

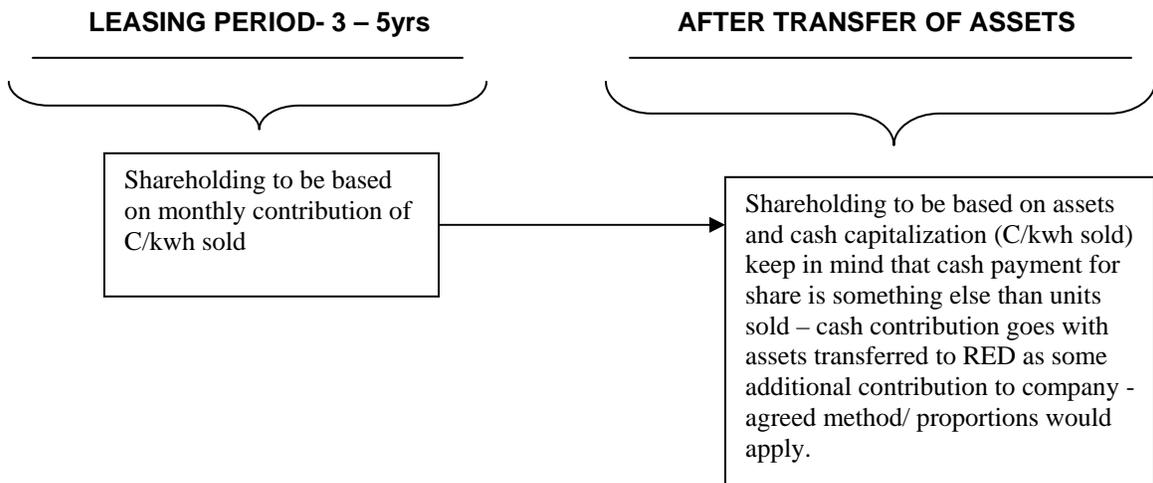
RED'S PROPOSED SHAREHOLDING FRAMEWORK

1. BACKGROUND

1.1 Formation of business organizations and Ownership agreements

The main three forms of business organizations are Sole proprietorship, Partnership and Corporations. The evolution of business organizations changed from one-person (one owner legal protection not needed), to two or more artisans pooling capital and skills together to defend and promote their interest (owners protected through a partnership agreement), to limited liability companies designated as juristic persons that could raise large amounts of capital to keep pace with increasing technology and mass production (protected through a shareholders agreements). These large amounts of capital could be raised through sale of shares on the stock exchange for listed companies, and sale of shares to owners for private-owned firms, whereby the owners agree on the basis of raising the required capital or assets for the company. The usual ways of acquiring share capital can be a combination or one of the following: *Capital contribution, Expertise contribution, and Assets contribution.*

The RED Companies are legal entities in terms of the Companies Act of 1973, are not publicly listed on the stock exchange, and therefore the stakeholders wishing to form the respective RED companies must agree on the shareholding of these companies. Such shareholding should be based on a value to be attached to the contributions given by the parties (i.e. see previous paragraph as to the type of contributions). It is often difficult to attach a specific value to a contribution in proportion to the contributions of other parties (i.e. expertise may be difficult to value in dollars and cents). Also, the parties may among themselves reach some agreement as to shareholding not entirely based on the actual monetary value of contributions (i.e. to avoid one party having a total majority shareholding). In this regard there are no prescriptive laws and it remains within the prerogative of the parties to agree on the value and % of shareholding. The following is a diagram depicting what may be incorporated into the shareholders agreements during the different phases.



1.2 Real Assets vs. Financial Assets

The wealth of any society is determined by the productive capacity of its economy - the goods and services that can be provided to its residents. This productive capacity is a function of the *real assets* of the economy: machines, land, buildings and knowledge that are used to produce goods and services. Therefore the *real assets* within an electricity supply industry are generators, transmitters, distribution networks and knowledge that are used to provide electricity to consumers.

In contrast to *real assets*, *financial assets* are shares/ stocks and bonds, which are no more than stock/ share certificates that enables owners to earn dividends or return on proportionate contribution of real assets, or proportionate capital contribution to that specific company. *Real assets* are income-generating assets, whereas *financial assets* are claims to the income generated by the real assets.

The Namibian Government (MME) through its Energy Policy Directive – June 2003, clearly realized the importance of the productive capacity of the energy sector when it prescribed that foremost RED's should be *asset based* – meaning it should own income-generating distribution assets. The Energy Policy Directive further acknowledged that should the RED's not own assets (in part or in full), proper agreements must be put in place between the RED and the asset owner that will ensure that the RED is responsible for operating and maintaining all distribution assets within its geographic area. The latter clearly indicates that owning distribution assets within a certain geographic area doesn't warrant automatic claim to financial assets in a RED Company especially during the initial operationalisation period of the RED Company.

1.3 Equity Valuation Models

In the process of valuing companies, analysts employ one of the following balance sheet valuation methods, or quantitative models to value common stock in terms of the firm's income stream as going concern. Ultimately the analyst interest will determine the appropriate approach.

1.3.1 Balance sheet valuation methods

- **Book value (net asset value)** – the net worth of the company as shown on the balance sheet, $NAV = \text{total stockholders equity} / \text{no. of outstanding shares}$
- **Liquidation value** – this represents the amount of money that could be realized by breaking up the firm, selling its assets, repaying its debt, and distributing the remainder to the shareholders.
- **Replacement cost approach** – what will it cost us to build such a firm from scratch? The replacement cost of its assets less liabilities.

1.3.2 Quantitative models

- Dividend discount models
- Intrinsic value versus market value
- Price-Earning ratio
- Free Cash flow approach
- Inflation and equity valuation

The above quantitative models are not applicable in valuing shareholding in RED's due to underlying complex assumptions, and the implicit notion of valuing assets' income stream as a going concern. The replacement approach from the balance sheet valuation methods would be applicable depending on the stakeholders' interest (as buyer of shares) and the Red Company (as a seller of shares).

2 BASIS OF RED SHAREHOLDING

The ECB, the regulator of the electricity industry, has identified the following attributes of current asset owners and prospective shareholders within RED Companies:

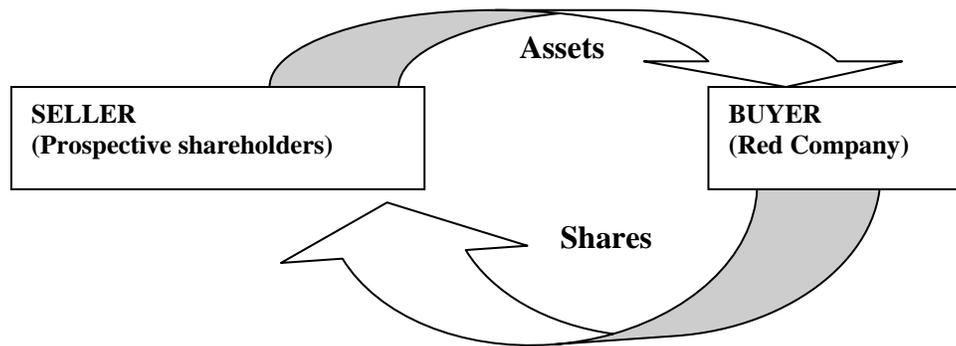
- ❑ Distribution assets are maintained at different technical standards
- ❑ New assets that are hardly depreciated (assuming depreciated asset values)
- ❑ Different life span of those assets (economic verses technical)
- ❑ Accounting principles underlying the asset valuation method (depreciated replacement values or full replacement values)

While assets form the basis for the generation of revenue streams it must be noted that the productivity of distribution assets - i.e their revenue generating capacity, varies considerably. Factors that influence distribution asset productivity in Namibia are:

- ❑ End-user tariffs
- ❑ Customer profile (urban/rural; domestic/industrial)
- ❑ Consumption patterns (load factors)
- ❑ Age of the assets and maintenance standards
- ❑ Cost of capital

Taking cognizance of the above factors, and the Namibian ESI regulatory environment the following diagram captures the overall RED shareholding framework, taking into account the interests of prospective **shareholders** and **RED Company**. Specifically the regulatory regime is predicated on rate of return methodology, entitling licensees to earn a regulated return on their distribution

assets. However this return is a function of the tariff that distributors charge for the electricity services they provide to customers. It is generally accepted that distribution tariffs do not reflect the cost of providing that service, and as such it would be impossible for distributors to earn an appropriate return. On the contrary most distributors (urban and rural) are operating at a loss.



The above diagram along with the following table is to justify ECB's recommended shareholding framework in RED's, which encompasses both weighted average of revenue (kwh sold) and assets.

Method mostly of interest	Assets valuation methods (as identified under 1.3.1)	Applicability/ not advisable
Sellers	Replacement value method	Applicable
N/A	Liquidation approach	N/A
N/A	Net asset value	N/A
Buyers & sellers	Income generating capacity of assets (Co.)	Applicable
N/A	Comparative approach (same assets)	Not advisable
N/A	Discount stream of cash flows	Not advisable

3 Recommendation

The ECB wishes to recommend to the RED stakeholders that the shareholding methodology in RED Companies should be based on weighted average of revenue (kwh sold) and assets. The accounting principles underlying the asset valuation method (depreciated replacement value or full replacement value) is recommended to be the replacement value, on the presumption that the assets would have to be replaced in the future not by the current owner but by the RED company (whereas the past depreciation expense remains with the current owner). This methodology is deemed by the ECB to be the most appropriate because it recognizes the investment in distribution assets the shareholders have made and the importance of these assets in generating revenues (without distribution assets there can be no income from electricity) while, at the same

time, by weighting assets with revenues cognizance is taken of the different levels of asset productivity in the Namibian ESI, particularly between urban and rural distribution assets. It is further recommended that the weighting be done on a 50/50 basis because each side of the equation is of equal importance as the other – i.e. revenues are as equally important as the assets that generated those revenues and vice versa.

In conclusion, the ECB is proposing a fair and defensible methodology from which the stakeholders can negotiate their shareholding in RED companies. The recommended framework is in line with the current regulatory regime and the ECB is optimistic that the stakeholders' negotiations would be mutually beneficial to all stakeholders as well as the envisaged RED company. Note that this is our preferred option and that it remains within the prerogative of the parties involved to determine what is most suitable and mutually acceptable to them.