JP Elektroprivreda (EPBIH) Sarajevo

Report of the Special Auditor

11 March 2003

SUMMARY OF MAJOR ISSUES

1. The process for selling surplus electricity is poorly controlled and does not provide protection against potential kickbacks.
2. Sales on the eastern grid are limited to Energy Financing Team (EFT), a London-based company who has the energy exchange contract with Elektroprivreda RS (ERS).
3. Coal used to produce domestic electricity is priced 25% higher than coal used to produce exported electricity.
4. Financial operations are inefficient, inadequate, cumbersome and costly.
5. Profit center accounting has not been adopted for the operating units severely crippling the ability to quickly identify problems and opportunities for improved efficiency and effectiveness.
6. Management plans to purchase or acquire and run businesses totally unrelated to their core businesses.
7. Inappropriate tenders and payments, which were not transparent.

OVERVIEW

Distribution losses are within international norms and improving. Although some problems exist, collections are considerably better than the other two electric companies operating in BiH. Nevertheless, there are a number of inefficiencies which, if properly addressed, could improve operations and reduce costs. We estimate a minimum of 50 million KM per year could be added to the bottom line by reducing staff to optimal levels, improving efficiency, budgeting and cash management, adopting international best practices and improving control over energy sales.

EFT, rather than EPBIH realized millions of Euros of potential profits on energy sales. They purchased electricity from EPBIH at approximately 25 Euros per MWh, which EPBIH delivered to the border of the RS in accordance with contract terms. ETF sold this same electricity to Montenegro at around 31 Euros per MWh in 2002 and 33 Euros per MWh in 2003. Montenegro took over the electricity at the RS border. The 2002 profit realized by the purchaser for reselling EPBIH's electricity is estimated to be approximately six million Euros or 24%, which is almost five times higher than normal for similar sales on the international market. Profits per MWh for 2003 are estimated to be six times higher than normal. Even after factoring in a premium charged by EFT to Montenegro for allowing them to purchase their electricity over time and any advance payments made to EPBIH, the amounts earned are considerably higher than expected. EFT's good fortune is only possible due to a monopoly-like situation, which they take advantage of through their total control of the RS transmission lines. This control was granted to them by Elektroprivreda RS (ERS) when they provided them the energy exchange contract for the RS. ERS has repeatedly denied EPBIH access to these same transmission lines limiting their sales to EFT.

The process for negotiating these sales of surplus electricity is uncontrolled providing opportunity for kickbacks. With the exception of Debis all excess electricity ends up in the hands of EFT. Sales are further incented by the Federation government through their policies on pricing of coal. Coal used to produce domestic electricity is priced 25% higher than coal used to produce exported electricity virtually assuring export. Furthermore, additional funds are spent on projects to increase excess production enabling greater amounts of electricity to be exported.

Financial operations are inefficient, cumbersome and costly; and controls are not always adhered to. Profit center accounting has not been adopted for operating units; therefore, EPBIH management does not have critical information available, which would enable them to run their business in accordance with internationally recognized best practices. The cost allocation methodology is nothing more than application of management's wishes to evenly distribute profits and losses among the operating units. Systems and supporting methodologies are inadequate. The business cannot produce basic management information such as an aged accounts receivable listing. Compensation agreements are used as the vehicle for distributing profit and losses to operating units. EPBIH is managing most of the financial operations for the independent coal mines including negotiating contracts for major supplies, taking over their loans, purchasing their equipment, etc. All of these activities are handled via compensation and cesija agreements between the mines and EPBIH and other suppliers. This inefficiency is one of the reasons the company is over staffed by more than 23%.

EPBIH has a large surplus of cash. At the time of our audit, there was 75 million KM in bank accounts. Significant funds were spent and/or budgeted for purchasing or acquiring businesses, construction projects, investments, donations and other purchases. These expenditures continue in spite of planned restructuring even though many of the expenditures will not improve this effort; and some, such as purchasing unrelated businesses, may actually hinder it.

We noted some instances where the tender process was not appropriately followed by both the former and existing management.

EPBIH is continuing to work on reducing distribution losses and has brought them down to within international norms. Their results in this area are significantly better than those achieved by either ERS or Elektroprivreda HZ HB (EPHZHB).

SUMMARY OF RECOMMENDATIONS

1. Improve control over the sales of surplus electricity.

2. Remove the impediments to selling on the eastern grid.

3. Eliminate the price reduction for coal used to produce exported energy and let market forces establish the rate for both domestic and international sales.

4. Curb unnecessary spending.

5. Ensure a fair and open tender process.

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

7. Comply with the spirit of the law prohibiting public companies from making loans.

8. Ensure housing loans comply with the rules.

9. Improve efficiency and effectiveness of financial operations.

10. Resolve remaining collection problems and ensure the application of write off policies do not inappropriately benefit one user at the expense of others.

11. Improve controls over meter reading and distribution of bills.

12. Remove the security guards posted at HE Mostar Hydro Plant.

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 examined processes including electricity sales, cash management, meter reading, bill calculation, collections, disbursements, and payroll and tendering. Transactions were sampled to determine if the control system was working as intended and could be relied upon. Where we found sufficient evidence that the control system could not be relied upon and/or controls were being overridden further testing was truncated.

We limited the timeframe of our audit to the last two years with primary focus being on the last 12 months of activity. In some cases such as disbursements testing, we examined transactions from the past three years in order to include activity from the current and prior management. Resources and time were our limiting factors. Therefore, we adjusted our scope accordingly. We made no attempt to uncover every issue or examine every transaction. Some areas, such as electricity sales, were given more attention than others due to the lack of controls and evidence of problems encountered early in our work. As a result, other areas received less attention.

Audit fieldwork took place from 16 September through 20 December 2002.

This is not an audit of the fairness and reasonability of the financial statements. Therefore, we express no opinion on the financial statements. The audit is not a forensic examination for the purpose of establishing criminality. Where we found the potential for possible criminal activity, we recommend an investigation by the appropriate investigative authorities.

The report expresses the opinion of the auditors based on the work performed.

FINDINGS AND RECOMMENDATIONS

1. Improve control over the sales of surplus electricity.

The process for selling electricity to foreign companies is accomplished through a limited offer process without the benefit of a valid public tender. This process works by sending offers to sell at a certain price to selected companies and asking them to accept or counter. The best offers are recommended to the Director of the Directorate for Transmission and Management of the Power System. Short-term contracts of less than a year can be approved by the Director. Long-term contracts of a year or more are verified by the Board of Directors and General Manager. There are no written standards to govern selection. Control over these sales is very poor since the Director is free to make any arrangements he sees fit. The General Director of EPBIH admitted to us that this process was poorly controlled and open to kickbacks. He also told us that they were now obtaining bids. However, during our testing we did not find the situation improved.

When we tested a number of limited offers, we found the documentation consisted of a number of faxed offers to various companies. Few responses were contained in the files often limiting the purchaser to one or two parties. In one case we found a losing “response”, which appeared to be fake since the respondent was not even in the business of purchasing electricity. In 2002, excluding Debis, who has a long-term contract with EPBIH to provide electricity, practically all sales went to EFT.

Management responded to this finding by stating that they are currently in the process of drafting appropriate procedures to define the rules regarding sales and to eliminate the existing control problems. We support and encourage this activity, and recommend corrective actions be comprehensive and quickly implemented.

2. Remove the impediments to selling on the eastern grid.

With the exception of Debis practically all surplus electricity is sold directly to EFT (the purchaser). Although a few contracts had been awarded to other companies such as Enron, Entrade and Gorenje, the electricity was resold to EFT, which controls about 80 percent of the electricity in the region. EFT sells the electricity obtained from the Federation on the eastern grid to Montenegro and Serbia through the RS. Since the means of transmitting electriticy to this part of the world are extremely limited, a monopoly-type situation is created; and the RS transmission lines are one of the few means of transmitting the electricity. These transactions are accomplished through an energy exchange contract with the RS. The energy exchange contract for the RS has been granted by Elektroprivreda RS (ERS) to EFT. Therefore, any sales to the east must be made to this company who has the energy exchange contract. The General Manager of EPBIH told us they were repeatedly denied access to the RS transmission lines preventing them from negotiating direct sales. In the past few years EPBIH made multiple written inquires to ERS and ZEKC requesting use of the lines without success. (See the ERS audit report for more information.)

Due to the situation described above, sales to the east were made to EFT, which purchased electricity from EPBIH at approximately 25-26 Euros per MWh. The purchaser sold electricity to Montenegro at approximately $30.85 USD per MWh for 2002 and 33 Euros per MWh for 2003. Although a company specializing in energy trading is expected to make a profit, the profit earned by the purchaser on the sale of EPBIH's electricity is five to six times greater than the one to five percent ordinarily earned by energy traders selling on the western grid without the monopoly.

Under the circumstances there is no market for surplus electricity except through EFT. This problem will continue as long as the RS transmission lines provide the only route for transmitting electricity to the border, and the energy exchange contract is held by EFT.

In spite of having no market other than EFT for surplus electricity, EPBIH continues to invest in further electricity production, which will in turn be sold to EFT further increasing their profits. This situation provides significant opportunity for individuals to enrich themselves at the expense of the people of BiH.

In April 2002 a law was passed to form a public company owned by the State of Bosnia and Herzegovina for the public operation of the electro-energy system in BiH. This was to be the successor to ZEKC, the coordinating body. The deadline was 1 January 2003. Due to a number of problems including the lack of a legal framework to get this independent system operator established, this is yet to be accomplished. This law is in the process of being drafted. We support this activity, and recommended the process be escalated to ensure all BiH electric companies are able to sell their excess electricity to the east to the highest bidder rather than being forced to go through EFT.

Management agrees with this finding and confirmed the situation is the result of a lack of connection between the transmission facilities and the monopoly in favor of EFT. They stated they are not in a position to sell direct until after Power III is implemented and the interconnection is ensured, which is scheduled for mid 2004.

3. Eliminate the price reduction for coal used to produce exported energy and let market forces establish the rate for both domestic and international sales.

The price of coal is set by the Government upon recommendation by the Ministry of Energy and not by market forces. Although the Minister of Energy claims this established price of 4.00 KM/GJ is competitive on the world markets, and backs this up with a study regarding the future viability of the mines (provided a number of significant changes are made), higher quality coal can currently be obtained cheaper than 4.00 KM/GJ. Coal can be imported from other countries at a lower price. In addition the price charged for coal is reduced for any coal used to produce electricity, which is exported. This reduction in price was established by the Ministry of Energy in a decision dated May of 2001. If, in fact, the price of coal were competitive on the world market, there would not be a need to reduce the price of coal used to produce exported electricity.

We recommend the Ministry of Energy let market forces establish the price of coal regardless of whether or not it is sold domestically or abroad. Reducing the price for electricity sold abroad places the entire burden for an inefficient mining operation on the people of Bosnia since it is absorbed in the price of their electricity and in reduced profits of EPBIH. This situation also ensures excess energy will be sold abroad rather than to EPHZHB, which is in a deficit position and has to purchase electricity from abroad. Artificially establishing the price of coal provides little incentive to quickly implement the changes necessary to improve the profitability of the coal mining industry in the Federation.

Management concurs with this recommendation.

4. Curb unnecessary spending.

EPBIH's 2001 profit before depreciation was 110 million KM. After applying depreciation of 175 million KM, they realized a loss of 65 million KM. Cash balances in various bank accounts amounted to 75 million KM at the time of our audit. In spite of the book losses and, perhaps, due to the large cash balances on hand, EPBIH spent large amounts of money on purchasing businesses, donations, construction, investments, renovation and other items, which are not directly related to the core business of generating and transmitting electricity. Additional expenditures are planned.

Perform feasibility study and financial analysis to ensure construction projects are necessary and cost effective before beginning construction.

Under the prior management, EPBIH contracted to build a new state-of-the-art headquarters building in Sarajevo next to their existing building. So far this building has cost 15 million KM. The green glass façade alone cost 10 million KM, and the contract for this phase was given to a construction company called ZGP without the benefit of a tender. An additional 12-15 million KM is estimated to be needed to bring the building to a state where it can be used. Further construction on this green glass building was stopped when management changed leaving a useless 15 million KM shell. This landmark building has no insides and cannot be used by EP or leased to anyone else. The current fair market value of the building as it stands is 7.5 million KM, which is half the sunk cost. The estimated fair market value if the inside is completed is 18 to 20 million KM. The cost of constructing similar finished office space ranges from 800 to 1200 KM per square meter or 6 to 9 million KM for a similar building.

Before committing to any large construction projects, management should assess the need for the project; perform a financial analysis and feasibility study. If the project is determined to be cost effective, they should ensure adequate funds are available for completion prior to commitment. In this situation either the building was not necessary, as they continue to work out of the adjacent yellow building and other locations with no apparent overcrowding (in spite of 1,600 excess staff) or adequate provisions were not made for completion of the building prior to beginning construction.

At this stage we recommend EPBIH perform a full investment appraisal and decide the best course of action for the existing building. The current General Director said EPBIH would never fully occupy the building, and the building is not needed. We recommend a decision regarding this building be made based on future and not sunk costs.

Management responded by agreeing to implement the recommendations in regard to the building.

Cease purchases of unrelated businesses.

EPBIH established a Diversification Department to invest in projects and companies, such as a bicycle factory, to employ staff, who may otherwise be laid off. EPBIH's charter was recently changed to legally enable such investments to take place. The 2002 investment plan for the Diversification Department was 22.6 million KM. Most of this amount was not spent as of October of 2002. However, their plans for these funds have not changed and will continue into 2003. Although the motivation to employ staff is admirable, it does not make sense for a company involved in the manufacture and distribution of electricity to purchase totally unrelated businesses.

In the past few years EPBIH spent millions on investments including various electrical manufacturing operations. They also own a hotel in Croatia from before the war, which we were originally told would be renovated for the use of EPBIH staff. We were later told the hotel was being fixed up for sale. Other large expenditures included in their 2002 plan includes 12.6 million KM for IT systems, 12.9 million KM for telecom systems and 2.9 million KM for automobiles. As of October 2002, approximately 10 million KM of this amount had been spent, and they plan on continuing the projects into 2003. We recommend expenditures which do not immediately and directly deal with continuing and improving existing (not expanded) production, operations and sales of electricity be stopped.

In addition to the above, the General Manager told us that as a result of political considerations the prior management allowed a number of uncollected debts to accumulate for 3.5 years including Polihem chemical industry in Tuzla (10 million KM), Central Heating in Tuzla (10 million KM), Fabrika Soda in Lukavac (3.5 million KM) and Vodovod in Tuzla and Mostar (4.5 million KM). EPBIH has now shut the electricity down, written off bad debts and is pursuing court action for most of these. The General Manager told us he hopes to force some of these nonpaying companies into bankruptcy and take over their operations in order to pay the debt and provide staff jobs. Once again, the motives may be admirable; however, it does not make sense for a company specializing in the production and distribution of electricity to dilute their energies in trying to run businesses they have no experience with. We suggest they concentrate on selling or liquidating these unrelated businesses to offset outstanding debts.

Management responded by reiterating their intent to acquire other businesses as stated in this finding. We concur that fixing up existing assets, such as the hotel, for sale at fair market value is appropriate as is investing in their own internal systems, which will improve the efficiency of existing operations. However, acquiring (through bankruptcy or purchase) other unrelated businesses merely dilutes their focus and their assets.

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

In spite of significant losses, EPBIH spent over 5 million KM in both 2001 and 2002 on donations. These donations were originally budgeted for; however, once the 2001 donation budget was close to being exhausted, a decision (BOD UO-7-16670-4/01) dated November 14, 2001, was passed to increase the budget for donations by 1 million KM. Some of the donations made via Managing Board decisions include:

- 235,092 KM cash to Toplane Travnik in December of 2001 to purchase and transport coal.
- 1.5 million KM cash, materials and work to the Federation Ministry of Social Policy in July of 2002.
- 470,975 KM cash to the Union Workers in Electro-energy Sector of BiH to finance extraordinary activities.
- 196,000 KM in material and labor in January of 2002 to the City of Mostar for reconstruction of public lighting.
- 201,700 KM in materials and labor in January of 2002 to the City of Konjic for reconstruction of public lighting.
- 172,000 KM cash to Merhamet for construction of an outpatient clinic in Kotor Varos.
- 130,000 KM in July of 2002 cash to the Franciscan order for the restructure and reconnection to the supply of electricity.
- 100,000 KM in cash in December of 2001 to the Islamic Community for decoration of Gazi-Husrev-beg Mosque in Sarajevo.
- 100,000 KM in cash to the Tuzla Canton government for flood recovery.
- 100,000 KM in cash in March of 2001 to the Basketball Association of BiH to attend the European Championship.
- 11,000 KM cash to Emir Solakovic for publishing the book “Heart Disease” in February of 2002.

Some donations such as providing cash to Toplane Travnik to purchase and transport coal is highly illogical considering EPBIH’s relationship with the mines, 19 million KM in outstanding advances to the mines, and EPBIH’s extensive use of compensation arrangements with and for the mines.

EPBIH donated 250,000 KM for coal to Konjic Municipality. This cash donation was made in spite of the fact that EPBIH was owed 19 million KM for advance payments to the coalmines and could have asked the mines to provide the coal to the municipality and reduced the debt.

In another instance we noticed that the Banovici coal mine made a donation to the Association of War Invalids. However, this donation was then assumed by EPBIH via a cesija agreement. Not only does this transaction raise questions regarding a marginal public company making large donations to associations already supported by the government, but also the means of paying for the donation limits transparency.

These donations were made without regard for the profit position of the company. We recommend limiting both the amount and circumstances under which donations from public companies can be made. Limited donations should come out of profits, and donations to government ministries should be stopped. When the company is in a profit position, the stockholders, in this case the government, can then decide what use to make of excess profits not needed for reinvestment.

Management responded to this issue by stating they would reduce the amount of donations and implement strict approval criteria. We will continue to monitor donations during the monitoring phase of our audit work.

5. Ensure a fair and open tender process.

During our audit we noted that proper tendering procedures were not always followed.

<u>Headquarters Building</u>

- The shell for the green glass headquarters building was built in four phases. All four contracts were issued to the construction company ZGP either through closed tender, where management decided whom to ask to bid, or there was no tender. To date this building is no more than a shell, which cost 15 million KM to build and is worth approximately 7.5 million KM. Another 12-15 million KM is needed to complete the building. The completed building is estimated to be worth 18-20 million KM, which is far below cost. We performed a series of price checks and found the rate per square meter of comparable finished office space in Sarajevo to range from 800 KM to 1200 KM. Therefore, the cost of this 7,500 square meter building should be between 6 and 9 million KM.
- In November 2000 a 300,000 KM contract was awarded to Studije i Projektavanje for technical design documentation for electrical, heat, sewage, etc. for the interior of the green building. This contract was awarded without a tender process.

Due to the much higher than market price paid for this construction and the failure to award the contract through a valid tender process, we recommend the Financial Police examine the payments made for the construction of this building, in particular the fourth phase, where ZGP was awarded the contract for 10 million KM and then sub-contracted the bulk of the work to another company for three million KM.

<u>Boiler Contract</u>

In May of 2001 EPBIH opened a tender for repairs to a boiler at ThermoElektrana (TE) in Tuzla. The cost of these repairs was estimated to be 11 million DEM. The tender was limited to four invited international contractors. Four bids were received. Three were immediately rejected for a number of major omissions from the tender documentation. Since these firms were selected to bid because EPBIH believed them to be sufficiently capable of doing the job, we find it interesting that three out of four couldn’t even put together the basic bid package.

This process resulted in Rafako of Poland winning the contract at a price of 22.6 million KM, which exceeded the original cost estimate by 11.6 million KM or over 100%. Once the price was agreed, credit terms were arranged between EPBIH and Rafako whereby EP would pay in installments with an interest rate of six percent when EPBIH had 75 million KM on deposit at various banks.

We recommend the Financial Police examine this contract.

Insurance contract

In 1999 EPBIH insured 175 million KM of their most important assets through Sarajevo Osiguranje. The tender was closed and limited to six companies, which were invited to bid. However, after eliminating companies not interested in bidding and companies incapable of doing the job, only Sarajevo Osiguranje was left. A ten-year contract was signed with Sarajevo Osiguranje. If the contract is broken without "good reason" a penalty of approximately 1 million KM will be required to be paid by EPBIH.

EPBIH is now planning on increasing their insurance to cover assets worth 375 million KM with this same company without the benefit of an open tender.

In response to this report, management stated that they consider the existing fixed asset insurance contract inappropriate and not beneficial to EPBIH in terms of term, risk and contract conditions. They now plan on re-examining the contract.

Orbiter

EPBIH has a SQ (System of Quality) procedures they are to follow. Purchases between 10,000 and 50,000 KM must be approved by the commercial department, and purchases of 50,000 KM or more must be tendered. During our testing we found seven contracts of 7,000 to 9,000 KM were awarded by the TE in Tuzla to Orbiter on 10 September 2002. The work described on each invoice was identical. The purchases were merely broken down into smaller pieces to get around the SQ requirements. Actions such as this, which deliberately circumvent controls, are considered a form of bid rigging and should be immediately stopped.

In response to this report, management plans on conducting a detailed review of this contract with special emphasis on compliance with the procedures, cost-effectiveness and completion.

Meters

EPBIH does not have meter specifications other than the law, which requires Class I meters in some situations and Class II in others. However, they only purchase ISKRAEMECO meters from ISKRAEMECO BiH. EPBIH owns 57.61% of this company and a Slovenian partner owns the remainder. Specifications could be established which will enable a variety of meters to be purchased which are specific to the particular set up. Such specifications can expand the choice of meters, increase competition and lower the price to EPBIH.

In response to this finding, management stated that they have a long-term arrangement with ISKRAEMECO until the end of 2004. They said the purchase of meters will be based entirely on market conditions after expiration of the current contract.

PC Kids

During 2000 under the previous management, EPBIH predominately used three companies to purchase all of their computer hardware. These were PC Kids, '58' and PC Comp. All contracts were signed as a result of negotiation. No tender process took place. We were told these purchases were not put out to tender because EPBIH specified Compaq computers be purchased, and these three companies were the only companies in Sarajevo, which sold Compaq computers, which could deal with their request.

The total spent on these purchases for 2000 was 1.1 million KM with ‘58’, another 1.1 million KM with PC Comp and 40,000 KM with PC Kids. At the time these purchases were made there were 3 to 4 other companies who could have provided Compaq computers and several other companies, which could have provided other models with comparable components.

In addition, it quickly became apparent that the three selected companies were related. PC Comp is little more than another trading name for PC Kids, despite being registered as a separate company. Whenever PC Comp received an order from EPBIH, PC Kids provided the goods. Money given to PC Comp from EPBIH was transferred to PC Kids. ’58’ operated in a similar manner signing contracts with EPBIH and then using PC Kids to supply all or part of the order. PC Comp has now ceased to trade and the sole employee and director is soon to begin work at PC Kids.

One transaction we followed took place in February of 2000. EPBIH purchased 200 computers and equipment valued at 745,000 KM from PC Comp. PC Comp paid 710,000 KM of the 745,000 KM payment to PC Kids. Upon receipt of this money, PC Kids made a loan of 100,000 KM to FC Sarajevo. The Managing Director of EPBIH at the time, Meho Obradovic, was also the president of FC Sarajevo. PC Kids claimed there is no relationship between these transactions and the loan was a coincidence.

Auto purchases

The process for purchasing automobiles could be strengthened. Currently a request is made for a particular make of car and then EPBIH contacts the only dealer, which sells that model.

The process could be strengthened by improving their budgeting processes and determining in advance the number of cars and specifications for a 12-month period. Care should be taken to ensure the specifications are not make and model specific or so narrow as to preclude qualified bidders. These requirements should be closely scrutinized and approved by management and the board. Once approved the fleet requirements can then be put out to tender. This annual purchase process will enable EPBIH to take advantage of price breaks, which can be negotiated for larger annual purchases.

Appropriate tender processes should be followed for all purchases over 10,000 KM. During our disbursement testing, we were told the department that handles tenders had recently lost ten staff members and believes they are understaffed even though the company itself is significantly overstaffed. We recommend management examine staff distribution to ensure all major risk areas are adequately staffed with qualified individuals to ensure control processes and procedures are carefully adhered to. Insufficient staffing should not be used as a reason for failing to apply adequate control processes.

Management concurs with the recommendation and said they plan on implementing it. They also stated that they are examining the organizational structure of their Procurement Department and intend to strengthen the department to ensure it can effectively carry out its mission.

Companies partially owned by EPBIH

The tender process is not followed when EPBIH owns a portion of the supplying company, such as Iskraemeco (57.51% ownership) and ETI (49%). The other partner in both these companies are from Slovenia. Since the process is not followed, prices paid can be significantly higher than market disproportionately benefiting the other owners at the expense of EPBIH. We recommend appropriate tendering processes be followed regardless of the ownership status.

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

FC Sarajevo

During 2000 under the prior management, Elektroprivreda made four loans totaling 720,000 KM to four companies – Euromedia, Farex, Ires and SMA. This money was then lent by these companies to FC Sarajevo on exactly the same terms as given to them by Elektroprivreda. When we met with the Director of Euromedia, who was the previous Director of FC Sarajevo, he admitted that all the money was intended for FC Sarajevo; and the method of transfer was Elektroprivreda's means for funding the club. At the time these transactions took place, Meho Obradovic, was both General Manager of Elektroprivreda and President of FC Sarajevo. He claims these significant payments from EPBIH to FC Sarajevo were merely a coincidence, and he had no knowledge of any connection. He also claimed that it was a complete coincidence that FC Sarajevo received 100,000 KM from PC Kids one day after EPBIH paid PC Kids for a 740,000 KM contract.

In addition to the loans other funding was provided by Elektroprivreda to FC Sarajevo via Euromedia. Total funding of FC Sarajevo by Elektroprivreda was approximately 1 million KM for 2000 alone.

We understand that the current Elektroprivreda management is attempting to collect on the loans through the court system. Although we support this action, the bigger issue is the hidden means of diverting funds to pet causes of the reigning management.

ASA Auto

In June of 2000, EP made an advance payment of 70,000 KM to ASA PVA. The stated reason for the advance was to pay for spare parts and servicing of cars. However, this advance remained unused while EPBIH spent another 300,000 KM with this same company. When we asked why the advance had not been used prior to expending other funds, they told us the advance could not be used for the purchase of automobiles and must be used for servicing. However, when the advance was finally cleared in September of 2002, it was offset against car purchases.

Management responded to these items by stating that the potential for processing such hidden transactions has now been stopped.

7. Comply with the spirit of the law prohibiting public companies from making loans.

In August of 2000 a law was passed, which prohibited public companies from making loans and charging interest. This law stopped most of the loans, which were being made up to that time. However, in October of 2001, EPBIH put one million US dollars on deposit at Central Profit Bank, and the bank lent the funds to BH Gas using the EPBIH deposit as security. Management claims this transaction is legal. While we do not dispute that fact that the transaction is technically legal, we believe this type of transaction circumvents the intent of the law to stop public companies from lending funds. The current General Manager of EPBIH was previously the General Manager of BH Gas.

In addition, in 2002 almost 20 million KM of bank loans were made by the coalmines and then assumed by EPBIH via cesija agreements. Once the cesija agreement was signed EPBIH became legally liable for the loan. For EPBIH to be assuming loans and then billing the mines has the same effect as lending funds to the mines themselves. Also, as of December 2002, EPBIH had approximately 19 million KM of advance payments outstanding from the coalmines. These loans were in addition to other loans to the mines for prior purchases of fuel oil. Interest was charged on the loans for prior purchase of fuel oil.

Regardless of the form the above transactions took, the end result was that a loan was made to a third party for which EPBIH assets were pledged and/or EPBIH was legally liable. Since lending money is not the business of EPBIH, we recommend loans and loan-look-alike transactions be stopped.

In another related instance the public heating company in Kakanj needed coal to heat the town, but could not afford to buy it. Therefore, EPBIH provided the coal on credit to them. Some of this loan was returned in coal and the rest was paid after EPBIH threatened to sue. We question EPBIH's intermediate involvement in a transaction, which clearly did not involve them and could have been made directly between the public heating company and the mine.

8. Ensure housing loans comply with the rules.

EPBIH has an annual budget to help employees finance the purchase or renovation of a home at very favorable interest rates. The rules require the employee not have housing other than the housing the loan is used for. The maximum allowed loan size is 100,000 KM and typical loans range from 35,000 to 50,000 KM. In October 2000 General Manager, Meho Obradovic was approved to receive a housing loan of 150,000 KM. In further violation of the rules he had other housing at the time. He signed the loan agreement on 28 December 2000, after he was replaced as General Manager, although the agreement still listed him as General Manager. At the time of signing, the monthly payments on this loan equaled 83% of his salary. The stated purpose of the loan was to renovate the house owned by Mr. Obradovic. He signed a statement stating that the renovated property was to be used as his residence. Instead, this property was rented to the Malaysian Embassy. In addition, Mr. Obradovic did not agree to have the monthly payments deducted from his salary, as is the usual practice for other loans of this type. At the time of our audit this loan was five months delinquent.

Given the delinquency, we recommend this loan be immediately called and foreclosure proceedings be initiated if the amount is not paid in full. We also recommend the Financial Police investigate the sources of funds used to purchase and construct this building. EPBIH should ensure all loans adhere to the requirements and that no one is allowed to circumvent the rules regardless of their level in the organization. All loans should be based on sound lending practices including debt/equity analysis. Salary deductions should be required to help ensure prompt repayment.

In response to this issue on 20 January 2003, the General Director of EPBIH sent a letter to Meho Obradovic terminating the loan and requiring full payment of 145,287.03 KM (interest plus principal) within 30 days. In the event repayment was not made EPBIH stated that they would initiate sale of the property to recover the amounts due to them.

As a result of the above actions, this loan was paid off in 15,000 Euro chunks deposited through Central Profit Bank on five consecutive days (February 25, 26, 27, 28 and 3 March 2003) As the amounts are curiously just under the reporting requirements for money laundering, we also suggest the Financial Police investigate the source of these funds.

9. Improve efficiency and effectiveness of financial operations.

<u>Re-engineer processes and upgrade computer systems</u>

The methods, processes and systems used by Elektroprivreda are inefficient and do not provide adequate and timely management information. For example, EPBIH cannot produce a basic aged accounts receivable listing. Their formula for calculating collection rates does not appropriately apply payments, which relate to previous periods. 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. We support this effort and encourage EPBIH to fully support this project to provide the basis on which to upgrade their systems to enable EPBIH to better manage their business and adopt internationally recognized best practices.

The methods and processes for transacting business will also need to be examined as part of the process for upgrading systems. For example, significant business is currently transacted using cesija and compensation agreements, which add complexity, cost and inefficiency to their processes. Improved more efficient means of processing can yield significant improvements in efficiency and reduced costs.

Implement profit center accounting

EPBIH, the parent company, distributes profit and loss to each of the operating units in an attempt to "even out" the costs among them. The vehicle used to make these "entries" is internal compensation agreements. This method of accounting for the operating units (Elektrotransmission, Elektrodistribucia, hydro power plants, thermo power plants) does not enable EPBIH to determine the profitability and efficiency of each unit. This lack of valuable and basic management information cripples their ability to quickly spot negative trends and opportunities for improvement. Furthermore, they do not have basic financial performance information to enable them to distinguish between managers whose units perform well and those, which do not.

We recommend profit center accounting be adopted to enable basic management information to be captured and used to improve operations. Appropriate integrated computer systems should be adopted to enable information to be captured quickly and efficiently in line with internationally recognized best practices for the industry. Compensation agreements should not be the vehicle for transferring costs.

Management responded to this item by stating that they are currently undertaking activities with the assistance of the World Bank to implement cost and profit center accounting. We support this activity and recommend measures to make this happen be quickly implemented.

Cease operating as the parent of the coal mines

The coalmines are separate legal entities. However, in spite of this fact EPBIH acts as their parent company in many ways especially as it relates to disbursements. EPBIH takes over loans to the mines via cesija agreements. Under the previous management, when Banovici mine wanted to obtain a loan to purchase five dump trucks, EPBIH management insisted EPBIH and not the mine purchase the trucks. In doing so, they did not use the recommendation of the mine tender committee. Instead, they put together their own committee made up of two members of EPBIH and the Director of the mine without adequate technical representation from the mine. EPBIH then purchased trucks and leased them to Banovici. Several members of Banovici management told us they could have obtained comparable trucks 20% cheaper than the deal cut by EPBIH. They based their comments on the tender process, which had previously been conducted by mine personnel. However, current mine management was unable to provide the original tender documentation to us, and claimed it had likely been destroyed when the prior manager of the mine left.

EPBIH arranges for fuel, other large purchases and even donations for the mine. They also administer loans for prior fuel purchases. In addition, EPBIH receives a reduced price coal used to produce electricity, which is ultimately exported. All these transactions and more are billed by EPBIH and paid for via compensation arrangements. The mine provides EPBIH with their immediate cash requirements for payroll, food and other expenses very much as a subsidiary would inform a parent company. They said this information is provided to enable EPBIH to budget payments to them.

The work that EPBIH does in arranging contracts, paying bills, compensating transactions, etc. adds additional layers of bureaucracy and paperwork to the process, which takes more time and cost to process further reducing profitability. Although the mines are important to EPBIH, they are not owned by them; and, therefore their financial transactions should not be managed by them in this manner. The mines should be free to negotiate their own contracts with suppliers, negotiate their own loans and purchase their own equipment without interference from EPBIH. The mines will need to stand on their own to operate in a free market economy and steps should be taken to enable them to do so.

Management responded to this recommendation by stating that the recently passed Action Plan for Restructuring of the Power Sector eliminates the need for EPBIH to continue to act as the parent company for the coal mines.

Significantly reduce the use of compensation and cesija agreements

As previously mentioned, EPBIH makes significant use of compensation and cesija agreements. Not only do they compensate for much of their own business, but they also negotiate contracts for all the major mine expenditures and even use these transactions as a means of distributing profit/loss to the operating units of EPBIH. The process is cumbersome, inefficient and costly since special legal agreements are needed. Compensations can easily be used to obscure the purpose of the payment. Some compensations we examined involve eight or more companies of which EPBIH claims they only know about and have support for the portion of the transaction involving them. The use of this type of multi-party transactions can be used to facilitate the diversion of funds and/or provide the means to inappropriately deprive the company of funds to which they are entitled. EPBIH is cash rich and had 75 million KM in various bank accounts when we were conducting our fieldwork. They do not need to do business via compensations, and we recommend they be eliminated. If they are retained, their use should be severely limited to cases of supported absolute necessity and should only involve two parties: EPBIH and the debtor and not additional parties who owe the debtor money. EPBIH should obtain complete supporting documentation for all phases of the compensation transaction for all involved parties before allowing the transaction. Compensations should not be used as a means of distributing profit and loss.

Management responded to this finding by agreeing to fully implement the recommendation.

Improve budgeting and cash management

As previously mentioned EPBIH had 75 million KM in various bank accounts as of September of 2002 when we began our audit. (According to EPBIH management September is usually the time when cash on hand is at its lowest point.) Time deposits earn approximately 5 percent while current accounts earn nothing. At the same time EPBIH has approximately 45 large loans with international lenders and donors. Although some of the rates received on these loans were favorable, others, such as the 2.5 million KM loan with Siemens at 8.5%, cost in excess of what can be earned on the money they have on hand.

We recommend EPBIH improve their cash management and budgeting processes to ensure the best and most cost effective use of their funds and reduce the need for any potential short-term emergency funding.

Reduce staff to appropriate levels

Current staffing is excessive for the business and severely hinders profitability. Some of the excess staffing is currently required due to poorly designed processes, inadequate systems and manually intensive paperwork. Management is aware of this issue and has been working to reduce staff to more optimal levels. They estimate they are currently overstaffed by 1,500 (23%) employees.

Management concurs with the finding, but plans on implementing by starting profitable companies. As addressed elsewhere in this report, acquiring, running and privatizing unrelated businesses will merely dilute the focus and assets of EPBIH and does not appear justified.

10. Resolve remaining collection problems and ensure the application of write off policies do not inappropriately benefit one user at the expense of others.

Distribution losses for EPBIH are within acceptable international norms of 10-13% and improving. Overall they are significantly better than those experienced by the electric companies in Mostar and the RS. For example distribution losses are presented in the table below.

Year	GWh	Percent
1999	400	15.6%
2000	374	11.0%
2001	341	10.6%
2002	338	10.4%

There are a few accounts with problems dating back to the prior management, which need to be resolved.

- The debt for the army increased to over 5.5 million KM in early 2000. In March of that year, in lieu of collection, management wrote off 3 million KM of that debt via a management decision. An agreement was reached to cancel another 1.6 million KM of debt in return for some demining work on Elektroprivreda land, which will be performed by the army. The remainder of 900,000 KM is for the current usage and represents three months supply of electricity. It is interesting to note that since the army began paying for their electricity; their usage is half of what it was when they weren't paying for it.

- The debt of the Polihem chemical factory stands at 10 million KM for heating and electricity. The problem originated from the poor collection practices of the previous management, which enabled their account to escalate beyond reasonable levels. The factory is no longer operating, but some electricity is still being supplied for "safety reasons" per instruction of the Federation Ministry of Mining and Energy. The cost of this safety supply is approximately 35,000 KM for the current year. Given the non-operational status of this plant, this amount is very likely to be uncollectable also.

- The Mostar area, which is served by EPBIH is experiencing a higher than average rate of non-payment than other regions. There are approximately 16,000 customers in this area and 3,800 (24%) were written off for non-payment in 2002.

Collection problems need to be resolved via whatever means possible. If debts are not collectible, they should be written off and appropriate arrangements made to shut off the future supply of electricity or assign the debt to the appropriate agency or party, which will guarantee the debt is paid. EPBIH should not be expected to bear the cost of continuing to supply free electricity on accounts, which don't pay but are protected by law.

Management responded by reiterating their commitment to resolve the problems.

11. 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 10 to 11 as compared to an international standard of 6 readers per 1,000 customers. This practice is inefficient, represents inadequate segregation of duties and is not in compliance with best practices for the industry. Problems, which can result from this situation, include taking cash for allowing illegal hookups and/or reporting less usage. An unscrupulous reader would also be in a position to establish his/her own hookups and collect cash payments.

We recommend a fully automated system of meter reading be adopted. Until the equipment and process is in place to enable this to happen, 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 independently investigated and followed up and dishonest readers immediately dealt with. Qualified meter reader inspectors can also check meters to verify they have not been tampered with and identify and follow up on illegal hookups.

Management agreed to implement measures for monitoring of meter readers.

12. Remove the security guards posted at HE Mostar Hydro Plant.

EPBIH has 24-hour guards posted at the eastern entrance of the HE Mostar hydro plant, which is owned by Elektroprivreda HZHB. EPBIH no longer owns the land or any assets in the area, yet they continue to man and run a guard station. This guard station has resulted in additional expense and inconvenience to EP HZHB since they are not allowed to enter their property through the guarded eastern entrance. Therefore, cranes had to be used to lift equipment onto the site for maintenance and repairs.

The General Manager of EPBIH confirmed that EPBIH does not own the land that the security guards claim they are protecting. When we asked why they were going to the expense to guard property they did not own, he also said the issue was "highly political" and would not discuss it further.

We recommend this issue be examined for a more cooperative, cost-effective and practical solution.

MANAGEMENT'S RESPONSE

A written draft was provided to management for comment. For the most part their reply was responsive to the issues. Where appropriate their corrective action has been incorporated into each of the individual findings. In addition to the written response, we also met with the General Manager to discuss his response and clarify a few items. As a result of these actions, adjustments we thought appropriate were made to the draft report.

In the case of EPBIH acquiring additional unrelated businesses, we agreed to disagree. EPBIH management believes acquiring businesses is the best way to reduce excess staff by employing them in these businesses. We disagree since EPBIH is not experienced in running these unrelated businesses greatly reducing the chances of success, and greatly increasing the potential increased costs. We recommend the electric company focus on correcting the problems and inefficiencies in their own business and not dilute their efforts by taking on political and social issues no matter how well intended.

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