objective of spending the budget does not. So perhaps in this area there is less difference than we might think between the effect of policy obligations on State owned and private Holding Companies.

I would like to finish with a few observations on the CDEEE's business portfolio, and what it means for CDEEE as a Holding Company. Please accept that these comments are based on my brief experience in your country. The businesses are asset intensive, and require investment, in some cases urgently. Like all utilities this means that the Holding Company must bring specific expertise and capability into providing the funding for investment in the assets. Obtaining funding on a commercial basis for commercial enterprises means knowing how those capital investments are to be recovered. There are only two ways of recovering investment – the normal method is by customers paying for the services that the investment has facilitated. The second is to hope for a Government subsidy, that is, for taxpayers to pay. The first method must become the normal approach if the electricity sector is to become viable. Finding ways of reducing the risk of the investment not being recovered is a skill that CDEEE will need. Helping to create an effective long term regulatory framework is one example of how Holding Companies of utilities have achieved this.

CDEEE starts from a bad position as a Holding Company, as its businesses, especially distribution, are so risky that financing is for the time being utterly dependant on Government subsidy, at huge cost to the national budget. Its urgent need is to reduce those risks rather than to add to them.

CDEEE has one business that is not asset intensive. It is a very different business, but it is not recognised as a business, perhaps because it does not have a corporate status. That does not mean it is not a business, and I have worked for businesses that have no formal corporate status, and have been involved in buying and selling them. This is CDEEE's critical role as central buyer of power in situations where the scale of the transaction is too risky for individual businesses in the sector in the Dominican Republic. This business activity, best represented in the contracts for the new coal fired generating stations and in the process of re-negotiation of the current generator contracts, represents a critical area in meeting the objective of reducing the cost base of the distributors, and therefore in keeping electricity prices for customers down. My personal view is that this should be recognised as a separate business, not a Committee, and be

given clear business leadership and expertise. It is a highly specialised area. It is important that this business activity is entirely dependant on the financial credibility of itself and its Holding Company. It too needs the cash flow crisis of the sector to be resolved before it can operate effectively.

Therefore I have to conclude by coming back to the problem of huge business risk that is crippling some of the businesses of CDEEE, that is therefore crippling the Holding Company itself, and restricting its ability to provide good ownership to its other businesses. After all, I am from Adam Smith, and our words seem to have become famous: “theft is the key”. Without sustainable cash flows the Holding Company cannot perform its duty.

What can CDEEE as a Holding Company do to help resolve this problem, one that in our view requires leadership across the society of the Dominican Republic as well as across the electricity sector? Here is our opinion.

The Holding Company must find the funds to enable investment in the renewal of the assets of the distribution sector, and must find ways of ensuring that the investment is recovered and earns an appropriate return. That has to start from a credible business plan that can be taken to the financial community. It needs to reduce the risks that cripple its business portfolio by supporting the operational managers in their needs for policy changes that will reduce the risk. Given the culture of the Dominican Republic in the area of electricity theft it should in its communications be strong in defending its businesses against those influential customers who have become used to not paying for power, and expecting the Government, the shareholder of the Holding Company, the taxpayers to pay for them. This is an area where the political element of public ownership can be used to the advantage of the businesses. And it can offer leadership in the issue in its own workforce, and in the workforce of the businesses it owns.

As an example from my own history, in the late 1970s the UK started to have a problem with electricity theft, not on the scale of here, but bad enough for a clearly adverse trend to become obvious, starting to push up tariffs. In my company we had an inspection programme for the connections of all employees, starting from the Chairman and Chief Executive. We also checked the accounts of employees for evidence of employees protecting their own accounts, or those of their friends, from collection action. Six employees were dismissed. When we repeated the exercise only one case was found. That became the typical frequency. The potential problem was stopped. By the way the Chairman and the Chief Executive were not stealing electricity.

Senor Segura. Thank you for the invitation to present my opinion on this important issue of a State owned Holding Company. It is only my opinion, based on what limited knowledge I have of your Holding Company and its businesses. You are welcome to disregard it, but I hope that it helps a little in your planning for a viable future for the Holding Company. The President was very clear in his allocation of roles on 14 July, and it is important that the Holding Company can be clear on what that role means, especially the commercial implications rather than the legal and administrative ones.

Thank you.

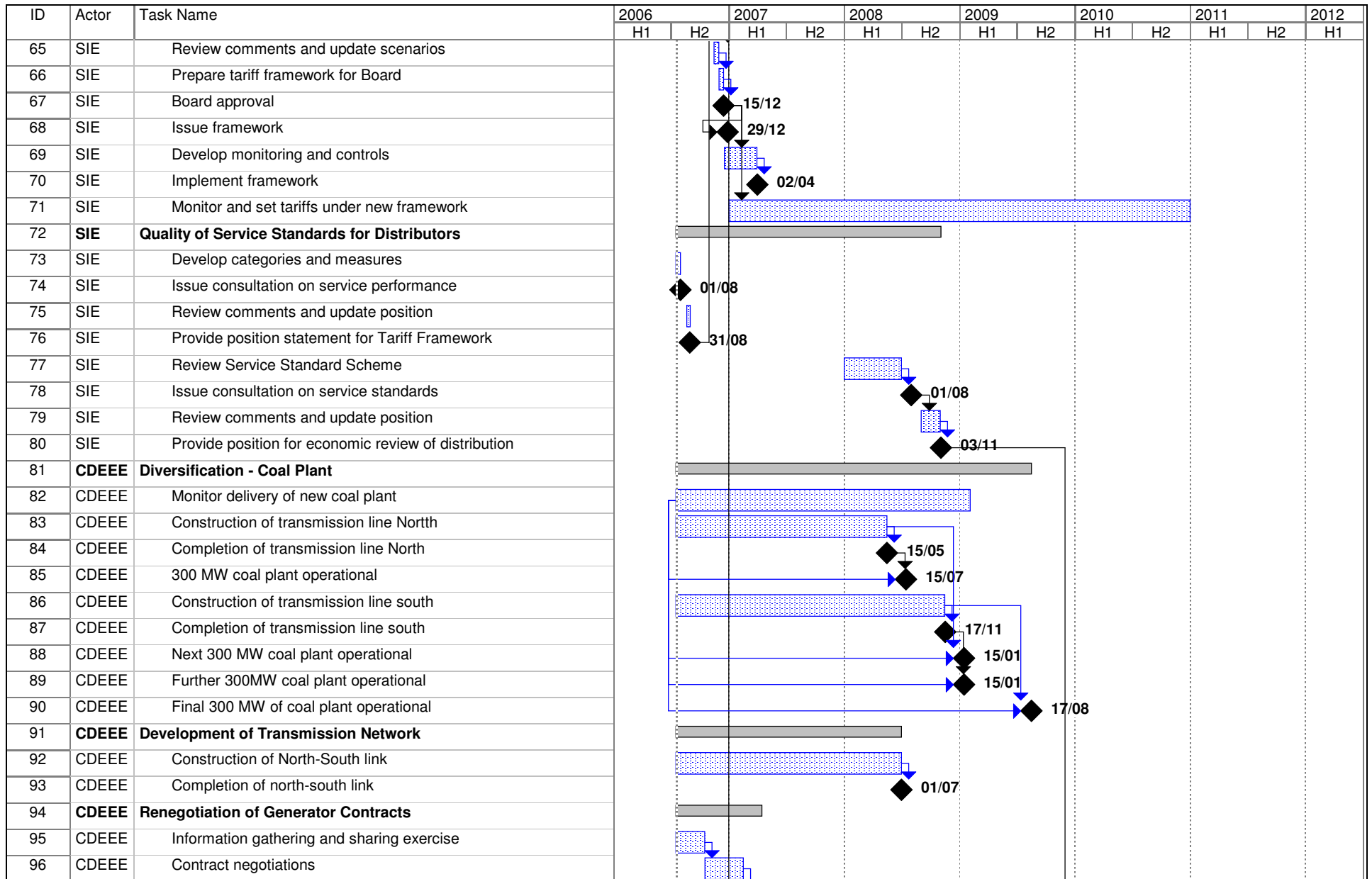
Attachment 5 – Full Plan including Tasks

ID	Actor	Task Name	2006		2007		2008		2009		2010		2011		2012
			H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1
1	CNE	Anti-theft strategy													
2	CNE	Develop Strategy													
3	CNE	Published Strategy													
4	CNE	Develop pro-poor offer													
5	CNE	Develop tariff structure and level for pro-poor tariffs													
6	CNE	Develop energy efficiency advice offer													
7	CNE	Develop customer service standards to apply													
8	CNE	Finalise pro-poor offer													
9	CNE	Removal of Legal Barriers													
10	CNE	Determine nature and scale of barriers													
11	CNE	Agree need to change legislation													
12	CNE	Draft change to legislation													
13	CNE	Clear congress with legislation													
14	CNE	Agree changes to legal processes													
15	Judiciar	Draft changes in process for training													
16	Judiciar	Train in new processes													
17	Judiciar	Implement new processes													
18	CNE	Removal of Regulatory Barriers													
19	CNE	Determine nature and scale of barriers													
20	CNE	Agree changes of regulation													
21	CNE	Clear SIE Board with changes													
22	CNE	Train in new processes													
23	CNE	Implement new processes													
24	CNE	Communications													
25	CNE	Agree opening communications message													
26	CNE	First stage communications campaign													
27	CNE	Agree second stage message													
28	CNE	Develop second stage comms campaign													
29	CNE	Agree second stage communications campaign													
30	CNE	Second stage communications campaign													
31	CNE	Funding Framework for Distribution Investments													
32	CNE	Develop view on who pays - customers or Government													

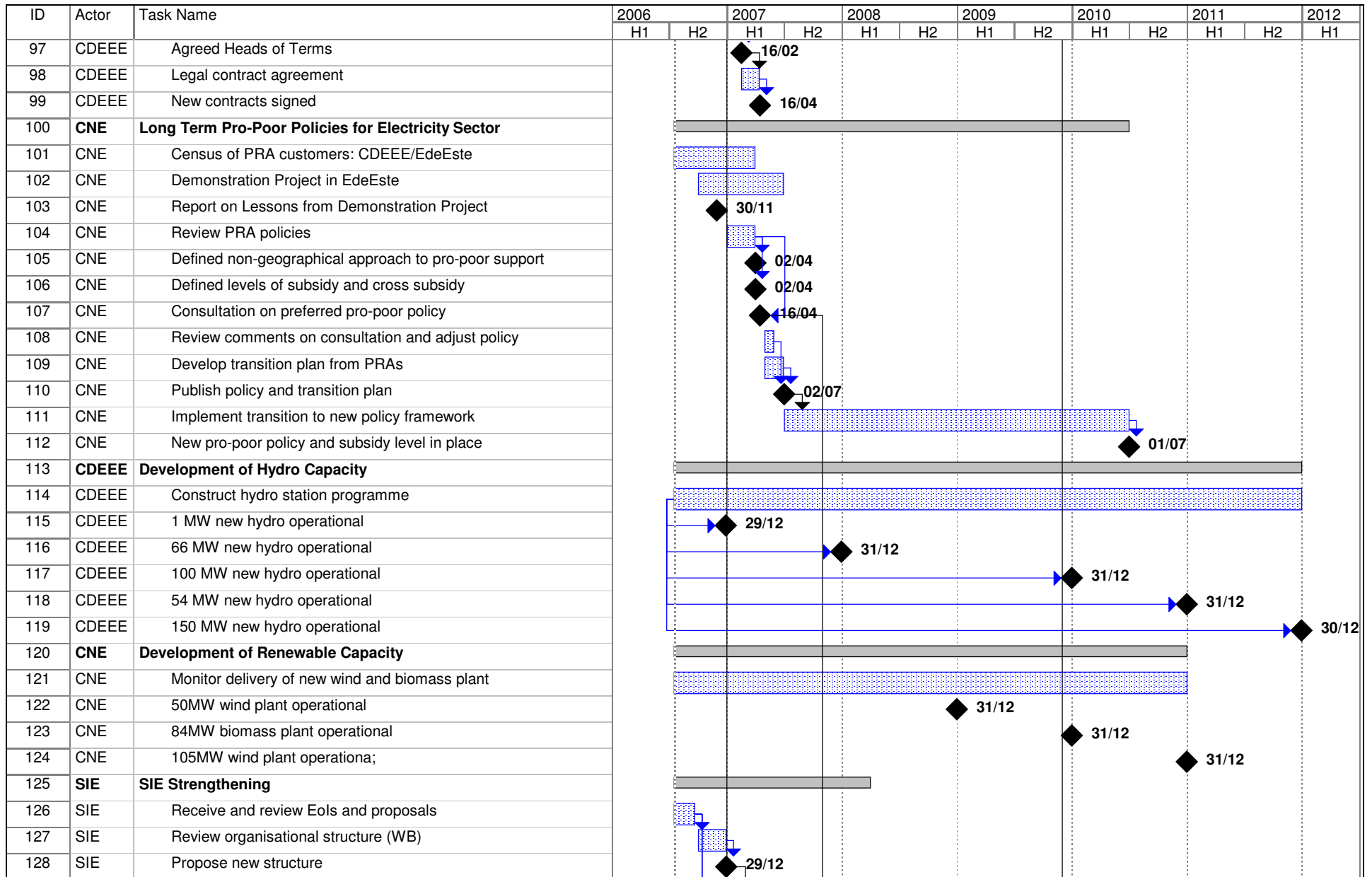
Project: HLP Date: Tue 18/07/06	Task		Milestone		External Tasks	
	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	

ID	Actor	Task Name	2006		2007		2008		2009		2010		2011		2012
			H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1
33	CNE	Develop view on spread of costs between customers over time													
34	CNE	Issue policy on funding													
35	CDEEE	Funding of Distribution Investment													
36	CDEEE	Review options for funding													
37	CDEEE	Joint review of funding for EdeEste with co-owner													
38	CDEEE	Review financing options, such as payment by customers													
39	CDEEE	Input to Policy review on distribution funding													
40	CDEEE	Prepare funding plan													
41	CDEEE	Approval of funding plan													
42	Distrib	Distribution Anti-Theft and Improved Collection													
43	Distribul	Upgrade of administrative procedures													
44	Distribul	Upgrade completed													
45	Distribul	Initial anti-theft programme													
46	Distribul	Principal Anti-theft programme													
47	Distribul	Improved collection programme													
48	Distribul	Asset renewal programme													
49	Distribul	Customer service and capture programme													
50	Distribul	Target performance													
51	Distribul	Target performance													
52	Distribul	Target performance													
53	Distribul	Target performance													
54	SIE	Tariff Framework													
55	SIE	Collection of information - distributors etc.													
56	SIE	Develop revenue needs model													
57	SIE	Scenario testing													
58	SIE	Review technical tariff options													
59	SIE	Preferred Baseline of Costs Tariffs and Subsidies													
60	SIE	Prepare consultation													
61	SIE	Issue consultation													
62	SIE	Review comments and update scenarios													
63	SIE	Prepare further consultation													
64	SIE	Issue second consultation													

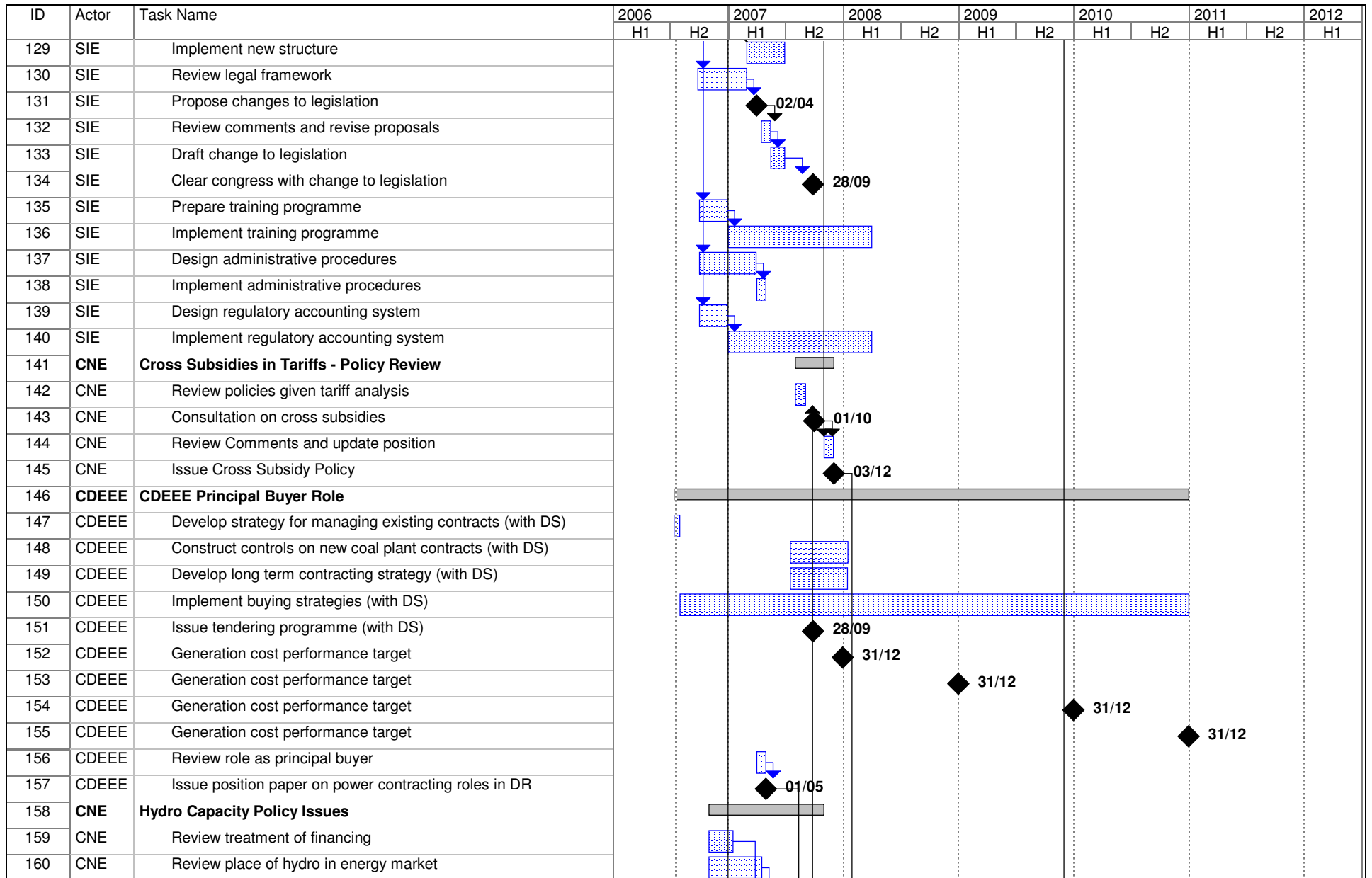
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	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	



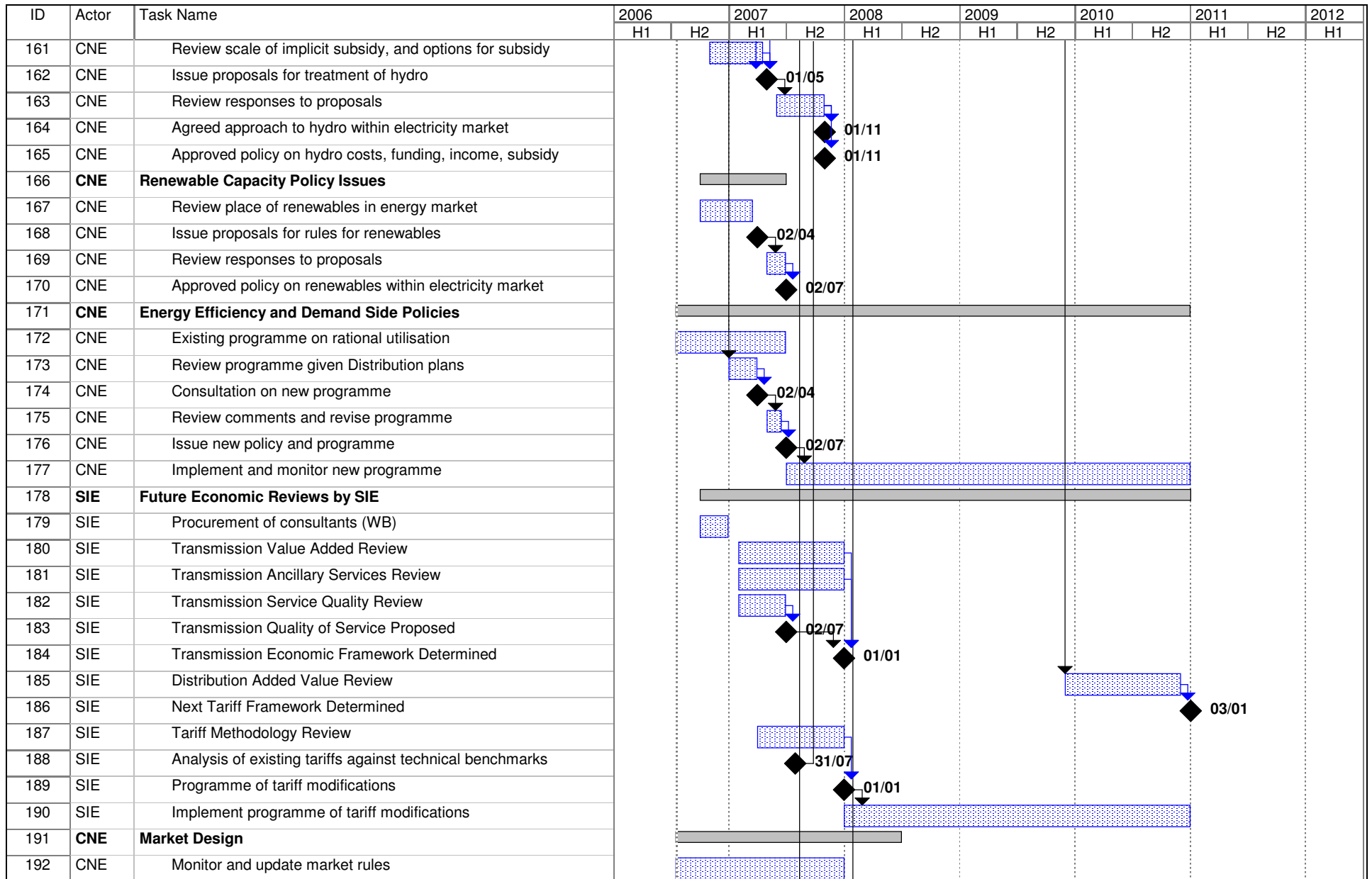
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	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	



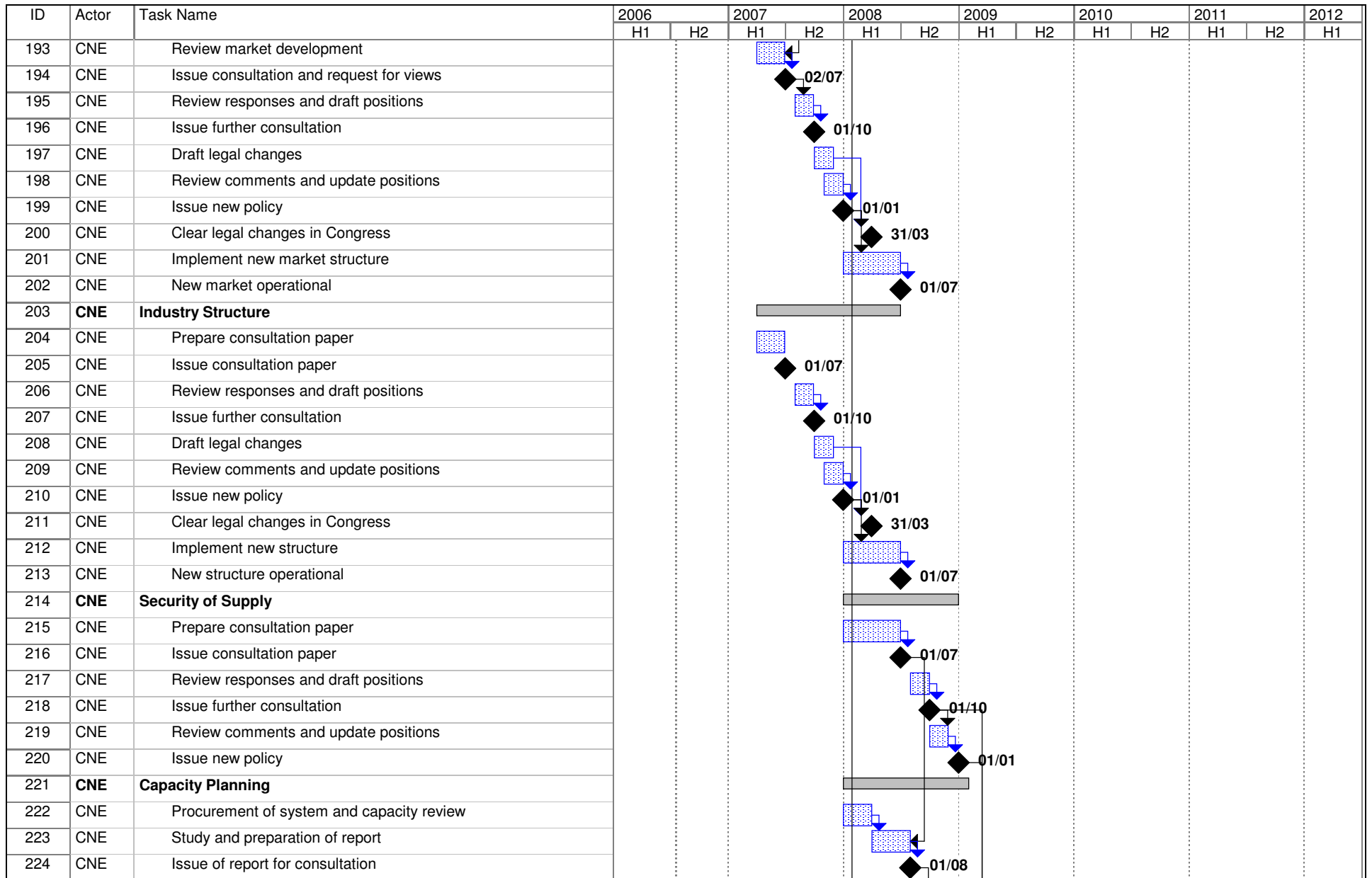
Project: HLP Date: Tue 18/07/06	Task		Milestone		External Tasks	
	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	



Project: HLP Date: Tue 18/07/06	Task		Milestone		External Tasks	
	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	

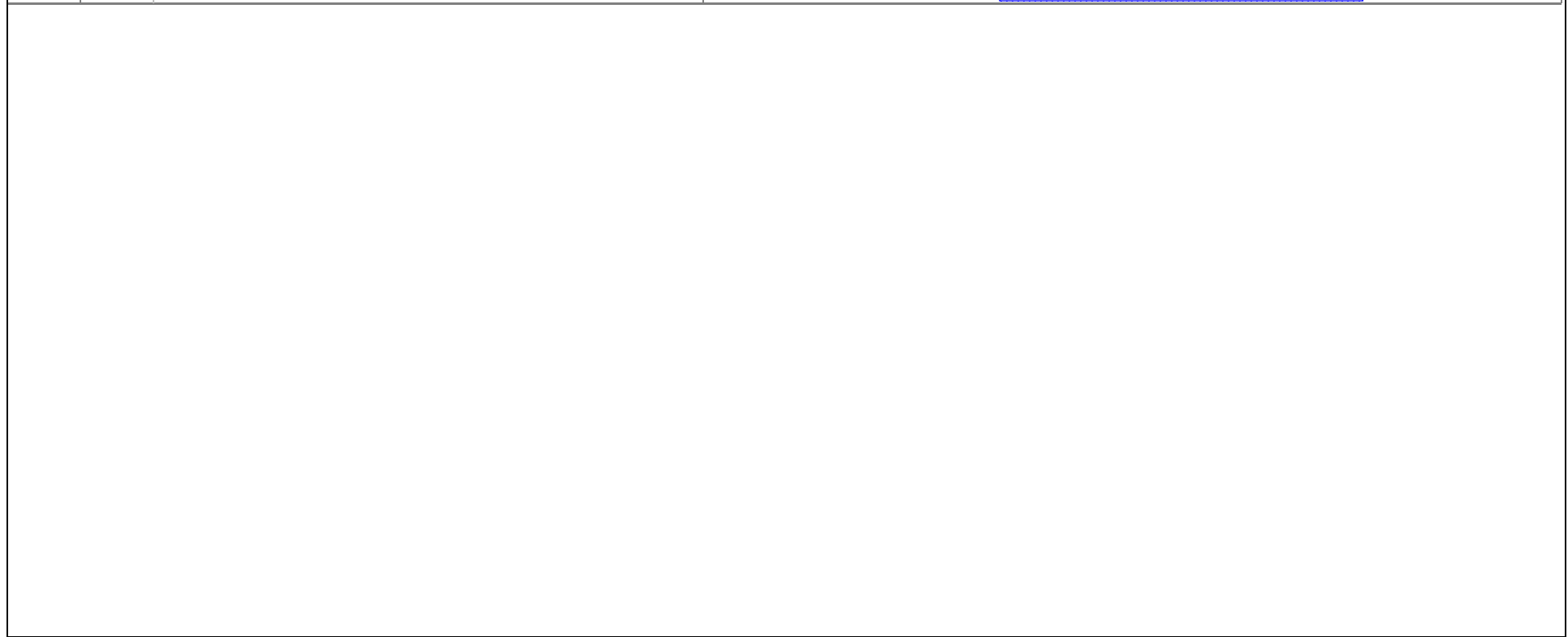


Project: HLP Date: Tue 18/07/06	Task		Milestone		External Tasks	
	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	



Project: HLP Date: Tue 18/07/06	Task		Milestone		External Tasks	
	Split		Summary		External Milestone	
	Progress		Project Summary		Deadline	

ID	Actor	Task Name	2006		2007		2008		2009		2010		2011		2012
			H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2	H1
225	CNE	Review responses and update positions													
226	CNE	Issue new plan and policy													
227	CNE	Competition Policy													
228	CNE	Review likely timetable for policy formulation													
229	CNE	Publish timetable for policy review													
230	CNE	Clarification of existing policy													
231	CNE	Review policy													
232	CNE	Issue consultation													
233	CNE	Review responses and update positions													
234	CNE	Issue new policy													
235	SIE	Implement policy													



Project: HLP
Date: Tue 18/07/06

Task		Milestone		External Tasks	
Split		Summary		External Milestone	
Progress		Project Summary		Deadline	