Executive summary of the public audit report

IMPLEMENTATION OF THE RECOMMENDATIONS OF THE PUBLIC AUDIT REPORT ON ELECTRICITY SECTOR REFORM

27 February 2015 No. VA-P-20-3-2

Full audit report in Lithuanian is available on the website
of the National Audit Office: www.vkontrole.lt
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DEFINITIONS

Definitions:

AB LESTO refers to the Lithuanian power distribution network operator;

LITGRID, AB refers to the Lithuanian electricity transmission system operator;

Associated company refers to a company, significantly influenced, but not controlled by a Group or a Company;

Service block refers to the 4th block of service companies;

Service companies refer to NT Valdos, UAB, UAB TIC, UAB ETP, UAB TETAS, UAB TPC, UAB VAC;

Subsidiary refers to a company, which is directly or indirectly controlled by the Company;

Vertically integrated company refers to a power company or a group of companies, when the same person or persons have a right of direct or indirect control and when the company or a group of companies performs at least one of the transfer, distribution or production functions;

The cost-plus pricing method refers to the method of pricing, when the price of a transaction is determined by calculating direct and indirect costs, experienced during the transaction and adding a mark-up.

Significant difference refers to a difference when the percentage value of an amount varies ten or more times.

Abbreviations:

CPP IS refers to the Central Public Procurement Information System;

UAB ETP refers to the UAB Elektros tinklo paslaugos (Electricity Network Service);

UAB TIC refers to the UAB Technologijų ir informacijų centras (Technology and Innovation Centre);

UAB TPC refers to the UAB Tinklo priežiūros centras (Network Service Centre);

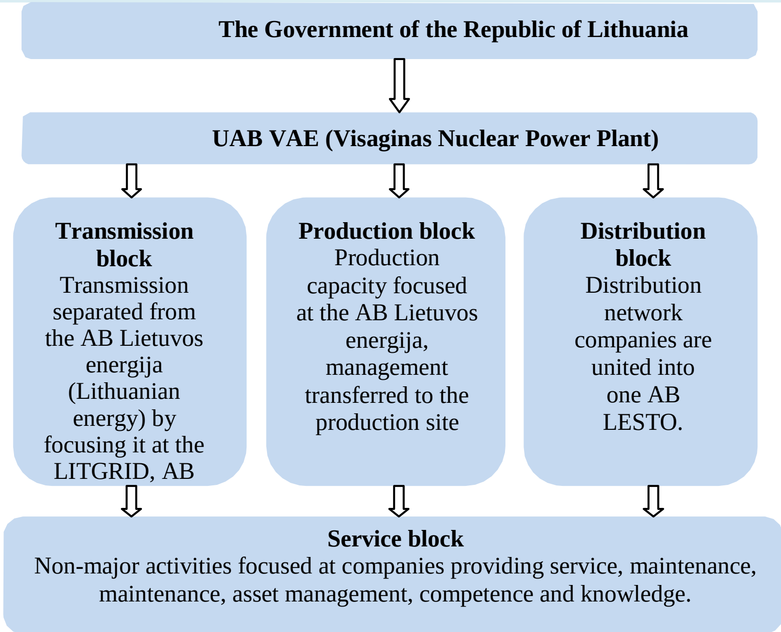
UAB VAC refers to the UAB Verslo aptarnavimo centras (Business Service Centre);

NCECP refers to the National Commission for Energy Control and Prices.

EXECUTIVE SUMMARY

Based on the directive of the European Union, at the end of 2009 the Ministry of Energy began the process of restructuring the Lithuanian energy sector, which included several major activities — power production or supply, transfer and distribution. Seeking to evaluate the implementation of this restructuring, in 2011 the National Audit Office performed an audit on the *Electricity Sector Reform*. The auditors found out that the restructuring involved creating a new 4th block of service companies, providing specific services for the electric power sector (Fig. 1). The goals of the service block are to optimise the service by implementing free market promotion measures and, in case of a need, to include a strategic investor.

Figure 1 The structure of the electric power sector in 2011



Source — the National Audit Office

The development of the service block involved separating the activities and functions of the service companies: they were focused at specialised companies, which also were appointed to manage the operated assets — buildings, information systems IT telecommunications equipment and its service costs, as well as the employees and their related costs:

- The UAB Technologijų ir inovacijų centras, founded in 2010 provides information technology services for the UAB VAE and its subsidiaries.
- UAB Kruonio investicijos (the company changed its name to NT Valdos, UAB, in November 2010) became the manager of the energy sector's real estate and assets that are not related to the activity implemented by companies;
- Two network service companies UAB Tetas and UAB Elektros tinklo paslaugos were founded.

The audit report concluded the following:

- the majority of the companies of the service block do not have any competition, since their services focus specifically on the electric power sector. Moving the network service into the competitive market creates a risk of cartels and increase in network service prices;

- the services provided by the service block companies directly influence the final power price for the customers, since they provide services for companies of the electric power sector. The activity of these companies is licensed or they are subject to state-regulated prices and their costs are included into the price of electric power. Therefore, the price and the profit rate of these services are very important.

Considering the risks mentioned, the Government of the Republic of Lithuania was provided with the following recommendation:

- To define a legal right for the National Commission for Energy Control and Prices to obtain all necessary information from the companies servicing energy companies about their costs, income and contractual obligations and to harmonise the pricing of the companies with the National Commission for Energy Control and Prices.

It is important to mention that during the coordination of the audit report conclusions and recommendations, the Ministry of Energy acknowledged the risk identified by the audit and the above-mentioned recommendation.

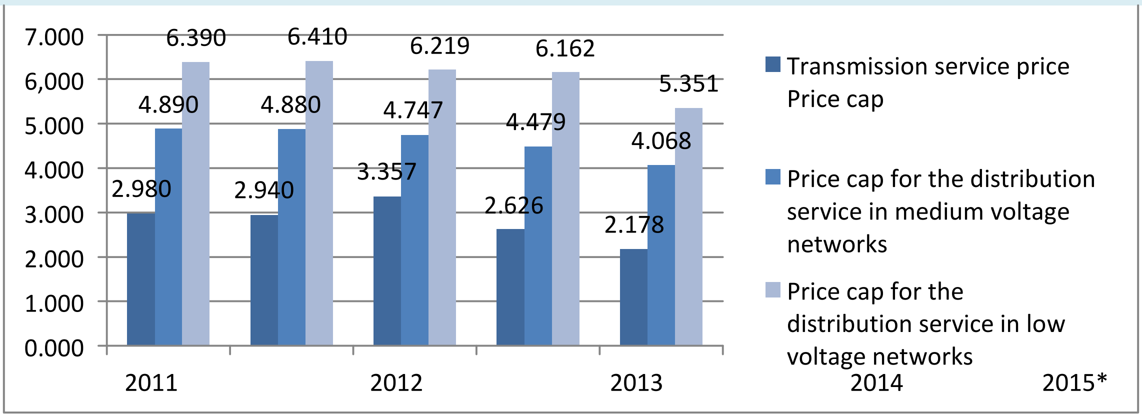
When the National Audit Office inquired about the implementation of the recommendation, in 2012 the Ministry of Energy informed that according to the art. 2, pt. 2 and the art. 68 of the Law on Energy1, the functions of the National Commission for Energy Control and Prices are sufficiently regulated and, if the service block companies had to coordinate their pricing with the commission, their activity essentially would become regulated, which would result in excess implementation of the recommendation of the public audit. The Ministry of Energy expressed the same opinion in 2014 as well.

In our opinion, the cost accounting and control, indicated in the art. 68 of the Law on Energy, regulates the activity only of those persons that have high influence on the electric power market. In such case the National Commission for Energy Control and Prices is unable to receive information directly from the companies providing services: LITGRID, AB, AB LESTO or Lietuvos energija, AB.

Every year NCECP determines the price caps for transmission and distribution services in medium and low voltage networks (the price of transmission services consists of the price cap of the transmission service in high voltage networks and the price of systemic service).

In 2011-2015 the price caps for transmission and distribution services decreased, except for the price caps for distribution services in low voltage networks in 2012 and transmission services in 2013 (Fig. 2).

Figure 2 Price caps for transmission and distribution services in medium and low voltage networks (VAT excluded)



*Note: 0.631 euro ct/kWh, 1.178 euro ct/kWh, 1.550 euro ct/kWh

Source — National Audit Office according to the data of the NCECP

1 The Law on Electricity of the Republic of Lithuania, 20-07-2000, No. VIII-1881 (amendment No. XI-1919 of 17-01-2012, art. 57, pt. 2; amendment No. XII-774 of 13-03-2014).

In 2014 NCECP performed an audit at LITGRID, AB, AB LESTO and AB Lietuvos energijos gamyba for the period 2011-2013. The results of the audit influenced the price caps for the transmission and distribution services in medium and low voltage networks, which were defined in 2015. Since the above-mentioned energy companies do not agree with the audit results of the NCECP and are currently engaged in litigation regarding the matter, these results are not final.

It should be noted that by the resolution No. XII-817 of the 10 April 2014 the Seimas of the Republic of Lithuania approved the conclusion of the Temporary Investigation Commission regarding the explanation of the situation in the energy sector and the evaluation of the results of the implementation of the goals defined in the national energy strategy in 2007. By analysing the restructuring of the electric power sector of 2009-2012, the Commission assessed the development of the 4th block of service companies, providing specific services for the electric power sector. In the conclusion the Commission pointed out the following:

- the operation of the service block companies was not based on any service pricing principles, which creates a risk of cartels which may have a significant influence on the increase of the service prices;
- the service prices of the service block companies do not enter the regulatory scope of the National Commission for Energy Control and Prices. The operation costs of these companies become the costs of the companies providing transmission, distribution and supply services, which are included into the electricity price paid by the consumers.

Considering the conclusions of the Commission and having evaluated the opinion about the recommendations of the audit *Electricity Sector Reform,* expressed by the Ministry of Energy, the National Audit Office included the audit *Implementation of the Recommendations of the Public Audit Report on Electricity Sector Reform* in the audit program of 2014.

The goal of the public audit was to evaluate, whether the services received from the servicing companies were purchased in competitive environment and whether their purchase was more economical, compared to the internal transactions.

During the audit we evaluated the purchase of real estate and vehicle rent, information technology and telecommunication, as well as electricity networks repair and maintenance services from servicing companies. Moreover, we evaluated the changes of the electric power price caps for transmission and distribution operators and the size of the share of the services in the electricity sector purchased in the market from subsidiaries or associated companies.

The subjects of the audit are the Ministry of Energy, the Ministry of Finances, LITGRID, AB, AB LESTO.

The audit covered the period of 2011-2013. The change and trend analysis used the data from previous and subsequent years.

The audit used confidential information provided by the audited subjects. According to the law, in order to protect the information received during the public audit, which is regarded as commercial (industrial) secret and confidential information, based on the art. 18, pt. 1 of the Law on Provision of Information to the Public3, the art. 1.116 of the Civil Code and the art. 38, pt. 2 of the Law on the State Control, confidential information cannot be published or distributed and thus the confidential data is not provided in the public audit report *Implementation of the Recommendations of the Public Audit Report on Electricity Sector Reform*.

2 The documents of the National Commission for Energy Control and Prices: No. R2-2694 of 30-10-2014 and R2-(E)-79 of 14-01-2015.

3 The Law on Provision of Information to the Public of the Republic of Lithuania, 02-07-1996, No. I-418 (revision of the Law No. X-752 of 11-07-2006).

4 The Law on the State Control of the Republic of Lithuania, 30-05-1995, No. I-917 (revision of the Law No. IX-650 of 13-12-2001).

Reducing the audit risk, we collected the information required for the audit from different independent sources of information, using the procedures of approval, verification, survey and analytic assessment. The audit methods and procedures are provided in the Appendix 1 of the report.

The public audit was conducted according to the Public Auditing Requirements[5] and the International Standards of Supreme Audit Institutions[6].

The audit was conducted based on the assumption that all the data provided for the auditors is correct, complete and final, and their copies correspond to the originals.

Having evaluated the collected evidence, we provide the conclusions and recommendations of the public report.

CONCLUSIONS

1. Electricity power companies entering into internal transactions with subsidiaries or works, goods or services are purchased from the only supplier without any competition, crates a risk that the prices of these works, goods or services may not correspond to the market prices.

2. In 2011 AB LESTO (83%) and LITGRID, AB (62.5Į) purchased electricity network maintenance and repair services by entering into internal transactions with UAB TETAS and UAB Elektros tinklo paslaugos and as of 2014 both companies purchase these services by implementing public procurement from market suppliers. This helped to achieve the goals of the electricity sector reform — to create a service block.

3. The costs incurred by AB LESTO and LITGRID, AB, by implementing purchases according to the exceptions of the Law on Public Procurement, i.e. art .10, pt. 1, p.6 (real estate rent) and art. 10, pt. 5 (internal transactions) decreased in all regulated operating costs. During the period of 2011-2013 the share of these costs for AB LESTO decreased from 17.1% to 8.2%, LITGRID, AB, — from 15.3% to 8.3%. This share may increase, since the year of 2014 marked the establishment of new subsidiaries and associated companies, as well as new internal transactions.

4. The recommendation of the public audit on the *Electricity Sector Reform*, conducted in 2011 "To define a legal right for the National Commission for Energy Control and Prices to obtain all necessary information from the companies servicing energy companies about their costs, income and contractual obligations and to harmonise the pricing of the companies with the National Commission for Energy Control and Prices" is substantially relevant, because:

- the prices of the services provided are calculated according to the fixed and variable costs incurred during the transaction, which, although influencing the price of the power transmission and distribution, are assessed neither by the National Commission for Energy Control and Prices, nor other controlling institutions;

5 Approved by the Order of the Auditor General of the Republic of Lithuania No. V-26 of 21-02-2002 (amendment No. V-171 of 28-06-2012).

6 ISSAI 3000 *Standards and guidelines for performance auditing* and ISSAI 3100 *Performance Audit Guidelines: Key Principles* (http://www.vkontrole.lt/meniu.aspx?dok_id=412).

- the purchases made by electric power companies in competitive environment are more economic than internal transactions;
- the gross margin of the public procurement contracts signed is significantly lower than that of the contracts of internal transactions;
- the electric power companies establish new subsidiaries and associated companies and enter into contracts in non-competitive environment.

RECOMMENDATIONS

For the Ministry of Energy of the Republic of Lithuania and the Ministry of Finances of the Republic of Lithuania

Upon conduction the audit *Implementation of the Recommendations of the Public Audit Report on Electricity Sector Reform* and upon evaluation of its findings, we provide a revised recommendation:

To define a legal right for the National Commission for Energy Control and Prices to obtain all necessary information from the subsidiaries and associated companies servicing energy companies about their costs, income, contractual obligations and pricing methods, when these subsidiaries or companies are the subject of internal transactions or when the goods, services or works are purchased from these companies as the only supplier.