

## I. Executive Summary and Diligence Background

This volume of the Study discusses Project Finance Advisor's (PFA) economic and business evaluation of ETESA's potential participation in a telecoms venture through an affiliate (the "Project"). The analysis incorporates conclusions drawn from other components of this study most notably the Legal Action Plan and the Market and Technical Assessment (the "Study").

Meetings conducted with ETESA in June and October 2003 underscored the need to fully understand the implications from entering the telecommunications ('telecoms') sector in some manner (the "Project"), and in such a way as to derive maximum value from use of its nationwide Rights of Way (ROW). The purpose of the Study is to help define how ETESA may enter the market or monetize its ROW in the most economic and feasible manner, given its organizational profile and needs.

In addition an economic model was constructed to measure Empresa de Transmisión Eléctrica's, S.A. (ETESA) profitability if it chooses to enter the telecoms sector by providing bandwidth capacity to domestic and international markets<sup>1</sup>. PFA has made a preliminary presentation of the economic results November 21, 2003 and some of the underlying assumptions in the economic review have been modified. This report incorporates the most recent version of the economic model and the recommendations derived from the use of the economic model. The analysis and its conclusions are discussed in Volume I of this report.

The economic model developed by PFA incorporates conclusions from other parts of the Study, and incorporates, to a limited degree, a market valuation of ETESA's Rights of Way (ROW).

In general, the Study had four related objectives which were the following:

- To provide an unbiased analysis of the economic feasibility for a nation-wide network based on a limited market review and line of business analysis;
- To provide a recommended project structure and market entry strategy for ETESA;
- To provide a set of cost-justified recommendations regarding the technology, architecture, configuration and coverage of the network; and,
- To provide a basis for ETESA to finance construction of the network with various sources of capital

The economic model and economic assessment address the two last topics while the Market and Technical Assessment addresses the first objective. To address the second objective, a coordinated legal and regulatory analysis was conducted by Piper Rudnick LLP in conjunction with Alfaro, Ferrer and Ramirez of Panama of issues that may arise from entering the market and how to best mitigate those concerns (the Legal Action Plan).

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<sup>1</sup> The Market and Technical Assessment indicates that ETESA would benefit from providing high bandwidth capacity (greater than 2 mbps) to several segments of the domestic market and, to a more limited extent, international demand. Pricing and market penetration rates over an initial five-year period are discussed more fully in the Market and Technical Assessment.

To perform the economic analysis multiple assumptions on a number of financial topics were made which may ultimately not reflect the structure or manner in which ETESA chooses to enter the market, but that are reasonable based on PFA's work to date. This volume discusses all of the assumptions used in the analysis in detail.

Although western style US GAAP statements have been provided to show the economic results of the Project, they do not constitute audited statements. It is strongly urged that ETESA retain a qualified accounting firm to verify treatment of certain assets and liabilities before it buys shares in an affiliate or enters into a joint venture to pursue the Project. Specifically, PFA's methodology uses a common "pooling" of interests between ETESA and the affiliate. Thus, costs that have been spent by ETESA to date and up to the point of the affiliate's incorporation as well as new costs that may be expended by the affiliate are combined into one set of financial statements. This was done to better evaluate the Project as a whole. In reality, the financial statements of the affiliate would reflect costs and assets it spends or acquires after its creation. The Legal Action Plan discusses various aspects of ETESA's regulatory regime in more detail and options for structuring the Project company.

With these qualifications in mind PFA believes that sufficient economic returns can be generated by the project to warrant a serious consideration for proceeding. PFA also believes that sufficient returns would exist for a partner to assume a management role for the network which is an organizational prerequisite for ETESA's participation.

PFA's primary conclusions from the analysis are as follows:

- The range of outcomes as measured by Internal Rate of Return and Net Present Value are strong over the first five years of operation
- Assuming that ETESA would own at least 34% of the affiliates shares<sup>2</sup>, the viability of the Project based on a cashflow analysis could range from 33% to a 66% Internal Rate of Return on an after tax basis<sup>3</sup>. Results of the financial analysis are organized around four growth scenarios (Low, Moderate, High and Moderate with a Fixed Payment to ETESA for ROW access).
- While a small percentage of its initial five-year revenue stream is based on international traffic these sales are critical to recognizing higher returns in the project. With limited international traffic, returns primarily from servicing domestic demand are still attractive. Servicing international traffic will depend on interconnections being built to Costa Rica and Colombia within the time frames in this analysis.

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<sup>2</sup> Share ownership percentages are discussed in more detail in this volume. A 34% ownership was based on the expected percentage of capital costs ETESA would bear to build the network with a partner. As discussed in November with ETESA, the value of prior contributions or the valuation of ETESA's Rights of Way (ROW) may increase share ownership in the affiliate.

<sup>3</sup> PFA has used a 30% corporate tax rate based on Marisol Alemán's comments from the November 21 meeting with PFA.

- The returns to the Project and its shareholders are highly dependent on the ability of the affiliate to borrow money in amounts and terms that are favorable. The Project is still viable under an “all-equity” funding scenario but such returns may be insufficient to attract investment by ETESA or a strategic partner.
- Capital costs that could only be rudimentarily estimated will strongly affect returns to the Project. However based on PFA estimates capital costs cannot be more than 40% higher before such returns may become insufficient to attract start up capital. Conversely, if capital costs are 10% to 20% less than expected, economic returns to ETESA are exponentially increased and could range to a 66% IRR over the first five years of operation.
- Simply measured in terms of profit that might be available to ETESA, the affiliate could generate cash on the order of 10% or greater of ETESA’s current profit from transmission services (EBITDA less required distributions of \$6.5 million per year to the government). For example using PFA’s baseline growth assumptions for revenue (the “moderate” case in the economic model), the affiliate could distribute almost \$17 million to shareholders. If ETESA owned 49% of the venture it could receive almost \$ 9 million in distributions for a relatively small cash contribution for completion of the network<sup>4</sup>.

**PFA recommends that ETESA proceed with efforts to clear any regulatory constraints barring its entry into telecommunications as per the Legal Action Plan. PFA also recommends that ETESA review the merits of the opportunity with its Board and if support is indicated proceed to the next steps of solicitation for a strategic partner through a competitive ‘bidding’ process as discussed with PFA in its November 21 meeting.**

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<sup>4</sup> Any cashflow estimate is contingent on a number of assumptions including costs, debt, capital costs and contractual arrangements with the affiliate. Such estimates should therefore be treated as preliminary and will need further refinement as the Project nears commercialization.