REPORT OF THE AUDITOR-GENERAL ON GEOTHERMAL DEVELOPMENT COMPANY LIMITED FOR THE YEAR ENDED 30 JUNE 2017

REPORT ON THE FINANCIAL STATEMENTS

Opinion

The accompanying financial statements of Geothermal Development Company Limited, set out on pages 35 to 78, which comprise the statement of financial position as at 30 June 2017, and the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information, have been audited on my behalf by PricewaterhouseCoopers, auditors appointed under Section 23 of the Public Audit Act, 2015. The auditors have duly reported to me the results of their audit and on the basis of their report, I am satisfied that all the information and explanations which, to the best of my knowledge and belief, were necessary for the purpose of the audit were obtained.

In my opinion, the financial statements present fairly, in all material respects, the financial position of Geothermal Development Company Limited as at 30 June 2017, and of its financial performance and its cash flows for the year then ended, in accordance with International Financial Reporting Standards and comply with the Companies Act, 2015.

In addition, as required by Article 229(6) of the Constitution, except for the matters described in the Emphasis of Matter section of my report, based on the procedures performed, I confirm that nothing has come to my attention to cause me to believe that public money has not been applied lawfully and in an effective way.

Basis for Opinion

The audit was conducted in accordance with International Standards of Supreme Audit Institutions (ISSAIs). I am independent of Geothermal Development Company Limited in accordance with ISSAI 30 on Code of Ethics. I have fulfilled other ethical responsibilities in accordance with the ISSAI and in accordance with other ethical requirements applicable to performing audits of financial statements in Kenya. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

Emphasis of Matter

I draw attention to the following matters:

1. Negative Net Current Assets

The financial statements of the Company reflect current assets of Kshs.7,532,217,000 against current liabilities of Kshs.7,715,570,000, resulting in a net liability position of Kshs.183,353,000. Unless this condition is reversed, the Company may find it difficult to service its short term obligations as and when they fall due.

2. Procurement of Rig Move Services

As reported in 2015/2016 report, the Company entered into a rig move service contract on 4 May 2011, for 12 rig moves covering a period of one year at a rate of Kshs.19, 550,000 per move of estimated 50 loads. The contract further provided, for prorated incremental charge levy where the loads per move exceeded 50 loads. The services were re-tendered in 2012 and re-awarded to the previous contractor in October 2012 for a period of two years or 40 rig moves on a need basis, at a price of Kshs.42,746,000 per move estimated to constitute 100 loads.

Amongst other clauses, the new contract provided for: constant payout rate when the load is 100 loads or below but prorated incremental payment for loads exceeding 100; constant payout rate when the distance covered is 11 kilometers or less but prorated incremental payments for distances exceeding 11 kilometers; and penalties on GDC in the event of delays occasioned by its staff at the rate of Kshs.50,000 per truck and Kshs. 160,000 per crane day but on the other hand, if the contractor was to cause the delays, he would only be liable to a penalty of 0.001% of the unit contract price, amounting to Kshs.427.

Further, as reported in 2016/2017 financial year, the above contract was investigated by the Ethics and Anti-Corruption Commission for possible irregularities. Consequently, the Company stopped using the contracted services, and the contractor threatened to commence legal proceedings for breach of contract. On 13 September 2016, GDC issued a notice to terminate the contract, following which the contractor put in a claim for Kshs.13, 350,000 for works done and Kshs.1, 025,904,000 for loss of revenue on the remaining 24 rig moves. The matter was subsequently referred to arbitration, with the contractor claiming Kshs. 3,334,125,195 for work done, loss of business and damages. The arbitrator, according to management, dismissed the claimant's claim save for a provable amount of Kshs 38,494,710. This legal suit has since been referred to the High Court by the claimant, who felt dissatisfied with the Award given by the Arbitrator. By the time of concluding this report, the matter was pending hearing at the High Court.

3. Unproductive and Abandoned Wells

The financial statements of the Company reflect Other Expenses amounting to Kshs. 1,574,206,000, as disclosed in Note 9. Included in these is Kshs.991,359,000 (2016: Kshs.876, 845,000), which relates to the cost of three unproductive and abandoned wells, written off during the year under review. Although, according to management, success rates for geothermal wells all over the world increase as more wells are drilled to provide surface information, the upward trend in the cost of unproductive and abandoned wells as well as the cumulative costs written off by the Company, are significant and requires review of the Company's technical evaluation and drilling processes with the aim of minimizing drilling losses.

4. Cost of Non-Productive Time

The Other Expenses of Kshs.1,574,206,000 disclosed in Note 9 to the financial statements include Kshs.125,390,000, relating to the cost of non-productive time (NPT) during drilling activities, which was written off during the year under review. According to Management, the causes of the NPT were mainly operational and part of the drilling program, as well as logistical delays, particularly the long procurement processes, attributable to delayed funding. Costs of NPT are avoidable costs which have increased the cost of drilling wells, and these costs should not have been incurred by the Company.

5. Corporation Tax and Related Penalties

GDC being a state corporation is required to comply with tax laws and other related regulations, including remission of taxes to Kenya Revenue Authority (KRA), as per the prescribed due dates. The statement of financial position reflects current tax liability of Kshs.2,409,858,000 (2016: 1,656,555,000), for the year ended 30 June 2015, 30 June 2016 and quarterly instalments due as at 30 June 2017. The financial statements further reflect other payables amounting to Kshs.1,435,486,000, as per note15, which include interest and penalties of Kshs.710,097,000 (2016: 405,572,000), arising from non-payment of income taxes. Although, according to management, the Company has requested for budgetary allocation by the National Treasury to enable it offset the liability, the liability is yet to be settled. The delayed payment of income taxes has exposed the Company to penalties and interest, which continues to increase with the continued delay.

6. Vesting of Olkaria Geothermal Wells

The financial statements reflect exploration and evaluation assets of Kshs.29, 610,870,000, as disclosed in note 18. Included in these assets are costs totalling Kshs.8,377,275,157 in regard to the drilling of 26 wells out of a total of 59, sunk using funds from the Government of Kenya. During the year under review, GDC sold steam worth Kshs.2,901,862,000 (2016 Kshs.3,160,664,000) from the 59 wells at Olkaria to Kenya Electricity Generating Company (KENGEN), and recognized it as revenue. However, as at 30 June 2017, only the cost of 26 out of the 59 wells, have been recognized in these financial statements, with the balance of 33 wells not recognized due to delay in completion of vesting procedures. According to management, this delay is due to challenges relating to some of the wells which are located on land used by KENGEN, to secure financing for their projects. Under the circumstances, it is not possible to confirm when the vesting of the wells will be completed.

My opinion is not qualified in respect to these matters.

Key Audit Matters

Key audit matters are those matters which, in my professional judgment, were of most significance in the audit of the financial statements.. There were no Key Audit Matters to report in the year under review.

Other Information Included in the Annual Report

The directors are responsible for the other information, which comprises the report of directors as required by the Kenyan Companies Act, 2015. The other information does not include the financial statements and my auditor's report thereon.

My opinion on the financial statements does not cover the other information and I do not express any form of assurance conclusion thereon. In connection with my audit of the financial statements, my responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or my knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work I have performed on the other information which I obtained prior to the date of this auditor's report, I conclude that there is a material misstatement of this other information, I am required to report that fact. I have nothing to report in this regard.

Responsibilities of Directors and Those Charged with Governance for the Financial Statements

The directors are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and the requirements of the Kenyan Companies Act, and for such internal controls as directors determine are necessary to enable the preparation of financial statements which are free from material misstatement, whether due to fraud or error. In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting assumption. The directors are responsible for overseeing the Company's financial reporting process.

The directors are also responsible for submission of the financial statements to the Auditor-General in accordance with the provisions of Section 47 of the Public Audit Act, 2015.

Those charged with governance are responsible for overseeing the Corporation's financial reporting process.

Auditor-General's Responsibilities for the Audit of the Financial Statements

The audit objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report which includes my opinion in accordance with the provisions of Section 48 of the Public Audit Act, 2015 and submit the audit report in compliance with Article 229(7) of the Constitution of Kenya. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISSAIs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit conducted in accordance with ISSAIs, I exercise professional judgement and maintain professional scepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, and for the purpose of giving an assurance on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If I conclude that a material uncertainty exists, I am required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of my audit report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities to express an opinion on the financial statements.
- Perform such other procedures as I consider necessary in the circumstances.

I communicate with the directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that are identified during the audit.

I also provide to the directors a statement that I have complied with relevant ethical requirements regarding independence, and communicate to them all relationships and other matters which may reasonably be thought to bear on my independence, and where applicable, related safeguards.

REPORT ON OTHER MATTERS PRESCRIBED BY THE KENYAN COMPANIES ACT, 2015

As required by the Companies Act, 2015 I report based on the audit, that:

(i) I have obtained all the information and explanations which, to the best of my knowledge and belief, were necessary for the purpose of the audit;

(ii) In my opinion, adequate accounting records have been kept by the Company, so far as appears from the examination of those records;

(iii) The Company's statement of financial position and statement of profit or loss and other comprehensive income are in agreement with the accounting records; and

(iv) In my opinion, the information given in the report of the directors is consistent with the financial statements.

FCPA Edward R. O. Ouko, CBS
AUDITOR-GENERAL

Nairobi

01 February 2018