STUCO

September 9, 2016

Authoriteit Consument & Markt (ACM)

RCN Building

Kralendijk, Bonaire

Caribbean Netherlands

Dear Ms. [redacted]

Following are some of our comments that we wish to summarize pursuant to:

1) Our review of the draft method for setting the rates for the production and distribution of electricity and drinking water in the Caribbean Netherlands
2) The work we are performing in designing a model for the new fee structure
3) Our review of the calculation of the WACC for energy and water companies in the Caribbean Netherlands
4) Ongoing conversations we have had on the same up to as recent as yesterday.

<u>Nominal and real WACC</u>

1. On page 19 of the document reference is made to a 5.85% WACC rate. This is following on an extensive analysis including benchmarking. While we appreciate the background work performed, we question whether this rate truly reflects the return an arbitrary investor in utilities in the Caribbean would expect. Investors in this area of the world tend to be conservative with respect to their expected returns as they weigh the risk of investing in small markets with limited capital market movements and with high incidences of national disasters (hurricanes) to be significant. The interest rates offered by lending institutions are reflective of this and are by large no less than 7% at this time. Investors generally expect better rates than the going rates on lending.

2. We have tried to recalculate the real WACC using the formula provided under chapter 8.2 on page 19, however, we were not able to arrive at the percentages in the table. Kindly clarify.

Nom WACC	Inflation rate	Real WACC	Calc WACC	Diff
5.85%	0.92%	4.66%	4.89%	-0.23%
6.22%	0.92%	5.02%	5.25%	-0.23%
5.85%	1.27%	4.29%	4.52%	-0.23%
5.85%	1.29%	4.27%	4.50%	-0.23%

Subsidy distribution network

From our discussion yesterday, we understand that the subsidy for distribution network should be applied against the capacity cost only. By extension this means that the full subsidy would be applied to the fixed capacity rate. Our understanding was that the subsidy for the distribution network was provided to mitigate the difference between the cost of electricity distribution charged to residence in European Netherlands and the cost charged in the Caribbean Netherlands. The discussion of fixed capacity rate and variable consumption rates is only of recent. Based on present indications in the model, if the subsidy for the distribution network is applied only to a capacity cost, the present subsidy will exceed the same which by extension means that the subsidy granted will be significantly lower in the future. With a loss making operation, we question how this can be justified.

We understand that a similar treatment is to be applied for the subsidy for water. Here too, the subsidy is likely to exceed the cost as most of the water assets are donated assets.

Insurance cost

Based on our conversation yesterday, we understood that insurance cost related to electricity and water assets are not to be included as capacity cost. Capacity cost therefore would reflect merely depreciation of none-donated assets. We view insurance cost as directly tied to the assets as they are not elective considering the region in which STUCO operates.

Fuel cost (1)

Because of the size, the item fuel cost is causing a disproportionate skew when distributing the total operational cost of electricity in the model (see row 24). As a result the distribution of allocated overhead cost is affected. We have therefore chosen to calculate the allocations using the direct operational cost excluding the fuel element. This approach also keeps the allocation method simple. Kindly let us know whether you think this approach would be acceptable.

WACC

We have discussed with you the question as to what basis the WACC should be applied against. Since the law is ambiguous about this, the alternatives discussed were:

1) The original value of the fixed assets
2) The book value of the fixed assets
3) The appraised value of the fixed assets

Taken from the point of view from an investor (which is a premise of the WACC document) we are of the opinion that the cost of the asset should be the basis on which the WACC rate is applied since an investor would expect to receive a return on his original investment (cash injection) as opposed to a return on a declining value of the asset (book value) as you have proposed.

General comments

In our meeting, we reiterated some general concerns that we expressed before:

Donated assets
You have confirmed that donated assets are to be treated as gifts and as such, depreciation cost on such assets are not allowed to be included in the capacity cost. By extension, these cost are not included in the rates charged to the customer. This means that STUCO is not allowed to build up a reserve for reinvestment in new assets once the related assets reached the end of their economic life. This matter concerns us as we are of the opinion that such a policy goes contrary to the principle of prudent management and by extension, good governance. We also would think that this policy goes against the intent of the Ministry which would expect that its investment would benefit the community of St. Eustatius for many years to come. Should STUCO not be provided the means to reserve resources for the purchase of new assets in the future and secure itself as a going concern, application for new investments at the end of economic life would be unavoidable. Kindly confirm if this indeed is the position of the Ministry.

Fuel cost (2)

According to the legislation the fuel cost adjustment will occur once, or at a maximum twice a year in the future. Up until now, fuel cost are charged to the client as a separate cost on the monthly bill and thus adjusted monthly. We are concerned that an annual or even bi-annual adjustment of fuel cost could have an enormous adverse impact on both the consumer and STUCO. Particularly in times of rising fuel cost, monthly adjustments serve to temper the effect on the consumer's budget and makes is easier to deal with increasing utility cost. By delaying for months even up to a year, the impact could be insurmountable in St. Eustatius. Conversely, for STUCO this also means that STUCO must carry cost increases for a longer period without reimbursement from the customer.

Large and distant connections

During our meeting we also discussed STUCO's concern of addressing request for large and distant connections.
Though these cases are now incidental, and of lower frequency, the concern was raised as we fear that the approach to the fee structure leaves very little room for the building up of reserves and by extension, seriously limits the ability of the Company to work in anticipation of the advancement of the St. Eustatius economy. In this regard we think of extensions to presently uninhabited areas on the island and extensions for new commercial connections in support of investments in the hospitality industry. Under the present structure demands by investors for upgrading or extension of large KVA connections must be funded up front by the investor themselves. Customers connecting on the upgraded facility at a later stage enjoy the benefit of the availability of the grid while the first customer actually paid for the connection. Needless to say, this is not a sustainable proposition. We look forward to your proposals on how STUCO should address this dilemma in the interest of the Company itself, the customer/investor and in the interest to support the economic development of the island in general.

Solvency/Going concern

We appreciate the philosophy behind the development of a rate structure that is equitable to the customer. We also appreciate the need for regulated control as espoused by the new legislation and by the ACM. However, given the fact that cost presently exceed revenues, we are concerned that the model which finds its basis in the cost, will generate chargeable rates that will be significantly higher than rates presently in effect on St. Eustatius. On the other hand, signals are that the Ministry foresees an end situation in which rates be lowered. We emphasize that this can only be realized by either a (structural) increase in subsidies or an expansion of the investments in cost reducing resources or a combination of both. Until such time that the two latter factors have been effected the likelihood of rate increases appear imminent.

I trust to have summarized the two points discussed and look forward to your comment on the same.

Yours sincerely,

Ing. Fred Cuvalay
Managing Director STUCO