

**REGULATORY ACCOUNTING MANUAL FOR THE
ELECTRICITY DISTRIBUTION COMPANY**

October 2007

Prepared by:

I. Uniform System of Accounts (USOA) for the Electricity Distribution Company, according to the requirements of the Law nr. 9072, dated on May 23, 2003 “On Power Sector”, as amended

A. The purposes of Law nr. 9072, dated on May 23, 2003 “On Power Sector”, as amended, and the Uniform System of Accounts for Regulatory.

(1) Article 23 of Law nr. 9072, dated on May 23, 2003 “On Power Sector”, as amended, provides as follows:

“Any licensed power sector company, conducting more than one of the activities related to generation, transmission and distribution, will keep separate accounts for each of the activities in its inside bookkeeping unit and shall also prepare consolidated accounting statement and balance in conformity with require accounting practices. In addition, such integrated company will keep separated accounts for activities unrelated to generation, transmission and distribution activities”.

(2) According to article 21 of the Power Sector Law, ERE, within one year from the date this law enters into force, shall establish and adopt a uniform and standardised system of accounts for all the licensees in the electric power sector based on Albanian legislation and internationally accepted accounting standards. The annual financial and economic reporting to the ERE by all licensees shall be done according to this system.

The Uniform System of Accounts (USOA) developed by ERE for the Distribution Company (DC) offers the framework of the rules for keeping separate accounts by the DC, including assets, equity, liability, revenues and expenses for the purposes of establishing prices under the appropriate tariff methodologies and monitoring the performance of the Distribution Company.

B. Applicability of USOA

The system of accounts specified in the USOA for Distribution shall be applicable to the licensed Distribution Company.

INSTRUCTIONS

A. General Instructions

1. Accounting Period

DC shall keep its books on a monthly basis so that for each month all transactions applicable thereto shall be entered in the books of the DC for that same month.

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Amounts assignable to any of the DC functions shall be so segregated monthly. Each DC shall close its accounts kept for regulatory purposes at the end of each calendar year unless otherwise authorized by the ERE.

2. Accounting Records

a) DC shall record in its accounting books, and preserve all other documents, records and memoranda, which support the entries in the accounting registers so as to be able to furnish at any time full information about any item/entry included in the accounting book. Each entry shall be supported by detailed information to permit easy identification, analysis, and verification of each transaction/operation.

b) DC shall preserve its accounting books for a period of 7 years, or any longer period required by Albanian Law.

c) DC may keep in addition to the accounting documents prescribed in the USOA clearing and temporary accounts, as well as subdivisions of the accounts prescribed in USOA, provided the integrity of the information, which is required for regulatory purposes is not impaired.

d) The arrangement of the accounts in the USOA will be used as data source for the regulatory reporting forms, elaborated by the ERE.

B. Accounting Policies for Regulatory Purposes

1. Funds

Funds received by the licensed companies shall be classified either as Funds Related to Assets or as Finances Related to Income.

Funds related to the assets of the company are resources transferred to the company under the condition that it will use them to purchase, construct or otherwise acquire fixed assets. Additional conditions may also be attached regarding the location of the assets or the periods during which they are to be acquired or used.

Funds, which are not related to assets, shall be considered as funds related to income.

Funds related to assets shall be presented in the balance sheet as deferred income, which is recognised as an income according to a rational and continual system which shall be applied for the period of the useful life of the asset. This way income from funds related to assets is allocated together with depreciation of the acquired asset.

Funds related to income shall be presented as obligations/borrowings in the income accounts, under a general heading "Other financial income".

All funds are described separately in the Appendices to the financial statements of the companies.

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Assets constructed for the purposes of connecting a Consumer to the network and paid for in full by the Consumer shall be treated as funds related to assets. They shall be recorded and presented separately.

Inventories

- a. Cost of Inventories (a eshte e nevojshme e gjithe kjo pjese?)

Definitions:

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of production cycle completion and the costs necessary to make the sale.

Formulas:

The cost of inventories of specific items that are not interchangeable and also goods or services produced and segregated for specific projects should be assigned by using specific identification of their own costs. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory, which are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on the net profit or loss for the period.

The cost of inventories, other than those dealt with in the previous paragraph should be assigned by using the weighted average cost formulas. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the weighted average of the cost of similar items purchased or produced during the period. The average cost may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the company.

The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of production cycle completion or the estimated costs to be incurred to make the sale have increased. The cost of written down inventories cannot be higher than their net realizable value.

Inventories are usually written off to net realizable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area. It is not appropriate to write inventories off based on a classification of inventory, for example, finished

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goods, or all the inventories in a particular industry or geographical segment. As a rule service providing companies accumulate costs in respect of each service for which a separate selling price will be charged. That is why each service is treated as a separate item.

2. Expenses Deferred pursuant to Regulatory Order

For pricing purposes the Regulator may ask the Licensees to treat (record and report) some categories of expenses in a way that differs from the way used by the financial accounting practice. In this case such expenses will be entered and reported as deferred regulatory expenses (placed in special accounts) and will be amortized/written down over a period of time. (These specific categories of accounts are usually excluded from the regulatory base.) Examples of such expenses are tariffing expenses, special research/study expenses and casualty related losses from uncontrollable circumstances like storms, floods, etc. In principle deferred regulatory expenses are unusual or one-time expenses.

Used and Useful Asset Test and Prudent Investment Test.

The Distribution Company has the obligation to ensure that only assets that are used and useful, and prudently acquired, are included in the regulated asset accounts. The Regulator has the right to determine whether an asset was actually put in service, for what period has it been useful and whether it was useful in providing the service indicated. If it proves that the asset does not satisfy the requirements the Regulator may decide to exclude the asset (fully or partially) from the regulatory asset base. This requirement is introduced to differentiate the set of assets needed to perform operations from excess capacity and consequently to satisfy prudent investment standards.

The Used and Useful Asset Test and Prudent Investment Test are used to determine whether the Licensee has exercised responsibility and strictness in the acquisition or construction of a particular asset based on the information it had and in light of the specific circumstances at the time of making the investment decision. If the asset fails to pass the test requirements the Regulator may decide to exclude it (fully or partially) from the regulatory base.

3. Assets Held for Future Use

Assets held for future use is the amount of assets that is not being used currently by the Licensee in the provision of service. In principle assets that qualifies for this category is limited to land and construction rights acquired by the Licensee. The time aspect of the acquisition plays an important role when deciding whether the property can qualify as asset held for future use. Assets held for future use may be included in the rate base only with the Regulator's approval.

C Accounting Assessments for Regulatory Purposes

4. Asset Valuation for Pricing Purposes kjo duhet te diskutohet dhe me konsulentin - do te ndjekim te njejtin parim dhe ne?

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The rate base in principle represents the value of assets used by the energy company in providing the related service. The Distribution Company is given the opportunity to earn a specified rate of return (established by the regulatory commission) on the price base.

The price base may be calculated under any one or a combination of the following accounting standards: historical cost, fair value, reproduction cost, or prudent investment. In the USOA, the Distribution Company shall follow the method established for the Distribution Company assets by the ERE. The Distribution Company shall propose to the Regulator the valuation method to be used for each asset. Asset valuations based on historical cost shall ordinarily be presumed to be appropriate. Where asset valuations are based on reproduction cost or fair value, the portion of the value above historical cost may, if ordered by the Regulator, be subject to amortization on a schedule different than the depreciation schedule for the historical cost of the asset.

Depreciation and Useful Life of Tangible Fixed Assets

Depreciation and useful life of Tangible Fixed Assets are regulated by the International Accounting Standards (IAS) and specifically addressed in IAS 16, where the following definitions are provided:

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable Amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Useful life is either:

- (a) The period of time over which an asset is expected to be used by the company; or
- (b) The number of production or similar units expected to be obtained from the asset by the company.

Historical Cost (acquisition price) is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

Residual Value is the net amount, which the enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Fair Value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Impairment Loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Carrying Amount is the amount at which an asset is recognized in the balance sheet after deducting the accumulated depreciation and accumulated impairment losses thereon.

IAS 16 also provides some recommendations on determining(defining) of “position of property” and assessing the useful life of assets.

Assessing the useful life of an asset:

- a) Some items of property, plant and equipment require replacement at certain intervals. Such items (components) shall be accounted for as separate assets because they have useful lives different from those of the items of property, plant and equipment to which they relate. Therefore, provided the recognition criteria are satisfied, the expenditure incurred in replacing or renewing the item is accounted for as the replacement or acquisition of a new asset and the replaced asset is written off;
- b) The depreciable amount of an item of property, plant and equipment shall be allocated on a systematic basis over its useful life. The depreciation method used shall reflect the pattern in which the asset's economic benefits are consumed by the enterprise. The depreciation charge for each period shall be recognized as an expense unless it is included in the carrying amount of another asset;
- c) The useful life of an asset is defined in terms of the asset's expected utility to the enterprise. The following factors should be taken into account to determine the useful life of an asset:
 - The extent to which the asset's capacity is used;
 - The expected physical wear and tear, which depends on operational factors such as the number of cycles for which the asset is used and the repair and maintenance program of the enterprise and the care and maintenance of the asset while idle;
 - Technical obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset;
 - Legal or other factors preventing the use of the asset, such as the expiry dates of related leases, licenses, etc.
- d) The useful life of an asset is defined in terms of the asset's expected utility to the enterprise. The estimation of the useful life of an item of property, plant and equipment is based on the experience of the enterprise with similar assets.
- e) The useful life of an item of property, plant and equipment shall be reviewed periodically (at least once every three years) and, if expectations for the useful life of the asset are significantly different from previous estimates, the estimate and the depreciation charge for the current and future periods shall be adjusted.

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- f) In addition to the requirements set in the previous section, adjustments shall be made in any moment of the life of an asset if it becomes apparent that the estimate of the useful life is inappropriate. For example, the useful life may be extended by subsequent expenditure on the asset, or following the company policy for maintenance and repair, which improves the condition of the asset beyond its originally assessed standard of performance. And vice versa, technological changes or changes in the market for the products may reduce the useful life of the asset. In such cases, the useful life and, therefore, the depreciation rate shall be adjusted for the current and future periods.
- g) The repair and maintenance policy of the enterprise may also affect the useful life of an asset. It may result in an extension of the useful life of the asset or in its faster wear and tear. Such policies may be encouraged by ERE through the method of revenue cap or price cap regulation. The adoption of such a policy does not negate the need to charge appropriate depreciation.

The Depreciation methods used by DC in the USOA shall be consistent with the IAS. The DC shall demonstrate to the ERE that it has complied with IAS principles. The ERE may require detailed justification of the assessment of the useful life, including statistical analysis supporting assessment, benchmarking, failure modes analysis, etc.

In estimating assets useful lives the DC can use (a) general guidelines obtained from manufacturers, vendors, procurers and professional or industry organizations, (b) information for comparable assets of other electricity distribution companies, or (c) internal information. In determining estimated useful life, DC also should consider an asset's present condition and how long it is expected to meet service demands. It is important, that such general information be adapted to DC specific circumstances. The following factors should be taken into account:

- Quality and technical specification: Similar assets may differ substantially in quality, and hence in their useful lives, because of differences in materials, design and workmanship. For example, a type SF6 110 kV breaker will not have the same useful life as a regular air-filled 110 kV breaker. Likewise, the materials used for paving purposes, the underlying base and coating, will affect the useful life of a highway.
- Application (expected level of use): The useful life of a given type of asset may vary significantly depending upon its intended use. For instance, the life of a motor vehicle used in customer service may differ from the life of the same type of vehicle used for general and administrative purposes.
- Environment: Environmental differences among DC service territories can have an important impact on the useful lives of their assets. For instance, the useful life of assets in the mountains is different from that of similar assets located in a temperate climate region.

The potential effect of each of these factors could be mitigated or exacerbated as a consequence of DC maintenance, repair and replacement policy. For example, the potential for transformer damage is increased if the transformer oil is not replaced regularly.

Estimating the useful life of an asset is not a one-time exercise. DC's need to monitor their actual experience with capital asset lives and make appropriate changes to estimated useful lives based upon that experience.

In practical terms Licensees shall submit to the Commission special reports titled "Depreciation Study" containing the estimates on projected parameters of the useful life and depreciation rates of the assets together with their annual reports. The Commission shall review and approve the estimates using as a reference the probable and residual useful life used by other participants in the industry. The approved parameters shall be used by the Licensees during the useful life of each asset.

The probable and residual useful life of each asset submitted by the applicants shall be considered untrue by the Commission if:

1. Estimates do not correspond to industry standards;
2. Estimates differ from international guidelines, or
3. Estimates are contrary to previous decisions of the Commission in similar cases.

The Commission may consider appropriate the proposals submitted by the applicants, even if one or more of the above-referred circumstances are present, as long as the parameters proposed are properly justified and defended.

In the context of tariff proceedings, the Commission may revise the probable and residual life of some assets, and, if applicable, adjust the depreciation rates.

5) Un-collectible Receivables (Bad debt)

A. Definition of un-collectible receivables

Un-collectible receivables shall be viewed as expense of selling on credit. The reason for that is that granting credit is considered an event that increases sales and revenues. The companies are often willing to incur bad debt losses that will prove un-collectible if the net effect to the business is increasing sales and profits. On the other hand the DC's are generally "forced" to sell on credit because of technical character of the operation, therefore DCs consider un-collectable receivables a needed sales cost.

Recording and reporting bad debt expenses under accruals accounting requires that the expense from bad debt be reported in the same accounting period as the revenue they are associated with.

The method used to record bad debt expense shall be referred to as “the allowance method of accounting for bad debt”. Besides satisfying the requirements of the accruals principle the allowance method, which involves an estimate of the bad debt also ensures that the accounts receivable are reported on the balance sheet at their net realizable value. Thus recording and reporting bad debt may be viewed as a normal end-period receivables adjustment entry.

B. Recording the bad debt expense

Receivables provision by the allowance method involves a contra asset account called Allowance for Sales Receivable. The book entry is recorded with a debit to the Bad Debt Expenses account and with a credit to the Allowance for Sales Receivable account. It should be noted that a contra asset account Allowance for Sales Receivable is used not only because it is always better to disclose the original amount of receivables but also because at the time of the adjusting entry the specific customer accounts and amounts in default are not known. Subsequently, customer accounts and amounts cannot be removed from the Accounts Receivable Ledger and therefore the controlling account for Accounts Receivable in the General Ledger (whose balance equals the total of all receivables recorded in the Accounts Receivable Ledger) cannot be credited with the bad debt total. Instead the Allowance for Sales Receivable account is credited. The credit balance of this account has the effect of reducing the Sales Receivable account to their estimated net realizable value.

On the balance sheet receivables appear as

Sales Receivable	xxxx,xx
Less Allowance for Sales Receivable	xxx.xx
Sales Receivable at Net realizable value	xxxx,xx

The different ways to produce an estimate of the bad debt are prescribed in section D. below.

C. Identification and writing off of a specific Sales Receivable account

When specific customer Sales Receivable accounts are identifiable as un-collectible they are credited against debiting with the Allowance for Sales Receivable account. Posting the credit entry to the customer’s specific Sales Receivable Account removes the amount of bad debt (writes the account off) from the Sales Receivable Ledger and therefore removes it from the General Ledger controlling account. Notice the following important moments: First, though a certain customer’s account writing off is treated as an expense, it is the Allowance for Sales Receivable that is debited. This is because the estimated total bad debt expense was previously recorded as an expense by receivables adjustment at the end of the period in which it occurred. Second, although the write-off removes the amount of account receivable from the ledgers it does not change the amount of net realizable value of accounts receivable (because the balance of the Allowance for Sales Receivable account is reduced by the same amount).

In the instances where the DC collects an amount that was previously written-off it shall make two accounting entries. The first shall reverse the original write-off and reinstate the customer’s account. The second shall record the collection of the reinstated account.

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D. Estimating bad debt

Income Statement method (Percentage of Sales)

The method assumes that there is a fairly regular relationship between previous period's sales and bad debt amount. This relationship is converted to a percentage and used to determine the year's bad debt expense.

Balance Sheet method (Percentage of Outstanding Receivables)

The method assumes that there is a fairly stable relationship between the age of outstanding receivables and bad debt. This relationship is converted in a series of percentages for the different age groups (30, 60, 90 and 180-day receivables) and used to determine the bad debt expense for the period as the sum of the un-collectible amounts calculated using these percentages. The percentage for each age group shall be based on statistical information. In general the percentage of un-collectible amounts increases with the age of the receivables.

This method is widely used and is considered more accurate. It must be noted, however, that it violates the accruals principle; therefore it is not recommended for monthly and quarterly statements.

The Distribution Company should clearly indicate what method it has used to record bad debt in its accounts. The Regulator may require the company to use a different method.

5. Working Capital

In general the working capital represents the capital investment provided by the owner during the interval between incurring expenses of providing service and receipt of revenues from customers.

The regulatory base shall include working capital in the form of a Working Capital Allowance (WCA) covering such elements as cash and minimum bank balances, materials, prepayments, and tax payments. The working capital allowance shall be enough to bridge the gap between the time when costs in providing the service are paid for and the time the utility is paid for that service.

The Licensee shall submit a study justifying his working capital requirements. The working capital allowance shall be determined based on the average amount of investor-financed capital (equity, borrowings or earnings retained in the business) necessary to finance the utility's working capital requirements. The DC shall propose to ERE its preferred method for calculating the WCA. The ERE may require a different method if the ERE

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concludes that the method proposed by the DC does not fairly represent the DC's working capital requirements.

The most accurate, and therefore the most complex method of determining working capital requirements is the so called performance of a lead/lag study. This is a comprehensive task conducted to compare the difference in the timing lead or the timing lag between cash inflows and outflows. The study requires detailed analysis of company expenditures to determine the time at which the enterprise actually must pay for its expenses and compares this with the time at which it receives payment for those expenses. The time difference under the lead and lag method is then multiplied by the average daily operating expenses to arrive at the required level of working capital for inclusion in the regulatory base.

An alternative to this method is to estimate the appropriate level of working capital using income statement and balance sheet information on the average level of inventory, the average daily level of expenses incurred by the Licensee (including operating, maintenance, administrative and general, taxes, etc.) and the interval between cash outflow and inflow.

The working capital allowance (WCA) is the sum of two components: Cash WCA and Materials and Supplies WCA. Cash WCA shall include Petty Cash WCA and Minimum Bank Balances.

Cash WCA is an estimate of the investor-supplied cash to finance the pre-defined Allowance for Utility Operating Costs (AUOC) in the period in which operating income is collected. The best way to determine Cash WCA is through a lead-lag study. The lead-lag study usually ignores the lag in recovery of non-cash expenses (depreciation, etc.) deferred taxes etc.

A lead-lag study will be performed in accordance with the following criteria:

- i The lead-lag study will use the cash method; all non-cash items, including but not limited to depreciation, amortization, deferred taxes, prepaid items, and return (including interest on long-term debt and dividends), will not be considered.
- ii Any unbiased method may be used in performing the lead-lag study.
- iii The payment order date or the invoice due date will be used for the lead-lag study purposes. In those cases where multiple due dates are offered by vendors/suppliers, the invoice due date is the date corresponding to the terms accepted by the DC.
- iv All funds received by the electric utility except electronic transfers shall be considered available for use no later than the business day following the receipt of the funds in any repository of the DC (post offices, branch offices, etc). All funds received by electronic transfer will be considered available the day of receipt.
- v For DCs the balance of cash and working funds included in the working cash allowance calculation shall consist of the average daily bank balance of all non-interest bearing demand deposits and working cash funds.
- vi The lead on income tax expense shall be calculated by measurement of the interval

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- between the mid-point of the tax period and the actual tax payment date of the DC.
- vii If the cash working capital calculation results in a negative amount, the negative amount shall be included in the regulatory base.

Petty cash WCA and Minimum Bank balance shall be added to the amount determined by the lead-lag study.

Materials and Supplies WCA shall include reasonable inventories of materials, supplies, and fuel held specifically for guaranteeing efficient operation of the DC in providing normal electric utility service. The Licensee shall bear in mind that any amounts of inventories, found by the commission to be unreasonable, excessive, or not in the public interest shall be excluded from the Materials and Supplies WCA.

When justifying the amount of inventories the Licensee shall take into account all inventory costs: carrying costs (storage and handling costs, insurance, property taxes, depreciation, and obsolescence); ordering costs (cost of placing orders, shipping and handling costs); costs of running short (disruption of production schedules and customer dissatisfaction).

6. Un-Audited Items

Whenever a financial statement is required by ERE, if it is known that a transaction has occurred which affects the accounts but the amount involved in the transaction and its effect upon the accounts cannot be determined with absolute accuracy, the amount shall be estimated and such estimated amount included in the related accounts. The utility is not required to anticipate minor items, which would not appreciably affect the accounts.

7. Cost Allocation

The methodology for classification of costs is in accordance with USOA. A major requirement is clear differentiation and financial separation of regulated from non-regulated activities of every energy company. USOA comprises the following costs classification:

- By functions
- By nature
- By groups of consumers
- By voltage levels

The methodology for classification of costs by functions in accordance with the functional expense accounts prescribed in the USOA shall be based on engineering, economical and statistical analysis. The electricity distribution company shall assign costs to certain services or certain rate classes, so as to secure that the total expense or a share of an expense is assigned to the related class. In the absence of detailed timesheets (tracking job

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costs) DC shall propose certain type of allocation of labor costs and shall be prepared to justify it to ERE.