Elektroprivreda RS

Report of the Special Auditor

25 February 2003

SUMMARY OF MAJOR ISSUES

1. Poor cash control, financial management, recordkeeping and management reporting, which could enable cash and other assets to be diverted without detection.

2. Manipulation of the tender process enabling awarding of bids to favored businesses. Subsequent contracts and/or billings, which exceed bids.

3. Surplus energy sales to a favored business at below market, tariff and generation costs made possible through tender manipulation resulting in the loss of millions of USD in potential revenue. Binding of future surplus sales to this same company for years to come at below-cost rates.

4. Distribution losses at approximately 3 times international norms.

5. Inaccurate reporting of collections, and poor collection practices resulting in significant uncollected revenue.

6. Emphasis on spending for new generation facilities and building construction even though existing generation capacity is three times domestic demand that is paid for, and the money could be better spent to improve the existing operations and recover significant losses.

7. Excessive use of poorly controlled compensation agreements to operate while cash goes to favored vendors.

8. Inefficient and ineffective systems and operations.

9. Interference from RS Government in the form of mandated contributions, write offs, multilateral compensations, and rescheduling of debt.

10. More supportive of Serbia/Montenegro than BiH

OVERVIEW

Mismanagement, conflicts of interest, theft and neglect are costing ERS at least 166 million KM annually in lost revenue. Improved efficiency will yield substantial additional savings. However, the poor state of accounting, information systems and recordkeeping made it almost impossible to estimate additional profits from improved efficiency.

All excess production is sold abroad to EFT, a London-based company, often at below market, cost and tariff prices. Through tender manipulation EFT, as the only "valid" bidder, won the tender on the energy exchange contract for the RS. This contract enables EFT to totally control the transmission network throughout the RS. ERS received no additional consideration for providing this contract. As a result EFT reaped windfall profits of 40% in 2002 on the resale of ERS electricity, which is astronomical when compared to more typical profits from energy trading of 1-5 percent. EFT accomplished this feat by taking full advantage of the monopolistic situation caused by limited transmission capacity to the east while preventing others from participating. EFT's good fortune was further helped by ERS's inappropriate extension of contracts for the purchase of electricity by EFT and manipulating tenders to enable EFT to also win building contracts. Other EFT profits are built into contracts by requiring electricity be sold to them at below market rates if major ERS generating facilities are out of commission as was the case with Gacko for 4-5 months in 2002.

Over 91 percent of the 130 million KM in cash transferred to Trebinje HQ from customers and export sales in 2002 was sent to or spent on behalf of the Gacko or Ugljevik coal mine/thermopower facilities). A number of these transactions such as oil purchases from two units of NIRS, Petrol Trebinje and Petrol Pale, could not be adequately supported, and the amounts spent are considerably higher than that of similar larger operations elsewhere in BiH. On another purchase for Ugljevik, the Minister of Energy and Mining illegally overrode the bid committee and specified the vendor to be used for the purchase of seven large trucks resulting in excess charges of $2 million USD more than the lowest bidder and $1.7 million USD more than the manufacturer's own list price. This transaction was also approved by the General Manager of ERS and transacted through Premar Services. Premar Services is also the intermediary company of choice to facilitate the planned April 2003 Gacko replacement plan, which once again circumvented the tender requirements. Cash expenditures are personally monitored daily by the General Manager who ensures Petrol Pale and Petrol Trebinje each receive from 20,000 KM to 120,000 KM every day while other bills go unpaid.

While most of the cash is going out through Gacko and Ugljevik, the rest of the business must make do with compensations. Priority is given to vendors who agree to accept compensations and prices of goods and services are marked up by 30 percent as a result. In some cases vendors are regularly allowed access to ERS customer billings in order to search for compensation partners. Bills often go unpaid for long periods of time, and large balances build up. In order for a vendor to receive cash, other than what the local operation can afford to pay, they must get Trebinje HQ to agree to take over the debt using cesija agreements. All of this inefficiency and complexity adds further to the cost and disguises the true nature of many transactions.

The situation is aided and exacerbated by extremely poor financial controls and recordkeeping, making it virtually impossible to know what is happening in this business and where the money is going. For example, cash controls do not ensure all cash collected is deposited. Once deposited the account sweep controls can and have been overridden. Collections are miscalculated and misreported. We found collection rates reported to be as high as 116%, which, after investigation, turned out to be as low as 65%. ERS HQ and units we visited were unable to list all past due accounts receivable or payable. Controls are lax, non-existent or simply overridden. The poor state of controls is not news as it has been reported by financial auditors, internal auditors and international consultants for years. Although promises may have been made through the years as a result of these reports, nothing substantive has happened.

Although distribution losses are approximately three times the international norm at over 30% (1,400 MWh for 2002), nothing substantive is done to improve the deteriorating network and to recover these losses. Instead huge amounts of money are spent building new generation facilities and buildings, even though only about two thirds of the electricity produced is actually consumed domestically, and one-half of that is lost or stolen.

There is significant government interference in the business of ERS. The RS Government passed a number of decisions affecting this company including decisions requiring the electric company to reschedule debt for large past due customers and requiring them to bear the expense of Pensioners coupons to be used for electricity bills. The RS Government removed Buk Bijela and Vrbas dam projects from ERS and placed them with the government, which will likely place the government in a competitive position with the electric company.

ERS's allegiance appears to be oriented more toward Serbia than BiH. The Development Strategy, referred to by the General Manager in the 2001 annual report, which is being implemented, was prepared before 1998 and makes no reference to restructuring for potential privatization. Although the plan requires cooperation with Serbia, there is no mention of promoting cooperation with Mostar or Sarajevo. Belgrade-based vendors are generally the vendors of choice. ERS provides almost two times the financial support to the Belgrade coordinating board that it does to the BiH coordinating board.

SUMMARY OF RECOMMENDATIONS

1. Financial Police and UK Serious Fraud Office investigate transactions and relationship with Energy Financing Team (EFT).
2. Bring core business up to international standards and recover losses before investing in additional and unnecessary generation facilities and building projects.
3. Stop inappropriate disbursements and overrides of the tender process.
4. Investigate and reconcile fuel purchases for ERS and its subsidiaries.
5. Eliminate multilateral compensations and severely limit two-party compensation agreements.
6. Improve financial controls and accuracy and adequacy of financial and management reporting.
7. Improve controls over metering, meter reading and distribution of bills.
8. Improve profitability and cash flow.
9. Ensure timely and substantive correction of audit issues.
10. Eliminate government interference and split loyalties.

OBJECTIVE AND SCOPE

The purpose of this limited scope audit was to assess the adequacy of selected internal controls over revenue and disbursements at selected locations. Therefore, we examined processes including electricity sales, cash management, billing, collections, disbursements, 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 the primary focus being on the last 12 months of activity. Elektroprivreda RS is made up of 12 separate legal entities consisting of the parent and 11 subsidiaries. Resources were limited; therefore, we did not examine each legal entity. We selected some entities for testing and within those entities selected some of the more significant transactions for more detailed testing. We made no attempt to uncover every issue or examine every transaction; and based on our results, we have reason to believe significant problems are also likely to exist in other areas of the company. Some areas were given more attention than others due to the lack of controls and evidence of problems encountered early in our work. For example, we concentrated quite a bit of our work on the sales of electricity due to the size of the transactions and the number of problems we found.

Audit fieldwork took place from 19 September 2002 through 31 January 2003.

This is not a financial investigation for the purpose of establishing criminality nor is it an audit of the fairness and reasonableness of the financial statements. Therefore, we express no opinion on the financial statements. Where we found evidence of potential criminal activity, we recommended an investigation by the appropriate authorities.

FINDINGS AND RECOMMENDATIONS

1. Financial Police and UK Serious Fraud Office investigate transactions and relationship with EFT.

EFT is given priority in all of the most significant contracts including the purchase of electricity and construction contracts to build new generation facilities. This favored position has enabled them to achieve a virtual monopoly over the purchase and sales of electricity on the eastern grid. Their involvement in large construction projects will enable them to tie up future surplus energy for 30-50 years to come. These new projects will likely have a negative effect on any potential privatization efforts, and may ensure that EFT will be the only bidder.

Sales of Energy to EFT

ERS supplies a significant amount of the electricity EFT sells on the eastern grid. The weighted average price paid by EFT to purchase ERS electricity was $21.59 USD per MWh for 2001 and $21.96 USD for 2002, which is below market price and below the price paid by EFT to JPEP in Sarajevo for their 2002 sales to EFT. These prices are below the levels allowed by Article 27 of ERS's Statute which requires the sales price to be higher then production costs. EFT's contract to buy electricity from ERS specifies that the electricity should be delivered to the border of BiH in the RS. EFT's contract for sale to Montenegro (at approximately $26 USD per MWh in 2001, $30.85 USD per MWh for 2002 and 33 Euros per MWh for 2003) specifies they will deliver the electricity to the border of BiH in the RS. In 2001 EFT earned approximately $3.91 USD (18%) per MWh or $5.8 million USD on the resale of ERS electricity. In 2002 EFT's earnings on resales of ERS electricity to Montenegro more than doubled at over $8.89 USD (40%) per MWh or $10.8 million USD. EFT's 2003 profit per MWh of electricity resold could reach a whopping 45% if current practices continue. Although a company specializing in trading of energy is expected to make a profit, the profit earned by EFT on these transactions is well beyond the 1-5% earned by other companies who specialize in energy trading. Offering terms to Montenegro does not adequately explain this kind of difference as suggested by EFT.

EFT's dramatically increased profits for 2002 were made possible by ERS giving away their own competitive advantage by providing EFT with the energy exchange contract for the RS through March of 2003. This contract gives EFT complete control over the RS transmission lines since the only way to transfer electricity through the RS is through an energy exchange contract. There was no additional consideration required from EFT as a result of being granted this substantial market advantage other than what was already stated in the sales contracts. Any company wishing to sell their energy to the east must go through EFT. Since EFT has a vested interest in keeping others out of this business, these requests are refused. Energy transfers should be a function of the ZEKC coordinating board of BiH and not EFT. These arrangements with EFT were unnecessary as ERS could have retained most of this revenue for themselves. Instead, large profits and competitive advantages, which clearly belonged to ERS, were simply passed on to EFT via a "tender" in which EFT was the only bidder.

An interesting note on the contracts with EFT is that EFT is granted a significantly lower price on their purchase of electricity if any major ERS generating facilities are down, which happened fairly regularly during 2001 and 2002.

Controls over energy sales and exchanges are lax, and, therefore, open to manipulation and kickbacks. Since we do not have access to the books of EFT, we were not in a position to determine if these weaknesses were taken advantage of. However, we are at a loss to explain ERS's actions toward EFT, and believe further investigation by the appropriate authorities is warranted.

Buk Bijela

The tender for the Buk Bijela project (consisting of two dams) is set up to favor EFT. In addition to three concluded EFT contracts totaling over 36 million Euros, the real cost of the current tender is estimated at over 375 million Euros. The bidding requirements state that payment for construction must be taken in future electricity. In addition the terms require the winning bidder to set up a separate company to construct and operate the dam. This company must be owned at least 20% by the senior partner and 20% by ERS. These terms severely limit the companies, which can submit bids. Four companies requested the bid package: EFT, Hidrogradnja Pale, Hidrotehnike Hidroenergetika in Belgrade and Porr Technobau. Coincidently, one of these companies, Hidrogradnja, is also the company hired by EFT on the Fatnicko tunnel. A list of questions and answers and changes to the tender was released several months after the tender. The most intriguing change was the statement that if only one valid tender is received, they will start negotiations with that vendor.

In the 2001 ERS Annual Report, General Manager Acimovic notes that he is following the Development Strategy of the Power Utility for the Republic of Srpska, with the issuance of bids for Buk Bijela Srbinje (Foca) dam project as well as other projects. We reviewed an English-Serbo Croatian language "abridged" version of this Development Study, and found it was prepared by EnergoProjekt in 1998 and adopted by the RS Assembly in October of 1998. EnergoProjekt is a Belgrade-based company with some of the same engineers who developed the original Yugoslav electric projects in the 1970's and 1980's. ERS paid 500,000 KM for the "new" Buk Bijela study, which appears to be little more than a reprint of the late 1980's study. EnergoProjekt has prepared various other studies to justify new projects. They billed ERS 1.1 million KM in 2002. ERS contracts with EnergoProjekt notes all payments must be made to their Cyprus bank account. (Note: The CV for EFT's Managing Director, Vuk Hamovic, notes that he used to work for EnergoProjekt.)

The Development Study shows that ERS needs $2.2 billion USD to complete a series of overhauls, improvements and new projects through 2020. The Development Study does not mention privatization plans of the World Bank or other international lenders or donors. In fact, it appears to run counter to privatization. When we requested documents regarding the Buk Bijela Dam Project, we were told that the Prime Minister signed a decision in November of 2002 taking this project out of the domain of ERS and placing it with the RS Government.

We question the need for this project. The two dams, which this project encompasses, Buk Bijela and Srebinje, are to be built in the upstream watershed of the HPP Piva Dam in Montenegro. However, the reservoir behind the Piva dam in Montenegro is extremely low in spite of normal rainfall for the past several years. It is unlikely the existing dam can operate at much more than 50% capacity, as is the case with the Piva Dam. Yet they are proposing two additional dams be built in this same watershed. Given these conditions we doubt their estimated average annual production of 1350 MWh, can be realized. There was no feasibility study, financial analysis or environmental impact study. The study did not mention highway or village relocation costs for the proposed new dams. Also, pre-building generation estimates for Trebinje Dams I and II, Capljina and PIVA were all overstated.

The situation gets worse in that the Buk Bijela contract will commit future surplus electricity and operation of this dam to the winning bidder for the next 30 years with an option to extend to 50 years. This arrangement will likely have an adverse effect on potential privatization efforts since we do not believe any purchaser other than EFT will be interested in purchasing a company where they have no control over surplus electricity produced for years to come. The ultimate beneficiary of this arrangement is EFT and not the citizens of the RS. It is likely that the purpose of this project is to place EFT in a position to where they will be the only company in a position to purchase ERS. Even if EFT does not purchase ERS, this transaction places a significant portion of the value of ERS at the disposal of EFT; and, therefore, will reduce the value and price to be received for the company.

In addition there are second boilers proposed for Gacko and Ugljevik even though coal quality is poor at Gacko and generation costs at both locations are very high. Given the fact that over 34% of all electricity produced in the RS is surplus, we question the need for additional production capacity at this time.

We recommend the Buk Bijela and other hydro construction projects, including the Fatnicko tunnel, be stopped until after restructuring for potential privatization.

Note on the Fatnicko tunnel

Hidrogradnja is partnering with EFT to complete the Fatnicko tunnel. Under this agreement EFT is to pay Hidrograndnja for the work, and EFT is to be paid in excess electricity. However, late in the audit during our visit to the Pale Distribution Center, when we asked about the high level of Hidrograndnja compensations, we were told that Hidrograndnja was being paid for their work on the tunnel and Gacko coal mine via compensations with ERS and not by EFT. If this turns out to be the case, EFT is being compensated with excess electricity for works they did not pay for. Given the extremely poor bookkeeping over cash and compensations, we were unable to make this determination during the time allotted. However, we recommend the Financial Police reconcile all payments to and from EFT and Hidrograndnja in cash or compensation.

2. Bring core business up to international standards and recover losses before investing in additional and unnecessary generation facilities and building projects.

New generation facilities

Approximately 65% of the total electricity generated by ERS (4,600 MWh) is either surplus (35% or approximately 1,600 MWh) or lost through the distribution process (30% or approximately 1,400 MWh). In spite of this fact, ERS is attempting to increase generation capabilities through the completion of the Fatnicko Tunnel at an estimated cost in excess of 24 million Euros, and the proposed construction (tender outstanding) of a new hydroelectric dam located at Buk Bijela at an estimated cost in excess of 375 million Euros. These contracts require barter for the surplus electricity and will essentially tie up all excess generation capacity of ERS for the next 30-50 years. On the Fatnicko tunnel, the Ugljevik truck financing and the pending Gacko rebuild financing EFT will have locked up significant future surplus energy production which will be preeminent to any tenders of additional surplus energy through at least 2009.

The continued expansion of generation capabilities is not justified when the present capacity to produce is almost three times the present domestic demand, which is actually paid for. The cost required to increase the generation capacity draws much needed capital away from maintenance and improvement of the existing deteriorating infrastructure and from efforts to collect current receivables.

The monopolization of future surplus generation and the deterioration of existing infrastructure will have a negative impact on the ability of ERS to privatize. Directing capital toward modernization of existing facilities and the collection of current receivables, would make the company much more attractive to independent investors.

We recommend:

- The Fatnicko Tunnel be cancelled and the offer to tender for Buk Bijela dam be withdrawn.

- The existing infrastructure be surveyed to determine what circuits need to be upgraded and/or repaired and emphasis be placed on getting those items funded and implemented.
- Westbound transmission facilities be concentrated on.
- Metering of the flow of electricity be improved by upgrading existing meters and placing additional meters at key points in the transmission and distribution network in order to identify problem areas and circuits.
- Identify and prosecute illegal connections.
- Develop, implement and aggressively pursue collection policies and practices, which are in accordance with international best practices.

Distribution Losses

ERS is experiencing distribution losses of more than 30% (30.6% during the first quarter of 2002). Losses as high as 47.35% occur at some working units. These losses result from a variety of reasons, primarily energy theft (illegal connections) and denigration due to inferior, outdated equipment. These losses are two to three times higher than the international norm. The problem is compounded by a lack of valid metering at key points in the system, preventing accurate pinpointing of problem locations. The losses are not being adequately addressed and continue at an unacceptable level.

We recommend management aggressively pursue reduction of these losses before spending additional funds to increase generating capacity, which will only produce a fraction of what is being lost through distribution.

Collections

There are no policies and procedures for collection of customer accounts. Practices utilized by the collection departments within ERS are lax. Customer records are decentralized at the various distribution centers. Computer software used to keep track of customer accounts are incompatible resulting in little or no control over the revenue of the company. There is no standardized process for monitoring and evaluating the collectability of accounts. Accounts are not properly aged and calculation of collection rates is inaccurate. Examples observed during our work follow.

- Pale Distribution Center

  The Pale Finance Manager admitted to having 34,000 small non-paying consumers, but only 45 or so large consumers with bills over 10,000 KM. The Finance Manager now claims lower number of small past dues, but is not able to define the number. Total past due amounts were approximately 20 million KM. When asked to explain the delinquency, the Finance Manager stated that his collection rates were being unfairly compared to rates achieved by Sarajevo. He claimed that the Federation Government, Police and courts were more forceful in allowing JPEP staff in Sarajevo to enter apartments in order to read meters. Although the comment regarding the court system may be accurate, the bigger problem results from their practice of billing zero when the meter reader cannot access the meter. Therefore, there is little wonder that they are often denied access. The bigger and more basic issue is ERS's failure to develop, implement and enforce appropriate collection practices rather than unfair comparisons. They refuse to cut-off non-paying customers.

  The Finance Manager said that he tried to initiate a plan to cut off 30 non-paying customers per day. He said his plan failed because it was not supported by the working units in the Pale region, who did not want to take tougher measures. Although the Finance Manager claimed that most meters were old, inaccurate and/or located inside customers homes, only 300 new meters were purchased during 2002. These problems are exacerbated by inaccurate and inconsistent methods of computer and/or manual recordkeeping between the units.

We found several large suppliers to the Pale Distribution Center were also delinquent on their electricity bills. Two of the largest examples are:

- Pale paid the Olympic Ski Center, Jahorina (three hotels, restaurants, ski lifts, etc.) 114,000 KM at the same time their past due electric bills exceeded 108,000 KM. The main hotels have been refurbished and are enjoying a good season, and all have past due bills.
- Famos/Koran (state owned metalwork factory) had a past due balance on their electric bills of over 300,000 KM, which grew to 705,422 KM by the end of 2002. In spite of these high balances, Famos Koran collected 351,892 KM in payments and/or compensations from the Pale Distribution Center in 2001.

Since the company pursues compensations as a means of payment, we question their failure to appropriately and consistently compensate all unpaid balances before processing payments. The company has such poor records they now say the above records may be inaccurate and are attempting to construct new records.

Based on the actions observed, we can only conclude that collections are not being seriously pursued. Required meters are not being purchased, internal controls remain weak, best practices are not adopted and recordkeeping systems are not improved. Yet, in 2002 the Pale Distribution Center managed to find 4 million KM in cash and compensations for the purchase and construction of new buildings. These problems are not new and have persisted for years. The issues have been repeatedly commented on by auditors and consultants.

- <u>Elektrokrajina Distribution Center (Banja Luka)</u>

The situation in Banja Luka was similar to what we observed in Pale with poor collections, claims of unfair comparisons and little action. There is no policy regarding collections, and the process used is extremely lax. Only 56.9% of the 193,000 households in this region actually pay for electricity used. Approximately 15,000 (7.7%) consumers, who have trouble paying are covered by a government decision, which attaches a 10% surcharge to other customers' bills to pay for these disadvantaged consumers. In addition, an estimated 48,000 (24%) households are stealing electricity and another 22,000 (11.4%) receive bills but don't pay.

The railroad is their largest 110 kV customer (making up about 25% of the total amount due) and the worst payer. Most of their payments are made via compensation and a few are made in cash. Ten percent of every payment is supposed to be made in cash, but this does not always happen. Payments are arranged by Trebinje and usually involve as many as five parties including those involved in the excavation of coal at Gacko and Ugljevik. Elektrokrajina is the last to be paid. Therefore, Banja Luka's collection efforts on this large account with growing delinquency consist of merely waiting for orders from Trebinje regarding payments.

- Questionable Write Offs

  At the 7 February 2002, Board of Directors meeting, they agreed to write off 2.4 million KM in unpaid electric bills from the Year 2000 for 750 households in Srpska Sarajevo residential apartments Dobrinja I and IV. These apartments are located near the Sarajevo Airport and were formerly part of Sarajevo. They were apparently returned to the Federation according to the Dobrinja Arbitration Decision. We were told the occupants were primarily war veterans, invalids and families of deceased soldiers. ERS decided the bills would not be collected and should be written off. The problem is that the 750 households would have had to have an average bill of over 3,200 KM for the Year 2000. Other households in the area averaged less than 400 KM for the year. The discrepancy totaling approximately 2 million KM was not explained or investigated by ERS.

Building Projects

ERS has considerable work to do in order to improve control and curb losses for their existing business. However, building projects at several units appear to be given priority. Pale recently finished a mammoth new marble lobbied HQ building (shared with the Pension Fund). Pale also bought a new S. Sarajevo building and are having a new Sokolac building completed. Trebinje ERS is finishing a large three-story HQ building, now in its fourth year of cost overruns. Gacko is building a large seven-story apartment building. ERS is paying 750,000 KM toward a sports center in S. Sarajevo. Total expenditures on these building projects exceeds 16.5 million KM.

Given the overstaffing situation and need for immediate and sustained improvement to the core business, we recommend management concentrate on bringing their core business into line with international standards and best practices before spending additional funds on generation facilities, buildings and other expenditures, which don’t directly relate to improving existing business operations.

3. Stop inappropriate disbursements and overrides of the tender process.

ERS routinely circumvents the tender process by either tailoring the bid requirements to favor an individual bidder, extending contracts beyond the end date, adding amendments and annexes, waiting until it is too late to tender then obtaining an “emergency exception” or simply overriding the bid selection or issuing decisions and protocols specifying acquisition without tender. EFT is frequently the beneficiary of these actions. Examples follow.

Tailored bid requirements

In the tender documents for the pending Buk Bilja Dam project, the financing is to be provided by BOT (Build, Operate and Transfer) with the primary incentive to be access to surplus energy generated by the dam for a period of 30 to 50 years. There are very few companies who would be interested in such a financing scheme. Therefore, this arrangement deliberately excludes most companies, which are in the business of building dams. EFT together with a “construction consortium” was the only bidder, but award is extended to 20 March 2003 “in hope” additional bidders can be raised.

In the awarded bid for the Fatnicko Tunnel project, payment is to be made in the form of surplus energy. This payment requirement severely limited the number of eligible contractors, who could bid. EFT won this bid.

Extended contracts

EFT's contracts to purchase surplus energy from ERS in 2001 and 2002 were extended into the first two months of the following years (2002 and 2003, respectively) as a result of ERS accepting advance payments. This practice gave EFT the tender advantage for the following year's contract as all other bidders would be subordinate to their claims for energy for the first two months of the year, which is the period when energy is at a premium.

Minister of Energy override of bid selection

The tender and bid selection for the purchase of seven trucks for Ugljevik was overridden by the Ministry of Energy and Mining **resulting in an overpayment of over $2 million USD**.

R&TE Ugljevik requested bids for 15 dump trucks and related mining equipment of 1 September 2001. Bids were required to be submitted by 3 October 2001. Ten companies submitted bids. On 27 November 2001 the R&TE Board of Directors issued a conclusion that the tender was completed and the decision would be based on the Bid Evaluation Commission list for the most suitable bidder.

Six days prior to the Best Bid List being issued, the Ministry of Energy and Mining, issued a Protocol saying Premar should get the bid for seven of the trucks "due to difficult financial situation in the ERS and the needs of Ugljevik." The justification was not explained further, and it is unclear as to how Premar's bid alleviated the concerns cited. This protocol was signed by the General Director of ERS and the Ministry of Energy and Mining.

The Bid Evaluation Commission issued the Best Bid List on 31 December 2001 and selected Terex Mining as the best bidder for all 15 trucks. They issued an addendum saying the Premar bid should be discussed with the Ministry of Energy and Mining. This addendum was also dated 31 December 2001 (but according to the fax line was not faxed until 29 January 2002). The ERS Board of Directors issued a Decision on 7 February 2002 that the order for the trucks should be split with seven obtained from Premar at a cost of 6,033,048 Euros and eight should be obtained from Terex at a cost of 4,429,336 Euros.

Ugljevik (ERS) requested a legal opinion from the Ministry of Finance on 11 February 2002. The request cited the Protocol from the Ministry of Energy and Mining as well as other related documents, including the ERS Board of Directors 7 February 2002 Decision. The Ministry of Finance responded that the RS Procurement Law did not give the Ministry the authority to determine the most appropriate bid subsequent to the solicitation of tenders. It stated that the selection was to be done by the ordering party "and based on the decision made by the (Bid Evaluation) Commission."

Ugljevik (ERS) awarded the bid for seven trucks to Premar on 28 March 2002 in spite of the 2.1 million Euro premium and the Bid Evaluation Commisson's wishes.

The liability for the payment to Premar AG was assumed by EFT a week later in return for excess electricity.

Emergency exceptions

The 2001 tender process for petroleum was cancelled and the existing contract extended because the tender was not prepared in time to obtain bids. ERS management knew for 12 months that the contract would expire on 31 December 2000, but failed to complete the documents on time creating the need for an "emergency exception" to the Procurement Law.

Gacko repairs and maintenance

In 2001, when Gacko was down for five months for 7.5 million KM in repairs and maintenance, they purchased a "new" rotor from Koncar Croatia. This rotor had been built (but they claim not paid for) in the late 1980's for Ugljevik's second proposed unit, and had been in storage since then. This rotor was purchased quickly for $954,000 USD on a special Government decree of "urgent need" avoiding the tender process.

For April of 2003, there is now an extensive replacement plan being prepared, which is once again bypassing the tender requirements. The boiler and piping replacement will cost 10 million KM and will be purchased from the original Russian supplier to Gacko, through Premar Services of Switzerland. (Premar is the same company used to purchase trucks at significantly inflated prices, costing the company over $2 million USD in unnecessary costs.) The contract raises several questions. It specifically states that the boiler is to be procured from a specific Russian factory, and it is not clear why Premar Services is even involved. A direct contract with Premar violates the procurement requirements. The protocol from the Ministry of Energy and Mining specifies a contract with the Russian company.

We find these purchases and methods questionable. Why would a company build a rotor for Uglivik in the 1980's without requiring at least partial payment at the time? Is a 1980's replacement part the best alternative for 2003? Since the Gacko Thermal Plant has had numerous well-known problems and breakdowns in its 20-year history of using Russian equipment, we question the wisdom of purchasing a new boiler from this same supplier.

It is also worth noting that a special clause in the EFT sales contract for surplus electricity mandates the sale of surplus electricity will be made to EFT at a **lower** rate, when a large generating unit, such as Gacko is out of operation. Therefore, adequate maintenance to prevent breakdowns as well as quality and reliability of repair work is critical for any of their large generating plants.

We recommend the Financial Police look into these Gacko purchases and the relationship with Premar Services.

Gacko Building

As you enter the small town of Gacko, there is a seven-story building under construction, which is approximately 30% complete. The sign in front of the building states that it is a joint building project of the Gacko Power Plant and the City of Gacko. When we asked to see the payments card for this project, we were told there were no payments in 2002. We later found out the building had been under construction since 1998 with apparent cost-overruns. In 2001, the latest Belgrade contractor was given an advance payment of 2.1 million KM and then an additional payment was made, contrary to what we were told, at year-end 2002 for 1.1 million KM. Management told us the building costs would eventually be split with the City as would the apartments.

We recommend the Financial Police examine the payments associated with this contract.

Gacko Contract Modifications and Tender Issues

Most contracts are modified after completion of the work to change the amount – always up, never down. For example, on 25 May 2002 a contract was issued to TrafiHolding Ltd (Cyprus) to overhaul the refractory and isolating wall of the boiler in TE Gacko in the amount of 62,000 Euros. This type of work should be a fairly well defined part of a normal overhaul. However, on 26 September 2002, Annex No. 1 was signed increasing the final range and value of these works by 277% to 172,108 Euros. TrafiHolding took over this contract from Samot's Serbian company, the largest compensation vendor at Pale. ERS Internal Audit Department noted that Samot was in an over-payment position of 200,000 KM when TrafiHolding took over.

ERS bid commission announces the prices offered to all bidders and then tells bidders that the lowest price must be equaled if they want a contract. Although this may appear to be a means of obtaining the lowest price, it can also be a means of awarding contracts to favored parties. As mentioned elsewhere in this report, actual prices are frequently much higher than the bid price especially where compensations are concerned.

One vendor complained that he was forced to make donations to the church and the Football club as a condition of doing business.

One of the Gacko vendors reviewed, who bills approximately 3 million KM per year and has been working with the coal mine since 1997, has his current office in a two-room shack with no running water. Although he is now in the process of building a large three-story HQ building from materials received via barter, we question the ability of a company of this size to have been able to do this level of business with the mine over the past five years.

Gacko geological estimates for coal and debris removal

While reviewing invoices for the eight largest vendors at Gacko, we found that controls over invoicing for removal of debris and coal are weak. At the beginning of a contract, a survey and preliminary estimates are made with the geologist/engineers of the coal mine and agreed to by the contractor's representatives. On the survey a cube is visually marked out of the coal mine walls or surface for each contractor and then drawn on a map. From this cube they estimate excavations of coal, dirt, rock or clay. Proposed removal in cubic meters is estimated. A coalmine manager, who is not on site full time, is assigned to each contractor, who completes a daily diary of work performed. The diary does not include a record of truck deliveries or weights even though a scale is located near the exit. Furthermore, the contractor told us it was common for the coalmine managers to request quick changes of equipment locations and takeovers of other contractors' shortfalls. Annexes and amendments to the original contracts after bidding was also common. The contractor we talked to was working on his fourth annex for 2002. As work progresses on each original "cube" invoices are prepared at intervals when removal work can be easily estimated, then a group of Gacko managers sign off on the invoices after the contractor.

This complicated procedure along with geologic estimates sets the stage for over invoicing and over payment. The ERS internal auditors determined in March 2002 that 360,000 tons of coal was extracted, which could not be accounted for as it was not burnt in the thermal plant. As of 17 January 2003, Gacko management had not responded to that report and claimed that a commission would review the report on or before 28 February 2003.

On a related issue we question the need for contractors to remove coal and debris when Gacko is overstaffed, and many employees are under utilized or not utilized at all.

We recommend management re-evaluate the need for contracts with outside companies. We also recommend that, as long as these contracts do exist, controls be strengthened. At a minimum trucks removing coal and debris should be accounted for and reconciled to billings prior to making payment. All trucks must be weighted. Vendor records should be computerized and reconciled monthly.

Thermograding d.o.o. Belgrade – Gacko Excavation Contractor

Thermograding has been a coal excavation contractor for many years at the Gacko RITE. In 2002, Thermograding had past due invoices from Gacko of over 4.2 million KM from 1999, 2000 and

2001. In mid-2002, Thermograding filed suit in the court near Gacko seeking Judgment. In one of the fastest civil suits in recent RS court history, they were awarded a judgment with penalty and interest of over 5.0 million Euros

Thermograding persuaded the court to block the main bank account of ERS in mid-December, and ERS promptly came to a settlement to pay back in installments. The first installment of 500,000 Euros (approximately 1 million KM) was paid by year end.

When we visited Gacko Finance Department and they explained the problems with this account, they told us not to worry since they no longer do business with Thermograding Belgrade. They said they now have contracts with Thermograding Gacko, a new company owned by the same people as the Belgrade company. Thermograding Gacko has a beautiful new modern office building overlooking the Gacko Thermal Plant.

Software contract

In January of 1999 a contract worth just under $5 million USD was issued to SB Soft, a Belgrade company, without the benefit of a proper tendering process. The contract was to provide all five ERS distribution centers and the parent company with a management information system including a unified billing system. The contract was terminated by SB Soft in early 2000 when they claimed that ERS did not fulfill the payment terms. As of May 2001, $1.8 million USD had been paid to SB Soft. At the time of our audit, the system was only partially implemented at two distribution centers (Banja Luka and Trebinje). What has been implemented is incomplete, not totally working and inadequate. What is running is not integrated and cannot even produce basic management information. In addition this "new" installation was based on Oracle 7 and Windows 95-98, which are now out of date. Oracle 7 is no longer supported by Oracle.

The company's requirements were not adequately defined nor alternatives studied and considered before awarding of the contract to this single vendor. Failure to adequately define system requirements results in failed implementations and systems, which do not perform as intended. This is the case with the SB-Soft package. We recommend management, in conjunction with the EU team, which is working on defining user requirements for all three electric companies, fully study their current and future needs in order to jointly agree on an appropriate package, which is fully integrated and meets international best practices for management reporting, monitoring, accounting and billing.

We recommend the Financial Police look into the awarding of this contract.

Mobile Commerce – Pale Distribution Center

Mobile Commerce, one of Pale's largest suppliers, was paid 956,813 KM in December of 2001 for 13 large spools of cable and other electrical goods delivered in November of 2001. This payment was the result of the Pale Finance Manager honoring a 1999 tender for which the goods had not been delivered due to disputes over compensation arrangements. The goods were priced at the 1999 price, using the 1999 dinar conversion rate, resulting in an estimated overpayment of 112,000 KM for the conversion rate alone. The new Public Procurement Tender Procedures and Law was not followed as the Finance Manager, Ljuban Turanjanin, believed Pale Distribution Center was obligated to honor the 1999 bid in mid-2001. In checking the company's registration, we learned Electro Pranonija founded and owned Mobile Commerce and Ognjen Turanjanin is the Manager of Electro Pranonija. Ognjen Turanjanin is the son of the Pale Distribution Center Finance Manager. This payment was rushed through at the end of the year, approximately four months after Ljuban Turanjanin took over as Financial Manager of the Pale Distribution Center.

We recommend the Financial Police investigate this transaction.

Beta and Lord - Pale Distribution Center

Beta doo won the tender to provide transportation to the workers of the Pale Distribution Center for 2002. Beta's registered owner is Zorka Kovacevic, who we believe is the wife of Dobro Kovacevic, General Manager of the Pale Distribution Center. She is also employed at the distribution center in the collections department. We saw two copies of contracts between Pale Distribution Center and Beta doo. Mr. Kovacevic signed the contract on behalf of the distribution center and Mrs. Kovacevic signed for Beta doo.

Lord doo won a tender to supply 130,000 KM in small electrical goods to Pale Distribution Center in 2001 and 2002. Lord's registered owner is Mrs. Zivana Klepic, who is employed by the Pale Distribution Center and who, we believe, is the wife of the Pale Distribution Center's Dispatch Manager, Djodje Klepic.

We recommend the Financial Police examine these transactions and a conflict of interest policy be implemented and enforced. Employees who use their position with the company for inappropriately furthering the financial interests of themselves, relatives or friends should be immediately dismissed.

Samot Sokolac - Pale Distribution Center

The largest vendor, Samot Sokolac, received 2.7 million KM in advance payments for a small building under construction in Sokolac, the grounds/paving work on the new Pale HQ building, and a small office building and fenced parking lot in S. Sarajevo. Samot's bid for the Sokolac building was accepted because Samot agreed to accept the full 1.2 million KM payment in compensations. Even though this small building is only 40-50% complete, 900,000 KM (75%) have been advanced against it as of year end. In order for Samot to receive the necessary compensations, they were allowed to access and review the list of the electric company's customers' bills at Pale HQ and proceed to contact these customers directly to compensate for the goods. Samot then supposedly sells throughout Serbia, Montenegro, BiH and Croatia. As of 31 December 2002, Pale Distribution Center paid Samot 1.483 million KM in cash and 1.175 million KM in compensations. In addition to problems with the recordkeeping on this account mentioned elsewhere in the report, we see several problems with relationship. Why is an outside vendor allowed access to the electric company's billings and customers? We drove by the buildings and it appears that the Sokolac and S. Sarajevo buildings are smaller than the contracted size. We also drove by the Samot Sokolac building material yard, and they do not appear to have the warehouse space or trucks necessary to be sweeping over 1.1 million KM in bartered goods across Serbia, Montenegro, BiH and Croatia.

We recommend the Financial Police investigate these transactions.

4. Investigate and reconcile fuel purchases for ERS and its subsidiaries.

During our audit, we reviewed 2002 fuel invoices for Gacko contractors and operations held by the thermal plant's accounting department. Based on our on-site review, we accounted for 6 million KM in fuel purchases. Two weeks later Gacko faxed updated fuel purchases of 7.1 million KM. However, it appears that ERS headquarters accepted cash cesija agreements for 8.9 million KM to Petrol NIRS in 2002 for this same Gacko operation. They could not support or explain the 1.8 million KM variance.

There are a number of other interesting issues concerning fuel purchases. The first bills right off the top that get paid by ERS via bank transfer, each and every day are Petrol Pale and Petrol Trebinje, who receive from 20,000 to 120,000 KM each daily. General Manager Acimovic personally reviews and approves these payments each day. It is very obvious from examining payments, that these two companies are given top priority for receiving cash.

The fuel purchases for Gacko remained the same for 2002 as 2001 in spite of the fact that they were out of operation for 4-5 months. We question their claim that the same contractors continued to work full time during the outages removing upper levels of debris. A high-level finance professional claimed the tender for diesel fuel oil and lubricants for Gacko and Ugljevik was handled by Trebinje HQ and was based on political circumstances, and Gacko was not allowed to have a member on the bid commission. Our review of Gacko diesel purchases indicates Gacko paid 1.7 million KM over the winning bid price.

Another interesting point is that Banovici coal mine in the Federation is about twice the size of Gacko mining operation and at least three to four times the size and production of Ugljevik, yet Banovici's annual fuel costs are 1-3 million KM, 2.9 million KM less than Gacko and Ugljevik. Gacko's poor quality brown coal requires a large amount of fuel oil to ignite, and this fuel oil accounts for approximately 12% of total petrol purchases in 2002. This would mean that 5.9 million KM was invoiced for 2002 diesel fuel purchases or approximately 2.9 million KM more in fuel costs than Banovici. It appears that over-use of fuel is even greater at the Ugljevik coal mine, which is one quarter the size of Banovici. Ugljevik used 8.3 million KM in petrol purchases in 2002 and a lower percentage of fuel oil required as it has better quality black coal that does not require the high use of fuel oil for iginition. As we prepare to release this report, ERS management claims their previous numbers are wrong and want to supply new numbers.

Given the fact that these two companies receive the largest cash payments for the year, we find it curious that management was not able to provide an explanation. In addition, the figures we are quoting are the most conservative showing the smallest amount of difference. Other records showed the variances to be higher. We recommend the financial police examine and reconcile fuel billings vs. actual usage as well as the ultimate beneficiary of the daily cash payments. We also recommend they look into any connections between NIRS, Mandic and Manco Petroleum.

5. Eliminate multilateral compensations and severely limit two-party compensation agreements.

<u>ERS</u>

The process for handling compensations is poorly controlled and costly. Forcing the core business to make do with compensations has crippled them while facilitating distribution of cash to favored vendors. ERS and their subsidiaries did 145.4 million KM worth of business via compensations in 2001, and the 2002 compensations for eleven months ended November 30, 2002 are 161.6 million KM. (Note: Management provided us with several different compensations numbers for the same period of time on various reports during and after the audit.) Compensations account for over 40% of the collections at most distribution centers and are used extensively to pay vendors at all generation facilities.

Management informed us that payment for goods via compensation arrangements typically costs the company 30% over the bid price and this was confirmed by our testing and discussions with vendors. ERS favors compensation agreements even when the ultimate cost to ERS is significantly greater. For example, the tender commission selected Elvako Bijelina to participate in the major overhaul of T E Gacko. Elvako Bijelina was paid a 36.4% premium over their own advance bid price due to the commission's selection of the compensation method of payment. The resulting price paid was almost double the price bid by the lowest advance payment bid submitted by another vendor.

During our limited testing at the Gacko Coal mine, we found large contractors with large outstanding balances, which were growing at a rate of 75% per year. These contractors are not sure when they will be paid or how the payment will come in. At one point Pale ED refused to sign to certify a vendor for compensations due to him based on 18 October 2002 letter from ERS stating that compensations should be reduced. Since he was not paid in cash either, the balance remained unpaid. In circumstances such as this, it is easy to see why the sales price is marked up considerably when compensations are used. It would take an incredibly good business with high margins to sustain continued non-payments that equal 30% of billings on top of non-cash compensations of 40% or more of sales. Bids need to be increased substantially to cover these variances, or work is just grossly over-invoiced.

The compensation agreements are generally one or two page documents that are composed only of the amounts, signatures and stamps of the companies and individuals involved in the agreement. ERS claims they only know about what they owe and what is owed to them in spite of the fact that many compensations involve multiple other parties. This weakness alone could easily result in misappropriation of funds. There is no description of the assets being traded nor are there valid appraisals of the true value of the assets being traded or services received. There is no control over the cumulative value of compensation agreements any individual company can enter into with ERS and its subsidiaries, nor does headquarters review compensation agreements between the subsidiaries and outside companies and individuals. Furthermore, the agreements have been used to fund overruns and contract extensions, and to obfuscate, disguise and otherwise hide unauthorized payments and/or charges. The use of these agreements has removed hundreds of millions of KM in assets from the books of ERS, and it impossible to determine if the value received was consistent with the value given. There are several thousand compensation agreements spread through the units of ERS.

Compensations are poorly controlled and can easily be used to facilitate misappropriation of funds and obscure the purpose of payments. The use of compensations was also mentioned by PricewaterhouseCoopers in their qualification of the 2001 audit results. We recommend ERS stop using multilateral compensations between three or more parties, and severely reduce two-party compensations to situations of absolute need where both sides of the transaction are documented and fully supported.

Republic of Srpska Multilateral Compensations

In 2002 Elektrokrajina Distribution Center (Banja Luka) was involved in the RS Multilateral Compensation (MLC) where the company had its tax liability and other debts to the state offset against electricity debts owed by budget users. This transaction was worth approximately 7.6 million KM and involved the electricity accounts of 300 budget users.

The RS Government carried out this multilateral compensation, where all budget users and public companies sent in their debts to and from other budget users and public companies to the Ministry of Finance, who then figured out how to cancel these debts. The total amount involved for the entire compensation was about 94 million KM. This amount is over twice as much as the 2001 multilateral compensation agreement. (At the time the 2001 transaction was to be the final multilateral compensation agreement as agreed following a number of problems reported in the June 2001 OHR/OSCE Audit of Government Accounts.) When debt is cancelled in this manner, the amount of relief should be deducted from the budget amounts provided to the beneficiary ministries since they are paying debts in compensation rather than cash. However, no reduction takes place. Therefore, this cancellation of debt is a hidden means of providing additional funding to each benefiting ministry. One of the largest beneficiaries of this hidden funding was the Ministry of Defense, which had 13 million KM of debt cancelled in 2002.

In addition since MLCs have continued and not been stopped as previously agreed, this type of hidden funding can be expected to continue providing a windfall to ministries which run up debts, which will later be compensated and not deducted from their budgets. This causes problems for companies such as Elektrokrajina Distribution Center (Banja Luka), which is not receiving timely payments on account.

We understand the IMF has requested these MLC's cease. We strongly concur with their recommendation.

6. Improve financial controls and accuracy and adequacy of financial and management reporting.

Throughout the audit we noted numerous cases of inconsistent, inaccurate and missing financial and management information and conflicting and changing explanations. PricewaterhouseCoopers also qualified their opinion on the 2001 financial statements due to a number of problems with the inconsistency and inaccuracy of reporting. Some examples of the issues we found during our review are listed below. These examples are only a few samples of the issues of this type we encountered throughout our audit. The PricewaterhouseCoopers management letter accompanying their qualified opinion on the 2001 financial statements, provided many more examples, which remain uncorrected. The state of recordkeeping makes it extremely difficult if not impossible to get an accurate picture of what is happening in the business and where the money is being spent and helps mask many of the issues reported here.

Inaccurate collection ratios

Management reported collection rates at the distribution centers as high as 98% to 116%. However, during our testing we found collection rates to be significantly lower. Cash collection rates are in the 25-50% range, and compensation collections are in a similar range. Other items counted as collections were payments on rescheduled debts and write-offs. For example, Elektrokrajina Distribution Center (Banja Luka) reported their 2001 collection rate as 88.5%. However, the real rate after making the appropriate adjustments was 75.7%. In 2002 they reported a collection rate of 95.9%, which was really 83.2% after adjustment. The Pale Finance Manager happily reported that their Distribution Center achieved the best collection results at 116% of billed amounts. However, as we dissected the figures, he recanted and admitted the collection rate was only 65% for 2002 billings showing no improvement over 2001.

In mid-2001, the RS Government passed a decision that all customers who owed more than 60,000 KM to the electric company could reschedule their debt over a 24-month period and interest would be waived. The new minimum monthly payment required was 30,000 KM. This decision resulted in 33.6 million KM of debt being rescheduled and 5.5 million KM in accrued interest being written off. Banja Luka Distribution Center's portion of this rescheduled debt was 19.8 million KM with 3.3 million KM of written off interest. Once rescheduled, payments under this program are not adequately monitored. As of year end 2002, Banja Luka only collected 43% of rescheduled payments they were to receive by that time.

In Pale most of the restructures were not paid, and these same customers ran up large unpaid bills again in 2002. The Pale Finance Manager was unaware of any efforts to collect the rescheduled debt and admitted that 140,000 KM in rescheduled payments on the large Famos account had been improperly applied to both the rescheduled debt and new billings. Rescheduling debt merely distorts account balances, delays write offs and enables collection rates to be easily manipulated by removing portions of debt classified as rescheduled. In addition, payments received on rescheduled debt were counted toward the collection rate, even though they apply to the balance, which was previously removed.

We recommend debt rescheduling polices be determined by management of the electric company and not the government. We also recommend management develop and implement a policy for rewriting old debt which includes provision for the customer to make a significant (not token) payment on the existing debt to qualify. Once they qualify monthly obligations should not be allowed to slip without consequences. Appropriate systems should be implemented to enable accounts receivable to be appropriately aged and for collections to be appropriately applied to each account and to improve the accuracy of the collection ratios.

Policies and Procedures

There are virtually no written financial, collection, recordkeeping, etc. procedures and certainly no procedure manuals anywhere we visited during our audit. The Trebinje Distribution Center had no procedures, only a one-page cash guideline, which they didn't meet. In Elektrokrajina Distribution Center in Banja Luka, they had no written procedures. They claimed they did get instructions from Trebinje each time something changed. However, they are not kept together and they could only locate one during our visit. Collection procedures could not be located at any of the Distribution Centers we visited, and the rate of collections shows a lack of attention to this area. At Elektrokrajina the General Director blatantly overrode controls over the sweep account. The state of management information reports to facilitate efficient running of the business is atrocious throughout the company. This basic business issue is not new, yet has been ignored for years.

We recommend the development, dissemination, training and enforcement of policies and procedures for the core business be given a high priority. These policies and procedures should be in compliance with internationally accepted best practices for the industry. Information technology requirements and organization structures should be studied to help the organization come up with a comprehensive, integrated, cost-effective method of implementing and enforcing best practices. Overriding of controls should not be tolerated at any level.

Automatic sweeping of bank accounts

During our visit to Elektrokrajina Distribution Center (Banja Luka) we found out that the Director of Elektrokrajina was overriding the daily automatic sweeping of the payment bank account. He claimed the bank was too slow to make their daily sweep. Therefore, the Director prepared his own payment orders and presented them at the bank before the daily automatic sweep of the account. The scheduled sweep sends 32% of the funds to the Distribution Center's operating account in Banja Luka and the remaining 68% to Trebinje. At the time of our audit, the General Director via his override was directing 50% to the operating account of the Distribution Center and only sending 50% to Trebinje. He claimed he had to do this as they were threatened by the tax authorities, if they didn't pay what was owed. He also claimed the remainder will be made up in compensations throughout the year. The Director claimed his overrides were done with the "alleged" consent of Trebinje. He showed us a form prepared by the Distribution Center showing funds in and out of the account. He said he faxes this form to Trebinje each day.

Automatic sweeping of a payment account is an internal control over payment receipts. Enabling internal controls to be overridden at will, negates the controls. It also delivers a strong message regarding management's attitude toward enforcement of internal controls. The bank should be instructed that the Director is not authorized to issue payment orders on the sweep account.

Cash controls

Control over cash at the Trebinje Distribution Center is practically non-existent. Management's attitude toward cash control is considered lax and cavalier putting the assets of the company at risk.

We conducted a surprise cash count in October of 2002. The result of our count could not be reconciled to either the manual records (Euro and KM) or the computerized collection system. Specifics of the counts and problems encountered follow.

- In the Working Unit Cashiers office, we found the cash in the unlocked drawer was greater than the amount listed on the Cashier's manual receipt ledger for the day. The cashier explained that the Head Cashier had been absent for several days so she had been unable to transfer her collections. She then produced two additional days of manual receipt ledgers. When the totals from these ledgers were factored in, the cashier was short by 2,788 KM, which she explained were due to advances she had made to employees. As support for these transactions she produced three unsigned pieces of adding machine tape with names and amounts. When we were still short by 2,088 KM (27.4%), she ripped off another piece of adding machine tape, put her own name on it and said she borrowed 2,000 KM to attend her uncle's funeral. When we pointed out the fund was still 88 KM short she said she must have borrowed 2,088 KM and changed the "receipt".

- When we opened another desk in the Working Unit Cashier's office, we found a shortage of 1,100 KM (25%) for the day. He had a handwritten listing of "advances to employees" located with the ledger, which totaled the missing 1,100 KM.

- At the Head Cashier's desk, funds were again less than the amount shown on the ledger by 39.2% or 19,271 KM. In addition the cashier informed us that she had 7,500 Euros of the company's money at her home. When asked why, she said she was on the way to the bank to deposit the money the previous week, but went to the hospital instead as her son was being x-rayed. We went to her home to collect the funds. However, rather than the funds being bundled by denomination as we expected for a bank deposit, they were bundled in three mixed denomination groups totaling 2,500 Euros each. This left us with a shortage of approximately 4,271 KM using the exchange rate for the day. The cashier told us the Euro amounts were included in the KM ledger and assured us multiple times that there were no other cash funds located anywhere else in the building. However, the following morning there were two deposits made at the bank 47,292 KM and 18,845 Euros, which exceeded the shortages of the day before by 25,000 KM. We also learned that the Euros were not part of the KM ledger as we had previously been told, but had their own ledger.

  We were still not able to reconcile the differences noted in the counts or the deposits made the day following the count. The next day the Finance Manager announced that he had formed a "Commission" to investigate the shortages of the cashiers. As expected the Commission found that there was no shortage and the cashier's action was not egregiously out of line. However, they didn't include the shortage of the Head Cashier in their investigation, illustrating that the Commission was merely an attempt to help cover up the shortages and defend poor control practices.

In addition to the above we learned that the Finance Manager personally went to the SFOR base located just outside of Trebinje every month to collect the base's electric bill in cash (Euros). He brings the cash back to the Head Cashier without the benefit of a receipt, acknowledgement or other documentation.

Although they had a one page cash procedure dated, 19 April 2002, none of the controls contained in the procedure were in place. Once they admitted none of the procedures had been implemented, they claimed the procedures were merely something they strive to achieve. Control is non-existent in this situation, which can enable cash to easily go astray without being accounted for or missed. We are skeptical that the cash found in the employee's home in three neat bundles of 2,500 Euros was intended to be deposited as we were told.

In addition to replacing some key people, we recommend:

- Financial police investigation and reconciliation of cash receipts and deposits of the Trebinje Distribution Center with special attention given to the Euro accounts and deposits of the Head Cashier.

- Revise the 19 April procedures to include surprise independent cash counts and reconciliation of collections to deposits by a person who does not have access to cash. The revised procedures should be implemented and enforced. Deviations should not be tolerated.

- Ensure SFOR payments are made via bank transfer. If cash is used they should be made in person at a bank or cashier's office and an appropriate receipt issued. The practice of the Finance Manager picking up cash in person should be stopped immediately.

- Implement a computer system, which requires the account be posted before a system-generated receipt can be issued to the customer. Require each customer be given a system-generated receipt.

- Ensure cash funds are kept securely locked. Do not allow cash to go off premises unless it is going directly to the bank.

- Forbid cashiers from giving loans to employees and themselves or keeping the company's cash in their homes.

Systems

ERS's computer systems are grossly inadequate. Systems are not integrated nor do they facilitate operations resulting in major inefficiencies and poor reporting. Many business units are still using manual systems and ledger cards. Trebinje HQ cannot even produce a simple aged accounts receivable or accounts payable listing, it has a hand booking vendor invoice system and no computer system for thousands of compensations totaling over 160 million KM.

We recommend ERS work closely with the individuals from the European Union, who are working to define user requirements as the basis for purchasing or developing software for all three electric companies. Any system adopted should be integrated and enable adoption of international best practices for the industry.

Pensioner Coupons – Pale

When we inquired in Pale about the level of Pensioner Coupons, the Finance Manager claimed no coupons were accepted and told us the 18 million KM government decision had been withdrawn. After we pointed out that this decision had been replaced with a lower amount and the other Distribution centers had accepted coupons, he produced a one-page report showing they had accepted 800,000 KM worth of coupons to date. His Collections Manager produced another report for the same time period showing approximately 1,100,000 KM of coupons had been accepted. The Finance Manager then got on the phone to demand the right figure and promised an explaination, which was never provided during our audit. In their response to this report several weeks later they reported the number was 1,072,119 KM.

Pale Distribution Center Vendor Records

Pale Distribution Center maintains several simple Excel type spreadsheets for vendors, suppliers and contractors. They do not separate cash payments from compensations, and various "analytical cards" are not cross-referenced. They do not appear to have any approval authority for multiple payments, and a review of contract bids indicates that most contracts have amendments allowing them to exceed the original bid. The largest vendor/contractor for 2002, Samot Sokolac, was not balanced as of 17 January 2003, and it took several hours to determine total invoices and payments for 2002.

Elektrokrajina Distribution Center (Banja Luka)

Management was unable to determine how much they spend per year on various categories of expenses since their computer does not enable sorting by payment type. For example, the budget for 2002 provided 250,000 KM for maintenance of computer systems, but they had no idea of what had been spent against this budget line even though it is a frequently used category. They had zero budgeted for emergency repairs even though they charge expenses to this category. The reason provided for not budgeting for this category is that they do not know what emergencies they will have.

We also noted that the accounts receivable balance as of 31 December 2001 differed by two million KM from the 1 January 2003 balance on the Distribution of Income Earned from Sales of Electricity report.

7. Improve controls over metering, meter reading and distribution of bills.

Estimate electricity charges on accounts where meters cannot be read

In both Pale and Banja Luka when the meter readers cannot read a meter due to inaccessibility or being denied access, they report electricity usage as zero, and no bill is sent to the customer. Under these circumstances, there is little wonder why they have a problem with being denied access to meters by customers.

If the meter cannot be read, we recommend usage be estimated and billed to the customer. Estimates should be based on the highest range of prior usage.

Implement proper segregation of duties

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 17 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 dismissed. Qualified meter reader inspectors can also check meters to verify they have not been tampered with and identify and follow up on illegal hookups.

Metering of Electricity

In addition to not having enough accessible and working meters, we have concerns about the generation reports and metering of electricity at various points in the grid system. We found that a direct transmission line exists from the Trebinje I dam to Montenegro. Management claimed it is not used and is only there because the dam was originally designed that way. However, control personnel at the dam told us the Montenegro line could be turned on concurrent with the transmission line to the dispatch station. We asked if the line had been recently used, but they refused to answer the question.

The Visegrad dam had a 220 V transformer installed during the war along with a 17 kilometer line to connect to the Serbia grid. They explained the current situation is that the Visegrad dam had more generating capacity than the rural areas around it could consume, and that the surplus would go to Serbia, but all the surplus to Serbia would be registered in swap or EFT billings.

We are concerned that electricity could have easily been shipped out over these lines and not properly accounted for. We observed that meters were being installed at the request of the World Bank at the large Trebinje dam, which should improve control.

<u>Cut-offs</u>

Across the RS, it appears there is reluctance to cut-off non-paying businesses and households. Cut-offs should begin aggressively.

8. Improve profitability and cash flow.

There are numerous areas where profit of ERS could be improved. Below is a list of some of the estimated savings, which could be achieved. We also believe significant additional savings can be achieved by implementing appropriate monitoring equipment, adopting a comprehensive accounting/management information package, which complies with industry best practices, improving internal controls and other basic management measures.

	Millions of KM
Eliminate compensations; thereby eliminating the 30%+ markup on vendor charges required in order to get vendors to agree to compensations	52.9
Overstaffing at Gacko and Uglijevic (1400 employees at 400 KM per mo.)	7.0
Selling excess electricity direct	18.0
Pensioner coupons per government decision	7.0
Forgone interest per government decision	5.5
Improve collections and reduce write offs	34.4
Reduce distribution losses to international norms	22.0
Reduce or eliminate inappropriate and excessive contributions	9.5
Follow procurement law	4.0
Reduce petroleum payments	6.0
Total	166.3

These savings were conservatively estimated based on selected documents we examined at a few selected locations. We believe some of our estimates of savings, such as following the procurement law, would likely increase significantly if the number of locations and documents selected for examination were expanded.

9. Ensure timely and substantive correction of audit issues.

Over the last three years, ERS received numerous recommendations for improvement from a variety of sources including PricewaterhouseCoopers (external auditors), the World Bank, USAID and their own internal auditors. Corrective action has been more lip service than substantive. In our opinion, the primary reason for failing to implement timely and appropriate changes, lies in management's poor attitude toward internal control, which forms the basis for an extremely weak internal control environment. The best control system in the world is doomed to failure without the active visible participation and support for strong internal controls, which cannot be overridden at will.

One of the few recommendations, which was implemented, was the creation of an internal audit department in January of 2001. Two individuals were hired and tasked with establishing the Audit Department under the direction of the General Manager. In spite of the lack of independence in reporting relationship, the two auditors identified a significant number of important control weaknesses and made appropriate recommendations to correct the problems. However, their recommendations were not implemented in a timely or substantive manner. Many of the findings appear to be totally ignored. Department managers are not required to respond to audit reports with a corrective action plan. Many problems have continued uncorrected for years in spite of management ensuring the international community that they were being addressed.

When we compared the Financial Management Action Plan prepared by ERS in response to the PricewaterhouseCoopers Audit report for the year ended 31 December 1999 and the Aid-Memoire issued by the World Bank Mission for Mid-Term Review of the Second Electric Power Reconstruction Project with the current findings, we found virtually all the same problems and concerns still exist three years later. Serious outstanding issues include:

- Lack of control over operating expenses as evidenced by findings in this report including the continued high level of compensation agreements, cost overruns at the thermal plants and circumvention of the tender process all of which increase costs.
- Need to reduce distribution losses, which consistently remain at the 30% or higher level.
- Need to increase the level of collections. ERS's 1999 response indicates that no one was able to determine what the actual collection level was due to a total lack of controls over cash collected and failure to identify collections made through barter and compensation agreements. The situation remains unchanged.

ERS management has a long history of agreeing to corrective action, while doing little or nothing. The business remains poorly controlled. Privatization is stalled, and management continues to override controls at will.

We recommend:

1. Management and Board Members be replaced with knowledgeable individuals, who will ensure appropriate changes are made quickly and effectively. Background checks should be conducted prior to appointments to ensure there are no conflicts of interest.

2. Internal Audit report directly to the Board of Directors.

3. An Audit Committee of the Board of Directors (made up of outside directors) be established to review audit findings and ensure corrective action is carried out in a timely manner.

4. The Audit Committee of the Board of Directors be actively involved in and responsible for selecting the external auditors and not merely accept management's recommendation.

5. Management be required to provide detailed corrective action plans in response to audit reports, and they be held accountable for completing those plans effectively and on time.

6. Background checks be conducted on internal audit staff to ensure they have the appropriate education and experience background and are fully in compliance with the International Institute of Internal Auditor's standard on independence.

7. Internal Audit Department be expanded to enable them to appropriately cover the risk areas.

8. Adopt a strict conflict of interest and ethics policy to be reviewed, agreed to and signed annually by management, staff and the board.

10.Eliminate Government interference and split loyalties.

Competing interests

In November of 2002 the Prime Minister signed a decision removing the Vrbas (total project consists of approximately 30 dams) and Buk Bijela Dam Projects from ERS and placing them with the RS government. We find it interesting that the RS Government is planning to build numerous power dams, which will compete directly with ERS in the export of surplus electricity and the use of transmission system. And the only bidder is EFT, the current buyer of surplus.

Government interference

In 2001 and 2002 the RS Government mandated payments to or on behalf of other entities or agencies totaling in excess of 20 million KM and required multilateral compensation agreements in excess of another 19 million KM.

The Pensioners and Invalids Insurance Department (PIO) has been the government directed recipient of "coupons" provided by ERS for the past two years, which are then provided by the PIO to beneficiaries to apply against their electric bills in lieu of their normal pension payment. These payments are not reimbursed by the RS Government and must be written off by ERS. Coupons used during 2002 amounted to just under 7 million KM.

Government agencies have large unpaid accounts with ERS including 2.2 million KM due from the Ministry of Defense.

Also as mentioned elsewhere in this report the RS made a decision in mid-2001 that all customers with electric company debts over 60,000 KM could reschedule those debts and have their interest forgiven. This resulted in 33 million KM of debt being rescheduled and 5.5 million KM of interest being forgiven. This type of decision, which has a significant effect on the earnings of the electric company, should remain with the electric company.

In November of 2001, the RS Government requested 90,000 Euros be provided to assist them in acquiring a Cessna Citation business jet for use by the RS Government. ERS was to receive access to 75 flight hours over a three-year period at the rate of 25 flight hours per year. The money was provided without any cost/benefit or need analysis on the part of ERS. In July of 2002 ERS ceded their right to 20 of the 25 hours at the request of the President of the Republic, and ERS contributed another 10,000 KM for expenses of the jet to be used by "our highest representatives of the RS." For over two months, we have been unable to obtain the flight log for examination in spite of multiple requests and promises that it would be provided.

Since ERS has not turned a profit, the company does not have any dividends to disburse to the government. Therefore, government mandated payments represent inappropriate distributions of the core capital of this company.

Split loyalties

ERS is a founder and shareholder of EKC Belgrade along with the Serbian and Montenegrin electric systems. EKC appears to compete with ZEKC is Sarajevo. In 2002 ERS admitted they supported the Sarajevo ZEKC with 497,075 KM while providing EKC in Belgrade almost twice that amount (889,805 KM). ERS provides the bulk of EKC Belgrade's income even though ERS management claimed that EKC is only contacted in regard to cross border swaps. ERS's invoicing for surplus electricity sold to EFT was coordinated through EKC in Belgrade in 2001 and EPCG in Montenegro, (who owns 25% of EKC) in 2002 rather than ZEKC is BiH.

MANAGEMENT'S RESPONSE

The draft findings were sent to ERS management for comment before finalizing the report. ERS management graciously agreed to provide us with their written response before the required deadline.

The audit team reviewed the 24-page response in detail in order to determine if any changes needed to be made in the report and to identify any additional relevant information, which may need to be followed up before the report was finalized. Although a few minor changes were made to the report as a result of the response, nothing substantive changed. Their response included limited agreement to some corrective action, outright denial of clearly substantiated facts and instance that the form (vs. the substance) of the law was met. Support for some claims did not address the issue, and in some cases appeared to deliberately obscure the issue by focusing on part of the problem but not addressing the larger issue. We did not find the response accurate or helpful. Major claims such as they "know nothing of the tailored conditions that favor some or restrict other bidders" or "contracts were arranged in a transparent way" were simply not true once you looked beneath the surface or form of the documentation. Although the documentation may have had the appearance of control, when we looked at the underlying transactions, the documentation turned out to be little more than window dressing. In their response ERS management denied information they supplied to us during the audit, including information and numbers we questioned and they confirmed during the audit. The written response did not provide any significant new information not already verified during the audit. We believe the response is another attempt to obscure the underlying issues.

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