4 March 2003

Elektroprivreda HZHB, Mostar

Report of the Special Auditor

4 March 2003

SUMMARY OF MAJOR ISSUES

1. Collection practices are inadequate and biased. Favored customers remain hooked up for years in spite of significant delinquency on their high-value accounts.
2. Distribution losses are double the international norm.
3. Disbursement controls are inadequate and have been overridden through various forms of manipulation to provide the appearance of control where none existed. Funds were diverted, and transaction details hidden to obscure the purpose of the underlying transactions.
4. Emphasis is on spending for costly new generation facilities, which will produce only a fraction of what could be recovered by better managing existing operations.
5. Inadequate and inefficient budgeting, cash management, financial recordkeeping and management reporting processes and systems.
6. Mushrooming donations.

OVERVIEW

We estimate that 2001 losses from mismanagement, favoritism, conflicts of interest and theft cost Elektroprivreda HZHB, Mostar a minimum of 50 million KM in lost revenue. During 2001 only 55% of all electricity distributed was actually billed and collected. Collections are lax and certain customers received favored treatment. High value accounts remained connected for years with negligible or no payments. Distribution losses at the end of 2001 were up to 27% (312 GWh), which is over twice the international norm. In April of 2002 Elektroprivreda management reorganized the Distribution Directorate, which resulted in reducing distribution losses to 24.4% (281 GWh). Although this is a significant improvement, much more needs to be done to bring losses down to acceptable levels. Instead funds are spent on costly construction projects, which will only produce a fraction (80 GWh) of what could be gained by better managing the distribution losses.

Disbursement controls are inadequate and easily overridden. Funds have been diverted and transaction details hidden. Bids have been manipulated in a number of ways including the use of fake bids, closed bidding processes where management decides who to ask to bid and failure to obtain any competitive bids on lucrative long-term commitments. The situation is further complicated by the use of cesija and compensation arrangements, which are unnecessary, not transparent, expensive to administer, and help facilitate misappropriation of funds.

Donations made via Managing Board decisions have mushroomed under the current management and include significant donations to the university where the previous Chairman of the Managing Board was Rector at the same time he was Chairman of the Elektroprivreda Board.

Recent improvements have been noted in the Distribution department where they are beginning to deal with thefts of electricity and non-paying customers. For 2002 the amount of electricity actually paid for increased to 64.4%. Although we are encouraged by these recent actions and hope they will continue, much more needs to happen. Most of the problems we noted throughout the audit are serious and cannot be fixed by merely implementing a few additional controls. A major overhaul of many processes, procedures, management and systems must take place. In addition, individuals who override controls, divert funds and cover up by circumventing procedures and providing the appearance of control where none existed, should not be tolerated. The system of internal control is only as good as those who administer it. As long as controls can be overridden at will, the control system is a sham.

SUMMARY OF RECOMMENDATIONS

1. Significantly improve internal controls over distribution, billing and collection.
2. Re-evaluate the need for planned construction projects in favor of less costly alternatives.
3. Significantly strengthen internal controls over disbursements.
4. Immediately stop the manipulation of tenders. Enforce and monitor controls over tenders to prevent future manipulation.
5. Eliminate all hidden transactions and methods of payment which are not fully transparent.
6. Ensure monies lent by Elektroprivreda are approved, documented and within policy.
7. Develop, implement and enforce policies and procedures to protect against conflicts of interest.
8. Develop, implement and enforce limits, policies and procedures regarding donations.
9. Remove individuals who do not work for the company from the payroll and implement appropriate payroll controls to ensure only valid employees receive salary payments.
10. Perform appropriate reference and background checks prior to hiring.
11. Curb the revenue losses.
12. Improve budgeting and cash management processes.
13. Upgrade computer systems.
14. Improve the efficiency and effectiveness of the process for paying operating expenses of the units.
15. Ensure Management Board decisions are appropriate for the business and within the authority of the Managing Board. Ensure statutes comply with international standards.

OBJECTIVE AND SCOPE

The purpose of this limited scope audit is to assess the adequacy of selected internal controls over revenue and disbursements. Therefore, we reviewed processes including meter reading, bill calculation, collections, payroll, disbursements and tendering. Limited sampling of transactions was used to determine if the control system was working as intended. We limited the timeframe of our audit to March of 1999 through mid-November 2002, since this is the period the current management has been in place. Our work was limited by time. Therefore, we highlighted some of the more significant issues, which need to be dealt with. We made no attempt to uncover every issue or examine every transaction. Some areas were given more attention than others due to the lack of controls and evidence of mismanagement we encountered early in our work. For example, we concentrated quite a bit of our work in the Distribution Center, and limited our work at the Transmission department to gaining an overview understanding of the activities of that department.

Audit fieldwork took place from 16 September through 29 November 2002. Report issuance was delayed until March 2003 to enable this report to be issued within the same month as the reports of the other two electric companies.

This audit is not a forensic investigation for the purpose of establishing criminality. Where we found evidence of potential criminal activity, we recommended an investigation by the Financial Police. This audit is also not an audit of the fairness and reasonability of the financial statements. Therefore, we express no opinion on the financial statements.

The audit is a survey of selected processes and procedures and this report represents the auditors' opinion on those processes based on the work, which was performed.

FINDINGS AND RECOMMENDATIONS

1. Significantly improve internal controls over distribution, billing and collection.

In 2001 only 73% of electricity used was invoiced to customers and only 75% of the amount invoiced was paid for. The net result is that only 55% of all electricity distributed was actually paid for. This average was worse in Citluk at 45%, Ljubuski at 42% and Vitez at 39%. However, in 2002 the amount of electricity paid for increased to 64% showing a recent positive step in the right direction. Most of the improvement is in the collection area.

During 2001, a total of 23 million KM was written off by the company for non-collectible debts, further confirming the poor attempt at payment collection. Issues, which should be addressed to improve the situation, include the following.

Implement aggressive measures to investigate, monitor and reduce distribution losses.

In 2001, the company calculated total distribution losses of 312 GWh for the year or 27% of the total electricity for distribution. In 2002 this amount was reduced to 24.4% Total loss is approximately double the 10-13% experienced elsewhere in the world. This loss is made up of two components: technical losses (i.e. loss as a result of poor network and standard electricity losses encountered by all electricity companies), which they estimate to be approximately 10-13% (standard is 7-10%) and “commercial loss” i.e. stolen. Elektroprivreda’s 15-17% (standard is 3%) commercial losses for 2001 represents approximately 175-200 GWh or 18,000 to 20,000 customers, who are not being billed for electricity used. Electricity theft can be accomplished in a number of ways including jamming meters, illegally connecting to the supply, bypassing the meter and so on. Up to 20 million KM could have been added to the bottom line in 2001 by better managing electricity theft.

For every year since 1998, the public accountants pointed out that the losses in distribution and collection were too high. For four years running management responded to this issue by stating “According to management investigations a large number of unregistered consumers were identified during (the year). The investigation is an ongoing process, and management believes that this will continue and as a result will decrease these losses.” However, up until 2002, the losses increased every year from 25.3% in 1999, to 25.4% in 2000 to 27% in 2001. Although we are encouraged by the recent improvements, we are concerned given the long history of inattention to this area and wish to stress that significant additional work needs to be done to bring distribution losses to within international norms.

Customers stealing electricity are not just limited to households. Large firms have illegally connected themselves to the high voltage network as well. In Citluk, 4 firms – Union Foods, Eurobemm, Mija and Barpeh illegally hooked up. However, they could only have accomplished this feat through collusion with Elektroprivreda staff since the power line into Citluk had to be switched off while the illegal connection was made. Each connection requires staff to switch the power off twice.This problem was dealt with six months ago after over three years of illegal usage, which we estimate cost the company 1 million KM for these customers alone. These customers are now paying their current bills, which total approximately 25,000 KM per month.

There are many other customers with illegal hookups including Gipi in Citluk. They hooked up illegally, were disconnected and then illegally re-connected themselves again. As of the end of our fieldwork, they were still illegally hooked up and stealing electricity.

Two of the customers mentioned above, Union Foods and Eurobemm, are owners of Hercegovacka Bank, which owns Hercegovina Osiguranje. Hercegovina Osiguranje received considerable favoritism from Elektroprivreda as detailed later in this report. Union Foods and Eurobemm were also main suppliers to the Federation Government (through the Ministry of Defence) at the same time that they were stealing electricity from the Federation Government.

Given the large potential for reducing commercial losses, we believe stopping theft and recovering distribution and collection losses should be immediately and aggressively pursued prior to spending funds to build new production facilities. Loss recovery may reduce or eliminate the need for additional construction projects.

Ensure collection policies are in accordance with best practices, enforced and applied equally to all accounts.

During our audit we noted a number of customers who, although they consistently do not pay their accounts, are not disconnected. For example, none of the HDZ offices we selected for testing pay their electricity bills. Some of the worst examples of accounts which are not paid include HVIDRA, Soko, Elektro Bosna, HVO and Monitor M (3 accounts) or any of their affiliated companies, etc. Many of these accounts have not paid anything in years or payments on very large debts have been negligible. Soko currently owes approximately 400,000 KM. The HVO owes approximately 10 million KM and Elektro Bosna owes 20 million KM.

We found the HDZ delinquency of particular interest as their delinquency was noted during an audit of political party financing two years ago. At that time, the HDZ Head Office had not paid their electricity bill for over three years and owed around 27,000 KM. The EASC was informed, and the HDZ was warned that this situation was a possible violation of Election Campaign Financing rules, as the cost of unpaid electricity would be considered a contribution from a public company. As a result, at the time of the prior audit, the HDZ made a payment of 20,000 KM to cover most of the amount. They have not made a payment since that time, which we believe illustrates both their intent not to pay and Elektroprivreda's intent not to collect. They have never received a disconnection notice or warning of any kind. They were never disconnected. The only time they have paid their electricity bill in 5 years is when they were visited by auditors. Not only did they continue to not pay their account as they indicated they would following the independent audit of political party financing, but they expanded their non-payment practices to other HDZ accounts we examined including the Mostar branch office. The Mostar branch was paying their electricity bills regularly until February of 2001, when all payments ceased.

The municipality allocated a sports hall to HVIDRA to run. This facility has not paid in four years but remains connected.

During 2001, a total of 23 million KM was written off by the company for non-collectible debts, which further confirms the poor attempt at payment collection. Most of these write-offs are for households, who have been connected for years and never paid. One of many such write-offs was for Rade Bosnjak, a senior, HDZ candidate, who accumulated a debt in excess of 5,000 KM for electricity. The amount was written off only after the original owner of the place he was living in returned. Prior to that time Elektroprivreda kept this active account connected with very little payment.

The total outstanding debt to Elektroprivreda increased significantly since the end of 1998 and now stands at approximately 170 million KM.

Ensure interest is properly accrued and applied to all accounts.

All accounts past due 90 days or more should be charged interest at a rate set by the managing board at 2 percent annually for households and high-voltage customers and 18 percent for other customers. Interest is automatically calculated by the computer once a month. During our audit we noticed that some accounts had interest calculated and others, which should have had interest charges, did not. During our fieldwork we were told by staff that they were instructed to go into certain customers' accounts and change the interest rate field to zero to prevent interest from being added. They then changed the field back to the stated interest rate causing the system to show the correct rate but not to add interest to the account. The General Director also told us of an incident when unauthorized employees went into one office to access the system and alter bills after the office was closed in the evening. He said he dismissed staff as a result. We were also told the computer system was written by the current department head, who refuses to write a manual for it and controls the entire system himself.

We also noticed that high-voltage customers are not even on the computer system and their accounts are recorded manually. No interest was added to a lot of these accounts including the Soko Group in violation of the managing board's directive.

We also found numerous cases where the interest has been calculated and then refunded to the customer via a management decision. These decisions appear to be little more than favored treatment for certain customers.

Interest rates should be calculated in accordance with best practices and policy and equally applied. The system should be adjusted to prevent the interest fields from being overridden. We further recommend the system be revised to produce a log to show when sensitive fields have been tampered with. This report should be reviewed by someone independent of billing and collection and all irregularities followed up.

After our audit of this area, we were told they began to create a procedure for handling interest. They said that calculations will be made every three months and no customers will be exempt. They said the computer program is being changed and any interest not previously charged is to be calculated and added at the end of December. We question the timing as interest should be added at least monthly and not every three months.

Ensure delinquency warnings, cut-off notices and disconnections are completed in a timely manner.

During our testing of the collection process, we selected five customers who had not paid their electricity bills for an extended period of time and tested their notification and collection process. One of the selected customers was an HDZ branch. As a result of our audit of this account, it was followed up for the first time in over three years. It turned out that the HDZ office was no longer at the location, although their name was still on the account. The office is now a community center that had been using electricity and not paying since 1998.

The HDZ main office was disconnected for the first time during our audit and then reconnected when they paid 9,000 KM on account and agreed to terms to pay the rest. The HDZ Mostar branch moved, and they are now trying to locate them. A tennis club selected for testing was disconnected during the audit and a café made a payment of 800 KM during the audit. However, they decided that 800 KM was insufficient payment on their debt of 30,000 KM, and made a decision to disconnect this account.

In order to protect the revenue of the company and prevent collection losses, it is critical that accounts be worked in a timely consistent manner. The longer an account goes delinquent the chance of collection diminishes and the larger the potential loss. Our limited testing illustrates that losses can be significantly reduced through timely and consistent follow up.

Eliminate special treatment for certain customers.

Elektroprivreda made a decision not to disconnect the HVIDRA run sports hall in spite of not receiving a payment on this account for four years. They also did not disconnect Soko as their electricity supplied 24 Soko companies, and two had made a small payment this year. We do not believe the reason provided is sufficient to justify continuing to supply Soko with electricity. Staff also explained that they wanted to connect each of the Soko companies separately to the supply, and this had been agreed to in principle with Soko, but nothing has been done. Our opinion is that Soko is treated as a special customer as none of the rules of customer payments seems to apply here. In addition, interest was never added to their account.

Establish and enforce a policy of requiring all electricity bills to be paid in cash or bank transfers rather than compensation arrangements.

As with many of the suppliers, GIP Neretva stopped paying their electricity bills when they became a supplier and deducted the amount due for electricity from the cost of goods they supply. In September 2002, 88,000 KM was deducted from their electricity account by Elektroprivreda. However, GIP Neretva had no record of this amount being deducted from what they were owed by Elektroprivreda and said that they had not come to an agreement with Elektroprivreda for the cancellation of debts to each other. When we asked for the documentation behind this transaction from Elektroprivreda, they gave us a letter from the General Manager that an amount in excess of 95,000 KM should be deducted from the account, which did not agree to the 88,000 KM amount, which was actually deducted.

The use of compensation arrangements to offset electricity bills is costly to administer and account for, inefficient, poorly controlled and prone to abuse in the current environment. We recommend all such arrangements be reduced or stopped. Suppliers, contractors, etc. should be required to pay their bills though the normal business channels and not through offsets. In rare circumstances where other payment means are not possible, the use of compensation agreements should limited to two-party (not multi-lateral) transactions. The full-transaction should be completely supported and documented prior to allowing the transactions.

Improve the laws, rules and process for collecting from customers who are protected by law.

There are a number of customers who are protected by law from being disconnected. These customers include hospitals, Federation Ministries, water supply companies and so on. While this law may have been well intentioned, the result has been that none of these organizations actually pay their electricity bills with the worst case being the HVO. This debt now belongs to the Ministry of Defence and stands at around 10 million KM. While there have been small payments from the Ministry of Defence during the past year, there has been no substantive attempt to address this issue.

The only route for Elektroprivreda to collect these debts is through the court system. However, we were told by Elektroprivreda staff that the court system continually fails to deal with their claims.

The result of this protection is that Elektroprivreda is required to provide limitless free electricity to all users in the protected category. This legal requirement as it is currently administered will have a negative impact on any potential privatization.

In addition to the legitimate customers to which the law applies, there are others who are inappropriately hiding behind this ruling. For example, Vitezit ammunition factory in Vitez currently owes around 3.3 million KM for unpaid electricity. When Elektroprivreda attempted to have them disconnected, they were told to deal with the Ministry of Defence.

We recommend the laws, interpretation and process be examined in light of this situation to enable legitimate accounts to be collected in a timely manner.

Strengthen and formalize the process for dealing with problem customers.

We realize there are some cases where Elektroprivreda has a very limited chance of obtaining payment from certain customers, who are determined not to pay. Disconnection staff have been regularly threatened as in the case of Diskoteka Rio Grande in Grude, and we were even informed of one case of kidnapping. In some cases customers who are disconnected merely reconnect themselves illegally. This was the case with Debora in Mostar, which as of the end of our fieldwork was stealing electricity following their disconnection.

Recently Elektroprivreda came to an agreement with the local police, who are to attend a disconnection in cases where customers are threatening or access has been denied. The court system has been ineffective when dealing with problem customers. A culture of entitlement to free electricity prevails with some customers.

We encourage Elektroprivreda to continue to formalize their procedures to include prompt notification and disconnection on delinquent accounts and involvement of appropriate local authorities in dealing with threats, denied access, illegal hookups and stealing. However, in order for any collection program to work properly the rules must be known and consistently, promptly and equally applied to all customers.

Improve controls over meter reading and distribution of bills

Each meter reader is assigned a specific territory. This reader is responsible for reading the meter and delivering the bill. Routes are rarely changed. The average number of readers per 1,000 customers is 12 as compared to an international standard of 6 readers per 1,000 customers. This practice is not only inefficient, it represents inadequate segregation of duties and is not in compliance with best practices for the industry. Problems can occur in a situation like this, including taking cash for allowing illegal hookups and/or reporting less usage. An unscrupulous reader would also be in a position to establish his own hookups and collect cash payments.

In one case Elektroprivreda staff told us about a meter reader who was illegally connecting customers to the network so they would receive free electricity. This same reader also informed the individuals with illegal hookups when Elektroprivreda was due to visit or perform work in the area so the illegal activity could be temporarily halted. There have been numerous cases where meter readers and customers have colluded.

We are told that Elektroprivreda uses contract meter readers when they suspect that a reader may be doing something wrong. This is not considered an adequate solution to the problem. We recommend duties be adequately segregated. Meter readers should not be allowed to continually handle the same route. They should be frequently rotated. In addition qualified independent meter reader inspectors should be employed to regularly and randomly duplicate the route of readers without their knowledge. This practice should take place an hour or two behind the reader. The results of the two readings should be compared, discrepancies followed up and dishonest readers immediately dealt with. These same individuals can check meters to verify they have not been tampered with and identify and follow up on illegal hookups.

Ensure Electricity is billed at the proper rate

The company charges different rates for different times of day and different seasons. The summer season is changed at two thirds of the winter rate. One customer we tested had not had their meter read for about five months due to a lack of access during construction works. When the meter was read in October, and usage for the five months calculated, the entire amount was calculated at the winter rate even though most of the usage had taken place during the summer rate period. When a meter reading spans more than one period we recommend the rate charged be appropriately prorated for the period of usage.

Improve the network layout.

There are cases where non-paying customers cannot be disconnected due to the network layout. For example, a company in Grahovo called Pilana "Inn", which currently owes over 250,000 KM cannot be disconnected as that would require disconnecting numerous other customers including the television company and Eronet.

2. Re-evaluate the need for planned construction projects in favor of less costly alternatives.

We were told by Elektroprivreda staff that if they make a profit, which didn't happen in 1998, 1999 or 2000, they re-invest the money in new construction projects. Pec Mlini is a hydro-electric project being constructed in Grude, which is estimated to cost approximately 60 million KM by the time of completion. When the plant is complete, it will produce 80 GWh of electricity per year. This is a mere fraction of the 312 GWh lost through theft and the poor network in 2001. Given the large losses being experienced, we do not believe it makes sense to spend millions on another construction project without first correcting the existing problems to bring the losses down to more competitive and reasonable levels. We also have serious concerns regarding the validity of the bids and process used to contract for the work on this project. Additional information is contained under the section on disbursement and tender controls.

Mostarsko Blato is another new construction project being planned by management at a proposed cost of 100 million KM. Even though the Ministry of Energy requested all new projects be stopped, plans for this project are going forward. Not only has the Ministry of Energy's instruction been ignored, but Elektroprivreda management is attempting to tie the company into a joint venture with private partners. This type of decision must come from the Ministry of Energy as representatives of the owners, the Federation Government. This situation could negatively affect any potential plans for privatization if some of the assets are partly owned by other companies and other assets are committed.

We recommend construction projects be put on hold until such time as they adequately demonstrate competitive management of the existing resources and the true need for additional construction projects. We recommend illegal and inappropriate activity be immediately stopped.

3. Significantly strengthen internal controls over disbursements.

Eliminate the use of cesija agreements.

During our audit we found a number of suspicious transactions that were facilitated by the use of cesija agreements. A cesija agreement is similar to a compensation transaction but between three or more parties. For example A owes B, and B owes C. A pays C and all debts are cancelled. Some of these transactions, which we recommend be investigated by the financial police include the following:

Hercegovina Osiguranje

In mid-1999 Elektroprivreda began purchasing insurance from Hercegovina Osiguranje. In 2000 when they were dealing almost solely with Hercegovina Osiguranje, their annual insurance cost rose 400% from 1.5 million KM per year to 6.0 million KM. The total amount spent in 2.5 years is approximately 15 million KM. Part of this increase was for a savings plan and life assurance product and the remainder was to insure vehicles, fixed assets and accident insurance. The 2000 and 2001 contracts were signed without any competitive bids in spite of the fact that a competitor, Croatia Osiguranje, provided a perfectly adequate life insurance and savings contract before this change.

The majority of Hercegovina Osiguranje is owned by Hercegovacka Bank and is run by Miroslav Rupcic, who was the head of finance in the HVO working for Ante Jelavic.

Through a series of "cesija" agreements, most of these funds intended for Hercegovina Osiguranje ended up being paid to other companies and organizations including:

- Over 2 million KM paid to MRM Ljubuski, a car dealer, owned by Miroslav Rupcic's sister.
- 117,000 KM paid to Partner Co. owned by Miroslav Rupcic's sister and the wife of the managing director of Hercegovacka Bank. This company is likely fictitious as it's address and the company is not recognized by the post office.
- Approximately 500,000 KM paid to VMG Grafika. This company handled the printing of the HDZ election material in 1998 and 1999.
- Over 600,000 KM paid to a company called Meteor. This company is also likely fictitious as the address for this company is the same as the address for Partner Company and the post office returned our mail. However, when we called the post office to inquire about the return of the mail, they remembered the company Meteor, but not the name of the General Manager we obtained from the court records. Post office staff place the mail for Meteor in a post office box at a building in Ljubuski. It is picked up once a week or so by Rudo Vegar.
- 200,000 KM to the Franciscan Church.

The reason given for these payments to others is that Elektroprivreda has entered into "cesija" agreements with Hercegovina Osiguranje whereby Elektroprivreda owes Hercegovina Osiguranje for insurance and Hercegovina Osiguranje owes a third party; Elektroprivreda would then pay the third party instead of paying directly to Hercegovina Osiguranje. There is no benefit at all for Elektroprivreda for handling the transactions in this manner. The process is cumbersome, inefficient and costly. They must use a lawyer to draw up the contract. As shown above, many of these payments are indeed questionable as it is hard to see how Hercegovina Osiguranje owes money to a church or to companies that do not exist.

Other issues related to validity of these insurance contracts include:

- The managing board often makes decisions to donate money when an employee has died. When we asked why they made such payments when they were paying premiums for a life assurance product, we were told that the pay-out from the life insurance is completely inadequate.
- During our work, we visited 2 other insurance companies to try and understand the products Elektroprivreda purchased from Hercegovina Osiguranje. Hercegovina Osiguranje told us that "collective insurance" is arranged by the insurance company for a group of employees, and the only details they need are the name, address and JMBG number of each employee. Both other unrelated companies we met with told us that this information was insufficient for an insurance company to be able to calculate the risk, and they would need to have medical history details as well. One company said they would probably ask an agent to visit each of the staff individually and take more details in private and possibly even ask for a medical to be done.

Elektroprivreda RS

We noted problems concerning payments for electricity made by Elektroprivreda HZHB to Elektroprivreda RS (ERS) via cesija agreements. Therefore, these payments were made not to ERS but to ERS suppliers. When we tested a couple of these payments, we found one recipient company called Cat Leko from Grude received 85,000 KM in 2 payments on 12th June 2000 and 26th June 2000. This money was the only money this company ever received from any source. We were unable to obtain a reply from Cat Leko. The company is registered to a gentleman called Slobodan Leko using his home address.

In addition to a Financial Police investigation into the above issues, we recommend the practice of using cesija agreements be immediately stopped. There is no logical or financial benefit to these transactions, which merely facilitated a number of very questionable transactions.

4. Immediately stop the manipulation of tenders. Enforce and monitor controls over tenders to prevent future manipulation.

In addition to the items listed in the previous finding, we found a number of other irregularities and questionable payments. We believe some of the disbursements may be fraudulent and recommend an investigation be carried out by the Financial Police. Controls are extremely weak and/or have been manipulated in order to provide the appearance of control but not the reality. Examples of problems noted during the audit follow:

In addition to the major construction projects previously mentioned, Elektroprivreda utilized a closed or private tender for a number of other construction projects. This private tender process enabled Elektroprivreda management to decide who they would allow to bid. Although we did not examine the value of these projects to ascertain whether the price paid was fair, this form of closed tender limits the company's ability to obtain the best price and terms for the work.

Until 2001 a team of experts decided which suppliers were to be selected for inclusion in the bidding process. For small repeat orders, a supplier was selected for an entire year. In 2001 one of the companies allowed to bid on contracts to supply concrete posts, protective shoes, tubing and tin boxes was Soko Air, an aircraft company. The current manager of Soko Air, who has been in his position for six months, told our auditor that Soko Air has never dealt in any of these products and would not know the first thing about any of them. Nevertheless, Soko Air provided the "losing bids" to nine categories of bids. Brodo Merkur was included as an authorized bidder for 18 different categories of purchases including transformers, concrete posts, electricity meters, wooden poles, shoes and stationary.

One of the products we selected for disbursement testing was strengthened concrete posts. In BiH, there are only 2 companies which can provide these poles from a centrifugal strengthening system, PromInvest (a Bosniak company from Konjic) and Tehnobeton. PromInvest staff informed us that GIP Neretva from Capljina provide a similar product but it cannot withstand extremely low temperatures. So in 2001, bids were received from - GIP Neretva and three companies which had no facility for making these goods: Soko Air, Brodo Merkur and Herc MB. In another concrete section, Herc MB actually won the bid, the winner was later changed to GIP Neretva at a higher price. The reason for the change was that GIP Neretva sent a letter after the winner had been selected, saying they had added up their bid wrong and could it be changed. This action allowed them to win.

In another instance, PromInvest was the lowest bidder; and, therefore, won an advertised public tender for strengthened concrete posts, in 2002. At the tender opening meeting, the bids were 1st – PromInvest with a bid of 826,000 KM and 2nd – GIP Neretva with a bid of 932,000 KM. Shortly after the bid opening, the manager of PromInvest was invited to meet with Mr. Zaric, General Manager of Elektroprivreda. At that meeting he was told Elektroprivreda had changed the bid for GIP

Neretva to 823,000 KM. Therefore, PromInvest would only get 50% of the contract they previously won. As of November 2002, 75% of the goods have been bought from GIP Neretva and only 25% from PromInvest. PromInvest informed us that their products are only used for the areas such as Livno where the product supplied by GIP Neretva cannot cope with extreme weather conditions. The manager at GIP Neretva told us that they had not changed their bid, and the change had been made by Elektroprivreda. However, Elektroprivreda then produced a letter from GIP Neretva dated in February 2002 saying that they wished to alter their bid, making it slightly less than that of PromInvest.

As shown above, GIP Neretva is favored when it comes to receiving contracts. The manger admitted GIP Neretva is favored since Elektroprivreda owns 21% of this company. They paid 824,000 DEM in 1998 for this share. In addition to the money which they received as a supplier, GIP Neretva also received money from Elektroprivreda for the purchase of three apartments. The apartments sold by GIP Neretva to Elektroprivreda were apparently ones that had been built or renovated by GIP Neretva. Although the road name and reference numbers are on the contracts, when we asked (in person and later again via phone) for the specific addresses of the apartments , GIP Neretva management told us they did not know the addresses, despite having built them.

One condition required for selection as a potential bidder is that the bidder should have a warehouse in the Elektroprivreda service region. In addition to this requirement, bidders are expected to receive 50% of their payment in the form of deductions from their electricity bill. This not only discriminates against anyone from the non-dominant ethnic group but severely limits the number of companies who are willing and allowed to bid increasing the cost of supplies to Elektroprivreda.

Herc MB is a company which won the bid to supply insulators and similar equipment for years 2000 and 2001. This contract was worth around 1 million KM per year to Herc MB. Herc MB operated from small premises and is nothing more than an unnecessary middle-man. The company purchased products from the manufacturer, Koncar in Zagreb, and then re-sold them to Elektroprivreda at a higher cost. There is absolutely no reason for Elektroprivreda to make use of such a middleman company. This fact was confirmed in 2002, when Elektroprivreda included Koncar on the list of bidders. They now buy the exact same goods directly from them. (Note: We asked the manager of Herc MB why they had not tendered in 2002 also. He told us the company had been a shareholder of Hercegovacka Bank and following the raid in April 2001, the owner decided it would be best if he closed down his business. He is now living in Germany.)

There has been no open tender process for the purchase of vehicles. When cars are purchased, Elektroprivreda faxes a request to maybe one or two suppliers and then compares them. What makes it even more difficult is that they contact agents for different manufacturers, which then leaves them trying to compare a bid to supply Skoda cars with a bid to supply Seat cars. For the last few years, the supplier of choice has been MRM Ljubuski, which is owned by the sister of Miroslav Rupcic of Hercegovina Osiguranje, as mentioned previously.

Pec Mlini – One part of this construction project was for electrical engineering and was put out to tender. Although we were told that this tender was open, we find it unusual that only two companies bid; and one of the two bidders was then eliminated for not supplying the correct number of work references.

We found payments at the rate of 1,500 KM per month made to Dragan Covic, current member of the Presidency and previous Minister of Finance. According to the contract, the payments were for expert services. During our fieldwork we asked Elektroprivreda management to show us evidence of the completed work, which they could not provide. Mr. Covic, who is a neighbor of the General Manager of Elektroprivreda, was involved with Soko Air as outlined elsewhere in this report.

During our test of disbursements, we noticed several individuals who do not work for Elektroprivreda received apartments or funds to buy apartments.

5. Eliminate all hidden transactions and methods of payment which are not fully transparent.

Mondo

In 1999, soon after the current General Director of Elektroprivreda assumed his position, the Elektroprivreda managing board made a decision to donate 5 percent of all income to a private company, Mondo in Mostar, owned 100% by the HDZ.

At that time, Elektroprivreda was controlled by the municipalities and not by the Federation government. We spoke to a member of the board who attended the meetings in which this transaction was discussed. He told us the purpose of the decision was to provide money to the Croat Government of Herceg-Bosna in order to fund Croat institutions such as Radio HB, Habena and so on.

However, the decision signed by the General Manager, Matan Zaric, states that the money was to be paid into the account of Mondo. The minutes of the management board meetings make no mention of Mondo. Our conversation with the board member confirmed this fact as he knew nothing about Mondo. A total of 675,000 KM was diverted in this manner before the General Manager changed the plan.

The 675,000 KM total was transferred in three payments of 75,000 KM, 200,000 KM and 400,000 KM. The first payment was for 75,000 KM and was made to Mondo's account on 5th May 1999. At the time, there was no other money in Mondo's account. On the same day the 75,000 KM arrived, this same amount was paid to Croatia Hercegovina Auto for car servicing and car parking.

The first payment was made to Mondo on 5th May 1999. However, the decision to make these payments was not made until 9th July 1999. Therefore, the General Manager was transferring money to Mondo without any authorization, two months before the management board were even aware of the issue.

The next payment of 400,000 KM was paid to Mondo on the 12th July 1999. On the same day, Mondo made a payment of 150,000 KM from this money to a company called Tempo Vranica to buy an apartment for an HDZ employee. A further 100,000 KM payment was made by Mondo on 20th July to VMG Grafika, a printing and design company. VMG Grafika confirmed to us that the money received was payment for the printing of election campaign materials for the HDZ for the 1998 elections.

It is interesting to note that Frano Ljubic, former chairman of the Elektroprivreda managing board, is now a shareholder of Tempo Vranica, the company which sold the apartment purchased for the HDZ employee. Tempo Vranica is also owned 25% by Herbos Fund, which is owned by Hercegovina Osiguranje and which operated from the offices of Hercegovacka Bank. Herbos Fund was represented at Tempo Vranica by Miroslav Rupcic from Hercegovina Osiguranje, who is mentioned above.

The next attempt to explain this money being paid from Elektroprivreda to Mondo was an invoice for 800,000 KM. There was also a contract for this work stating that for 800,000 KM, Mondo would provide services in connection with the design of television and radio advertisements for Elektroprivreda. The invoice issued actually describes the service as the provision of posters. We were not able to follow the payment of this money as it went into Mondo's account at Hercegovacka Bank. However, the staff at Elektroprivreda confirmed that although some printing did exist, it was not at all adequate to explain a payment of 800,000 KM.

We believe the invoice is fictitious and was only produced in an attempt to cover up the diversion of funds. One other point of interest is that Mondo ceased trading on 27th September 1999; however they invoiced Elektroprivreda for the 800,000 KM on the 30th September 1999.

The activities of Mondo are questionable. None of the money we traced was used for the Board approved purpose, Croat institutions. Instead it went to fund HDZ campaign expenses, car parking and an apartment for an HDZ employee. We recommend the Financial Police examine these transactions.

Purchase of Hercegovacka Bank Shares

On 6th June 2000, Elektroprivreda took 2 million KM off deposit at Hercegovacka Bank then paid the same amount to Hercegovina Osiguranje for advanced payments of insurance. Hercegovina Osiguranje then lent the same amount to a company called Antonio Trade who said they wanted the money to build a car showroom in Grude. Instead, Antonio Trade immediately spent the money on Hercegovacka Bank shares. This whole process was completed within 24 hours and the money was transferred around the Hercegovacka Bank between accounts there.

Each party to this operation claims that they were only aware of their own part. This we find hard to accept given the facts. Elektroprivreda claim they were asked to pay for insurance premiums for the year 2000 up front because Hercegovina Osiguranje claimed they were not paying promptly enough. This is not true. The payment records show that payments were made to Hercegovina Osiguranje very promptly, often within days of receipt of the invoice.

It is also difficult to believe their claims since it was Miroslav Rupcic, from Hercegovina Osiguranje, who called Elektroprivreda to request the 2 million KM up-front payment for insurance; and it was Miroslav Rupcic who lent the same money to Antonio Trade. Antonio Trade then bought the shares in Hercegovacka Bank where both Miroslav Rupcic and Ante Ljubic (Antonio Trade) were both members of the steering board.

We also find the recording of this transaction by Elektroprivreda to be unusual. Instead of treating it as an advance payment in the supplier account of Hercegovina Osiguranje in their books, they opened a new account just for this transaction. All other advance payments were recorded in the account of the particular supplier.

Given the facts and sequence of events, we believe it is more likely that the transactions were manipulated in order to transfer the funds from Elektroprivreda to capitalize Hercegovacka Bank while obscuring this intent. We recommend these transactions be looked into by the Financial Police.

Bonus Fund

At the beginning of 2001, an organization called Bonus visited Elektroprivreda to ask if they could receive deductions from staff, at a rate of 3 percent, to support the families of indicted war criminals. Elektroprivreda agreed to this and in the year 2001, they deducted around 450,000 KM from staff wages and sent it to the Bonus Fund, for the staff that agreed.

When we visited Bonus Fund, we were told that they would only give us documentation since February 2002, the reason being that the previous manager was now living in Croatia and the documents were "somewhere else". We asked why the arrangement had not continued into 2002 and the current manager of the fund said that they no longer needed the 450,000 KM per year from Elektroprivreda employees so they had cancelled the arrangement. It is not often that we see charities and organizations such as this refusing such large donations.

Previously, it was HVO staff that contributed for this purpose, but after the change of government at the beginning of 2001, this funding was no longer available. Bonus Fund is located in an apartment in Mostar.

6. Ensure monies lent by Elektroprivreda are approved, documented and within policy.

Soko Air received a loan of 50,000 KM from Elektroprivreda which was repaid the following week. There was no loan documentation for this loan and no interest was charged. Soko Air also sold Elektroprivreda a crane for around 100,000 KM in October 2000, again with no other bids being required by Elektroprivreda. The loan and purchase were made in spite of the fact that Soko Air and the Soko Group were not paying their electric bills. (See other findings concerning this company.)

In April of 2001, the Managing Board made a decision to take out a loan for 25 million KM with Zagrebacka Bank and offered the assets of the company as security. The Managing Board are not allowed to pledge the assets of the company as security on a loan. This action was stopped by the Ministry of Energy.

7. Develop, implement and enforce policies and procedures to protect against conflicts of interest.

In July 2000, Frano Ljubic became the Chairman of the management board of Elektroprivreda, and held the post until July 2001. When we met with Mr. Ljubic, he confirmed he has also held the position of Rector of Mostar University since February 2000. He also told us he recently become a shareholder in Tempo Vranica, and was Chairman of the Hercegovacka Bank steering board for a few months in 1998.

As part of his University responsibilities Mr. Ljubic explained that he was to "get as much money as he could for the University from Elektroprivreda" from donations or commercial agreements. At the end of 1999, Elektroprivreda made a decision to donate 4.8 million KM per year to Mostar University. Although the full amount could not be paid, they still managed to donate approximately 2 million KM per year during 2000 and 2001. The amount paid represents approximately 25% of the budget of the university. In spite of these substantial payments, Mr. Ljubic expressed his dissatisfaction with the management of Elektroprivreda for failing to keep up with the agreed payments of 400,000 KM per month to the University. Later the agreement changed and the University attempted to provide some services for the money they were receiving from Elektroprivreda. However, this was merely an attempt to justify and disguise the payments rather than a serious commercial agreement. This situation is a conflict of interest.

In relation to the Hercegovacka Bank chairmanship, Mr. Ljubic stated that he was Chairman of the steering board in 1998 when the company was created, but once HN Canton had sold their shares, he was no longer Chairman. However, according to court documents of the bank Mr. Ljubic was still Chairman in September 2000, despite his statement saying that he left in 1998.

He also told us that he had never signed anything for the bank nor attended any management or steering board sessions. When we showed the court documents to Mr. Ljubic, his explanation was the same. He insisted that he had not been chairman of the bank since 1998. He did state that somebody had appeared at his offices once and asked him to sign some documents, which he did, without knowing what they were and being told by the bank representative that it was merely a formality. He suggested to us that his name may have been misused by bank management.

Until the raid in April of 2001, the bank of choice since mid-1999 was Hercegovacka Bank. As previously mentioned Hercegovina Osiguranje, which is 60% owned by the bank, was awarded all insurance contracts. This situation suggests a serious conflict of interest if the Chairman of the Elektroprivreda management board at the same time was Chairman of the company's chosen bankers, and paid 15 million KM to their insurance subsidiary.

Conflicts of interest and the appearance of conflicts of interest should be avoided. Policies for screening individuals to ensure these conflicts do not exist should be put into place prior to appointment. We recommend the company adopt and enforce a conflict of interest policy, which includes ongoing review and disclosure to prevent conflicts from developing. Individuals who do not comply in both form and substance should be immediately removed from their position.

8. Develop, implement and enforce limits, policies and procedures regarding donations.

Elektroprivreda is owned by the Federation Government. The Federation Government budgets for a number of donations to worthy causes. However, Elektroprivreda also provides a number of their own donations via management board decisions; thereby, reducing profit and funds which potentially could be distributed to the Federation Government. In addition to significant donations to Mostar University as discussed above, Elektroprivreda donations include:

- 80,000 KM to the Franciscan Church being built in Mostar;
- 90,000 KM to buy an apartment for a soldier;
- 30,000 KM for an employee to buy an apartment;
- 50,000 KM to buy an apartment for a previous employee;
- 500,000 KM to war veterans;
- 10,000 KM for road construction;
- interest on 2,000,000 KM worth of employee loans at Hercegovacka Bank;
- 100,000 KM to build a church in Jajce;
- 48,000 KM to buy an apartment for a invalid war veteran;
- 62,000 KM for the Cantons for agricultural purposes;
- 15,000 KM for Croat writers;
- 10,000 KM to a health center;
- 10,000 KM to Mostar Tennis Club (despite the club never paying its electricity bill);
- 20,000 KM for an Aero club;
- 10,000 KM for a canoe competition;
- 150,000 KM to Tempo Vranica for them to repair a school;
- 50,000 KM to an employee's family and so on.

These donations, which mushroomed under the current management, were made without regard for the profit position of the company or sufficiency of reserves as required by law significantly reducing funds potentially available for distribution to the Federation Government. Furthermore, in February 2001 the General Manager and the Chairman were given the power to make future donations as they saw fit without even consulting the Managing Board. Donations should be made in full accordance with the law including requiring the approval of both the Minister of Energy and Mining and the Managing Board as required by law. Any attempt to delegate legal control requirements should be forbidden and appropriately dealt with as an attempt to circumvent the law.

We also recommend the policy for donation be rewritten to include reasonable limit on amounts given to individual causes as well as absolute limits.

As noted in the Management Response section of this report, additional large contributions continued to be made in December following our discussion of the draft report with management.

9. Remove individuals who do not work for the company from the payroll and implement appropriate payroll controls to ensure only valid employees receive salary payments.

We performed limited testing of the payroll at two locations. One of these was HE Plant Capljina. One individual, who is on the payroll and described as an "adviser", does not work for Elektroprivreda. When we met with this man, he explained that he was a member of the SDP party and a friend of the current Prime Minister, Alija Behmen. Elektroprivreda management was requested by Mr. Behmen to accept this person on the managing board of Elektroprivreda.

Once this was accomplished an agreement was reached whereby he gave up his position on the management board in exchange for a full-time position within the company. He was then placed on the payroll of the HE Plant in Capljina and an office was provided, even though he does not work there.

Appropriate controls should be implemented to ensure only qualified individuals, who are appropriately screened and working at the company are employed. Favoritism regarding hiring should be eliminated. Inappropriate pressure regarding hiring should be brought to the attention of the government.

10. Perform appropriate reference and background checks prior to hiring.

In 2002, the company also discovered 18 employees who had provided them with fake University degrees. This type of situation can be rectified through proper verification of background details before hiring. Management implemented appropriate checks.

11. Curb the revenue losses.

We estimate losses resulting from poor management increased from 35 to 50 million KM from 1999 to 2001.

	1999 (millions KM)	**2000 (millions KM)**	**2001 (millions KM)**
Reduce electricity theft	21	14	18
Improve collections	15	15	25
Reduce inappropriate donations and inefficiencies	4	6	7
Total	40	35	50

In April of 2002 after three years of neglect, management began to work toward reducing losses bringing them down to 24.4%. Although we did not have the full year 2002 figures available for verification during our fieldwork phase, we are encouraged by this trend. However, the reduced losses are still unacceptably high at almost double the international standard.

The above figures represent only a fraction of the total estimated losses since they do not take into account further savings that could have been achieved by following appropriate tender processes, reducing distribution losses enabled by Power III, eliminating inappropriate construction projects, stopping the overriding of interest charges for high voltage and selected late customers, and stopping compensation and cesija transactions. In addition improving systems, streamlining procedures, adopting profit center accounting, reducing staff to optimal levels and adopting industry best practices can significantly improve the profit picture.

12.Improve budgeting and cash management processes.

In December 2000 and January 2001, Elektroprivreda took out short-term loans with Hercegovacka Bank with an annual interest rate of up to 28% when prevailing rates were 13 to 17%

During this period, Elektroprivreda borrowed - 2 million KM on the 14th December 2000 at 28% interest which was to be repaid on the 30th December 2000; 3 million KM on the 28th December 2000 at 28% interest which was to be repaid on the 28th January 2001; 1 million KM on the 28th December 2000 at 14% interest which was to be repaid on the 28th March 2001; 2 million KM on the 16th January 2001 at 14% interest which was to be repaid on the 16th April 2001.

They were taking out these loans at the same time they were putting money into the savings plan at Hercegovina Osguranje. (See previous issue regarding this company.) Hercegovina Osiguranje told us that all the money they received for this plan was placed on deposit and provided us with a document showing they had invested the money on behalf of Elektroprivreda back in Hercegovacka Bank where it was earning 5 percent interest.

This situation illustrates poor financial management. A simple income projection and financial plan could have enabled management to better plan their cash requirements and shop for more competitive interest rates when loans may have been necessary.

We recommend the company improve their financial planning and cash management to ensure loans are only taken when necessary and at competitive interest rates.

13.Upgrade computer systems.

The systems used by Elektroprivreda are inefficient, disjointed and inadequate for existing and the future needs of the company. The European Union is currently sponsoring a project in which one of the end products is to be a requirements document to be used as a base for making a decision on appropriate software. The team is in place and working at the three electric companies in BiH. Even though Elektroprivreda Mostar has been working with the international consultants, they decided to go ahead with their own purchase of software without waiting for the requirements or even fully understanding what their needs were.

Purchasing software without an appropriate analysis of current and future needs will likely do little more than waste resources. We recommend the current purchases be immediately stopped, and Elektroprivreda continue to work with the consultants to develop and/or implement an integrated software solution for all three electric companies in BiH. The solution needs to consider not only the needs of Elektroprivreda but future needs including restructuring for potential privatization.

14. Improve the efficiency and effectiveness of the process for paying operating expenses of the units.

All money is held by the head office and transferred to the various operating units around the country for payment of operating costs. The process requires each unit to fax the head office monthly with their requirements. Head office then reviews the request, checks how much money is in the bank and generally sends less than they requested for their requirements. When we asked about the process, head office staff told us that the units could save a lot of money if they tried.

The current process is inefficient and inexact. Strict budgetary control and appropriate financial planning will help ensure money is available when needed. In addition implementation of a Treasury system can improve control and efficiency.

15. Ensure Management Board decisions are appropriate for the business and within the authority of the Managing Board. Ensure statutes comply with international standards.

The Management Board made a number of decisions, which are beyond their authority. Examples include:

- A decision to donate 5% of the income of the company to the University.
- A decision to establish a private company with HEP of Croatia and Koncar of Zagreb.
- A decision to allow Elektroprivreda to become a mobile telephone company in partnership with Mobilcom of Austria.

The Managing Board should only approve decisions within their authority. We recommend the Ministry of Energy and Mining review and approve pending decisions before they go to the Managing Board for approval to ensure the decisions are appropriate for the business and within the authority of the Board. We also recommend the company statutes be revised to be in full compliance with international standards and best practices for the industry.

16. Other issues

During our audit, we noted a number of other issues, which need to be investigated further and/or addressed in some manner. These are:

Hydro Plant Capljina

This plant receives water from Trebinje which is under the control of Elektroprivreda RS (ERS) and according to staff at Elektroprivreda HZHB, ERS have a legal requirement to release a minimum of $8m^3$ of water per second down the river to Capljina. However, this requirement is not being met, and water is being sent to Dubrovnik instead. Despite requests for the Joint Co-ordination Center in Sarajevo (ZEKC) to deal with this, nothing has happened.

Part of ZEKC's job is to deal with disputes such as this.

Rental of HE Capljina Pump

The company is currently in the process of seeking bids from interested parties who wish to rent the hydro electric power pump at Capljina. This is one of the major assets of the company. Committing this asset to rental could potentially have an effect on any potential future privatization plans. We recommend this situation be fully evaluated prior to reaching any agreement on rental. Following the audit during our on-going monitoring, we learned that management has put this process on hold.

Mostar HE Plant Security Guards

After the war, the river Neretva was considered to be the border between East and West Mostar in this area. This meant that the land to the west would fall under the control of Elektroprivreda HZHB and the land to the East would belong to EPBiH. The problem here is that the plant is across the river and the access to this plant was previously through the east. This meant that the plant could not be repaired as access was denied by EPBiH.

The plant therefore needed to have cranes to lift equipment onto the site from the west causing vast extra expense and inconvenience. EPBiH managed to control access to the site from the east by providing security guards. These security guards are still there today, 7 years later.

When we visited the plant, we had to provide identification to EPBiH staff to gain access to a facility owned by Elektroprivreda HZHB. We asked the security staff what they were doing there, and they explained that they were protecting access to their land and were there in case of fires. However, they are located at the access to the plant not at the access to their land; by the time we reached them, we had already been across their land and were actually leaving their land to enter the plant; the land is also completely bare and they were unable to show us something that could catch fire anyway.

We see this as an attempt by EPBiH to do nothing but cause inconvenience and costs at the plant, and this has been the case for the last 7 years. This also costs EPBiH money as they have to arrange a 24-hour presence at the site.

There is no reason for the EPBiH staff to be there, and we recommend they be removed. However, there is need for the Elektroprivreda HZHB staff to have access to the dam and land immediately surrounding it in order to maintain and protect against potential collapse. The dam has not received adequate maintenance since before the war and there are cracks in the concrete along the banking.

MANAGEMENT'S RESPONSE

All issues were discussed with management of Elektroprivreda HZHB, Mostar during the audit. In addition, we sent them a copy of our report for their review and comment prior to publishing. They responded in writing and provided additional documentation, which we reviewed. As a result of this process we made changes and clarifications to our original draft report and/or performed additional follow up. The General Manager and members of his staff also met with us again on 21 January 2003, to further discuss the issues.

In both the verbal and written responses Elektroprivreda HZHB management comments emphasize technical compliance with the law, which does not address the issues. Many examples cited in the report do indeed show transactions were deliberately set up in order to meet the form of the law while circumventing the intent of the law. This sort of behavior makes the law meaningless when it enables less than arms-length transactions to be hidden behind a legal façade.

For example, Soko Air provided losing bids for products they do not produce or trade in nor are they set up to do so. Management's response focuses on the charter of Soko Air which allows them to engage in the type of business they bid on (even though they are not equipped to do so). Management also emphasized that since Soko Air didn't win the tenders on which they bid, a problem did not exist. This logic precisely proves our point. Soko Air never was a serious bidder. Soko Air's submission of losing bids was done merely to enable Elektroprivreda to get around the tender requirements while appearing to meet them.

Management also expressed their preference that we not include names and relationships in the report. We made adjustments when appropriate, but left names and relationships in where we felt they presented the reader with a more complete picture of the interrelationships between individuals, companies and payments.

The written response contained almost no plans for corrective action other than the recent improvements in distribution losses included our report.

During our 21 January 2003 meeting with the General Manager, he told us they are currently planning to employ Jadranko Prlic as an expert consultant for financial and privatization issues. Given his background as previous Minister of Defence and Minister for Foreign Affairs, we question the appropriateness of this appointment.

RESULTS OF ON-GOING MONITORING

We began our monitoring phase in December. This phase began after the draft was discussed and distributed to management. We were disappointed to note that contributions continue to be made in large amounts including an additional 456,250 KM to the university, 209,000 KM via cesija to MRM and an additional 75,000 KM to the Franciscan church.

Three new loans have been taken out from two to five million KM. The head office real estate was pledged on the five million KM loan. Compensation and cesija agreements continued unabated including cesija agreements with Hercegovina Osiguranje to benefit the Franciscan church.

Collections remain poor particularly for favored customers. Many of the same accounts remain connected without paying or with minimal payments. For example, the HDZ main office was disconnected during our fieldwork until a payment of 8,900 KM was made. They made no further payments as required by the payment plan. When we asked for an update on 31 January 2003, they told us it would take a few days for them to provide us with supporting documents. During that time on February 4, they sent a disconnection notice to the HDZ, and the HDZ paid 10,300 KM on 6 February 2003. We were then provided with the documents we requested that same day. We do not believe any collection activity would have been pursued on this account if we had not requested an update as part of our monitoring.

In spite of our being told that the interest charging process had been overhauled, no interest was charged to the past-due Soko account. The total outstanding has risen to 475,000 KM, and the only payment made since we finished our fieldwork was for 8,500 KM on 28 January 2003. Lost income from failing to charge interest on this account is approximately 80,000 KM per year.

Inter Invest is still not being charged interest on their past-due balance which has risen to over 100,000 KM. As with the HDZ, they were sent a collection notice only after we inquired; and they paid 8,000 KM on 6 February 2003, the day we received the documentation. The amount paid is inadequate, yet they remain connected.

Dale Ellen Ralph
Special Auditor
Appointed by the Decision of the High Representative