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**ECONOMIC  
CONSULTING  
ASSOCIATES**

**Lesotho:  
Implementation of Economic  
and Financial Regulatory  
Models for LEA and Future  
LEWA**

**Inception Report**

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**Submitted to the World Bank by:  
Economic Consulting Associates (UK)**

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## Abbreviations

ADB	African Development Bank
AFUDC	Allowance for Funds Used During Construction
CWIP	Construction Work in Progress
DoE	Department of Energy
ECA	Economic Consulting Associates Ltd
EDM	Electricidade de Mocambique
ESKOM	South Africa's public electricity utility
GoL	Government of Lesotho
GSA	Government of South Africa
IFRS	International Financial Reporting Standards

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LEA	Lesotho Electricity Authority
LEC	Lesotho Electricity Company
LEWA	Lesotho Electricity and Water Authority
LHDA	Lesotho Highlands Development Authority
M	Maloti
MHP	'Muela hydropower plant
MoNR	Ministry of Natural Resources
NERSA	National Energy Regulator of South Africa
RAB	Regulatory Asset Base
RAGs	Regulatory Accounting Guidelines
RAV	Regulatory Asset Value
RSA	Republic of South Africa
SAPP	Southern African Power Pool
WACC	Weighted Average Cost of Capital
ZAR	South African Rand

## Currency conversions

1 Maloti (M) = 1 South African Rand (ZAR)

US\$ 1 = M 7.6

# 1 Introduction

Economic Consulting Associates (ECA) has been engaged by the World Bank, with funding from PPIAF, to carry out a project for the *Implementation of Economic and Financial Regulatory Models for Lesotho*.

The contract was awarded on 12 April 2011. This *Inception Report* is the first deliverable under the project and follows the kick-off visit to Lesotho. The Report is laid out as follows:

- ❑ A brief summary of the kick-off visit and key findings that impact on the scope of work
- ❑ A restatement of the tasks and outputs from the TOR, our approach and methodology from the Technical Proposal, and notes of any updates or changes arising from the inception visit to the approach and methodology
- ❑ The project workplan and the next steps

The remainder of this introductory section contains a brief background to the project and an overview of the project objectives.

## 1.1 Background

The current project follows on from an earlier project (Phase I), managed by the World Bank and financed by PPIAF, on behalf of the Lesotho Electricity Authority (LEA), for the Development of Economic and Financial Regulatory Models for Lesotho. The objective of the Phase I project was to develop economic and financial regulatory models for the water and electricity sectors in Lesotho that would be used for tariff setting and sector and investment planning. With this tool LEA which is to be re-named the Lesotho Electricity and Water Authority (LEWA), will be able to prepare various scenarios taking into account the constraints of the licensees (costs of operation, maintenance and investments) as well as the Government's (parameters of expansion targets and social policies). Its goal was to provide the framework for a consistent and quantitative regulation and increase accountability and transparency of regulatory decisions and processes.

In addition to the model itself, a number of other deliverables were provided including regulatory accounting requirements, assessment of the state of preparedness of the licensees to implement unbundled accounts, draft regulatory accounting guidelines, and some draft tariff regulations.

## 1.2 Overview of the project objectives

The Phase II project aims to ring-fence the accounts for the LEC and the Lesotho Highland Development Authority (LHDA), support stakeholders in developing

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cost-allocation manuals, populate the models developed in Phase I with data from the regulatory accounts (to the extent possible), review the 2011/2012 tariff application and simulate consequent (multi-year) tariff applications.

This project includes the elaboration of the accounting and reporting manuals, training workshops for the staff from LEA and the operators and audits of the annual reports of the utilities.

## 2 Key findings of the kick-off visit

We began the project with a kick-off meeting in Maseru between the ECA Team Leader, LEA, LEC and LHDA. During the visit, ECA was updated with the latest developments in the electricity (and water) sector in Lesotho. These are summarised below.

### 2.1 Developments in the electricity sector

LEC and GoL continued the policy of extending access to consumers. The number of connections increased by 12,654 in the year 2010-11, similar to the increase in the previous year. The share of residential sales in terms of MWh continued to increase and in the year 2010-11 the share increased by 1.8 percentage points to reach 32% by the end of the year. Consumption per residential customer dropped by an estimated 6% over the period.

Despite the substantial increase in the number of connections, electricity demand continued to grow at a comparatively modest rate of 6.7% in 2010-11.

In line with the multi-year tariff order, ESKOM (South Africa) increased tariffs for electricity sold to LEC by an average of 25.8% effective from 1 April 2011.

LEC reported problems with production from the 'Muela Hydropower plant resulting in higher than budgeted purchases of electricity from ESKOM and EDM. LEC's latest estimate for the year 2010-11 indicated that purchases from ESKOM would be 55% higher than originally budgeted but at the same time they predicted that purchases from 'Muela hydropower plant would be virtually unchanged – this appears to suggest that at the time LEC prepared its 2010-11 budget (i.e., in early 2010), it under-predicted the impact of load growth on the cost of electricity imports. We have observed previously that imports from ESKOM will grow faster than the average growth in LEC demand because the supply from 'Muela is already at, or close to, a maximum and increases in demand must be met in large part from imports until new generation is developed in Lesotho.

The Generation Master Plan, commissioned by LEC, and the contract with the Consultant was signed on 10 February 2010. Reports describing the wind and solar potential were submitted to LEC in November 2010. We understand that an economic assessment of these, and other, generation development or import options has not yet been prepared.

### 2.2 Annual Reports

A draft of LEC's statutory accounts for the year 2009-10 is available but has not been finalised. The financial year 2010-11 has just ended and audited accounts could not be expected yet. LEC has prepared a budget for the year 2011-12, which includes the latest financial information for the year 2010-11, but neither the budget nor the year 2010-11 financial statements are final.

LHDA has not submitted an audited annual report since 2007/08.

## 2.3 Tariff submission

On 14 March 2011 LEC submitted to LEA an application for a tariff increase. LEA agreed the following programme for review and approval of a tariff increase to take place on 1 May 2011:

Receipt of tariff application	14 March 2011
Publication of the application for public comment	16 March 2011
Closing date for public comments on the application	8 April 2011
Public hearing	13 April 2011
Pricing Committee meeting	18 April 2011
Extraordinary meeting of LEA Board	28 April 2011

Comments from 11 stakeholders were received by the deadline of 8 April 2011, the meeting of LEA's Pricing Committee was held and revised tariffs approved on 28 April for implementation on 1 May.

We estimate that the approved tariffs will lead to an overall average increase in charges per kWh of 15.6% (including levies), bringing the average tariff to M 0.696/kWh (US¢ 9.2/kWh excluding VAT). The approved tariff increase was more-or-less the same for all classes of customer, but the increase was very slightly lower for the demand charge.

## 2.4 'Muela Power Sales Agreement

LHDA has made no applications to LEA for an increase in the tariff for power sold to LEC from the 'Muela power plant. Sales continue to be made on the basis of the original contract in which indexation was suspended nearly ten years ago. The revised contract signed in 2005 has still not been implemented.

## 2.5 Ring-fencing of accounts

LEC has set aside a budget to seek support in management restructuring and developing unbundled accounts, but no movement had taken place at the time of the inception visit.

Neither LEC nor LHDA have begun to prepare Cost Allocation Manuals.

### 3 Approach and methodology

The six tasks described in the TOR are expanded below.

#### Task 1. Technical Assistance

<b>Scope of work</b>	Technical Assistance for: <ul style="list-style-type: none"> <li>• Ring-fencing the regulatory accounts for LEC and LHDA;</li> <li>• Supporting LEC and LHDA in developing cost-allocation manuals;</li> <li>• Populating the models with data from the fully developed regulatory accounts, and</li> <li>• Supporting the review of the 2011/12 tariff application using the model for LEC and simulate a multi-year tariff application.</li> </ul>
<b>Outputs</b>	<i>Cost Allocation Manuals for LEC and LHDA.</i>  <i>Review of 2011/2012 LEC tariffs submission using the Economic and Financial Regulatory Models and audit for accuracy, completeness and correctness.</i>

We shall begin this task by supporting LEC and LHDA in relation to the Cost-Allocation Manuals. These must be developed first since they form the basis for the regulatory accounting. We anticipate that LEC and LHDA will have prepared draft Cost Allocation Manuals but if not we will support them by drafting the primary provisions of the manuals. Given the timetable for the whole assignment, and given that all other activities are contingent on appropriate cost allocations, it will be urgent to complete this work quickly, even if the manuals will still need to be improved and refined later<sup>1</sup>.

After reasonable drafts of the Cost Allocation Manuals have been prepared, we will support LEC and LHDA in the preparation of regulatory accounts with cost allocation based on the principles laid down in the manuals. Audited accounts are available for the year 2008-09 for LEC and earlier for LHDA and only provisional accounts are available for 2010-11 and forecasts will need to be made for 2011-12. Since the accounting systems cannot yet have been adopted to comply with the proposed cost allocation principles, it will only be possible for the regulatory accounts to approximate to the principles. Time is, again, limited and this severely limits the detail and accuracy of the regulatory accounts that can be prepared for the current year (2010-11) and for the forecast year (2011-12). It should also be recognised that at the present time any misallocation of costs between LEC's electricity businesses has few consequences in terms of distortions to competition, and therefore accurate allocation is currently less important this year than it may be in future. The regulatory accounts for 2010-11 and forecasts for 2011-12 can therefore be considered as the first, but important step, toward improved cost allocation and regulatory accounts.

<sup>1</sup> The Cost Allocation Manuals will always be subject to on-going improvement and updating.

We will support LEA and LEC with entering the regulatory accounting data for the year 2011-12 into the tariff model in order to review the proposed level of tariffs for that year. If appropriate, we will also help prepare outturn adjustments relating to the year 2009-10 and interim adjustments for the year 2010-11.

Based on the above, we will review LEC's tariff submission. We note that this will be too late for the formal tariff submission and we will therefore prepare an initial review of the tariff submission within one month of the start of the assignment and then revisit the review toward the end after some of the other work has been completed. We will also help simulate a hypothetical multi-year tariff application for a five-year period 2011/12 to 2015/16.

LHDA has not made a tariff submission.

The outputs of this stage of the work will be the *Cost Allocation Manuals*, the *regulatory accounting submissions of LEC and LHDA*<sup>2</sup> and a report which reviews LEC's tariff submission<sup>3</sup>.

## Task 2. Establish auditing procedures

<b>Scope of work</b>	Establish auditing procedures before submission for control of accuracy, completeness and correctness of the LHDA and LEC's reports to the LEA.
<b>Outputs</b>	<i>Report on auditing procedures.</i>

We will discuss with LEA, LEC and LHDA the requirements and options for auditing. Auditing typically refers to work of certified accountants operating under professional codes of conduct and legislation governing private or state-owned companies. Such audits are relatively expensive. However, the auditing of regulatory accounts does not necessarily fall under the same set of rules. Simpler, less expensive, arrangements may be satisfactory in the short- or medium-term. Such arrangements may include formal internal cross-checks to ensure consistency of data, use of standardised formats, attribution of data used to individuals within the organisation, and certification by senior management of the licensed entity of specific data. We will consider options available and, following agreement with LEA, we will develop procedures to be issued by LEA to the licensees governing auditing of their regulatory accounts. We note that it will not be possible to apply these auditing procedures to the latest submissions of regulatory accounts relating to Task 1.

<sup>2</sup> The Cost Allocation Manuals and the regulatory accounting submissions will be a joint effort by the Consultant, LEC and LHDA and, where appropriate, LEA.

<sup>3</sup> We will provide verbal or written advice to LEA on the tariff submission and our "report" will be a summary collection of advice or comments provided.

### Task 3. Establish review procedures for tariff submissions

<b>Scope of work</b>	Establish review procedures for LEA of the tariff submissions.
<b>Outputs</b>	<i>Report on review procedures for tariff submissions.</i>

Based on the review of the LEC tariff submission (Task 1), we will prepare a set of generic procedures for LEA to follow in relation to any tariff submission from any licensee.

### Task 4. Perform a year-end audit

<b>Scope of work</b>	Perform a year-end audit of one or more reports, and prepare a summary report to LEA summarizing all important issues in this respect.
<b>Outputs</b>	<i>Summary report to LEA including all important issues in auditing reports submitted by LEC and LHDA.</i>

We will review the regulatory data submitted by LEC and LHDA to LEA using the templates developed in Phase I, comment on the data that has been provided, and make detailed recommendations on data that should be provided.

### Task 5. Presentation

<b>Scope of work</b>	Final presentation seminar for the top management of the Ministry of Natural Resources and the Private Sector Development Unit (PPP) in the Ministry of Finance.
<b>Outputs</b>	<i>Presentation.</i>

Toward the end of the project, we will make a presentation of the key findings to key stakeholders. We assume this presentation will be made to a small number of top management of LEA, Ministry of Finance, Ministry of Natural Resources, LHDA, and the Rural Electrification Unit, and that the presentation will be made at the offices of LEA or one of the Ministries.

### Task 6. Training

<b>Scope of work</b>	Hands-on training seminar for LEA, LEC and LHDA staff on usage of model, the cost allocation manuals and reviewing tariff submissions and reports.
<b>Outputs</b>	<i>Training seminar.</i>

Toward the end of the project we will deliver a one-day training seminar to the staff of LEC, LHDA and LEA on the usage of the models, the Cost Allocation Manuals,

and auditing procedures, and procedures for reviewing tariff submissions and reports. We will also provide training to simulate a multi-year tariff application.

## 4 Workplan

The workplan, beginning mid-April, is summarised in Figure 1 below.

