

12 September 2006 – Public Hearing on Allowed Revenues

Comments and responses

Comments received are shown in *italics*. Responses and statements by ERO are shown in normal font.

Introductory remarks

- [ERO] Decisions are needed on who pays for non-technical losses and non-collection. ERO will write to MEF and MEM raising these issues and requesting a response.
- [ERO] KEK needs to develop appropriate internal transfer pricing arrangements and KEK and KOSST need to develop a process for settling transactions between them. A Transitional Market Working Group is addressing these issues. There is also a requirement for KEK to develop transitional agreements between mining, generation and supply.
- [ERO] It will also be necessary for KEK to adapt its customer-facing software to accommodate changes in the tariff structures.

Allowed revenues for KOSTT

- *[ERO] What is included in the metering recalibration cost allowance in opex?*
- [KEMA] Metering recalibration costs are separate from major new metering programme (included in capex).
- *[KOSTT] Does the calculation of maintenance costs take account of the agreed asset allocation between KOSTT and KEK, which differs from that used by Deloitte in their asset valuation? Does future asset revaluation impact on the calculation?*
- [KEMA] The calculation takes into account the agreed allocation. A further review will take place of the asset base prior to the implementation of the next price control period. The asset base used for the maintenance calculation is determined on a different basis to the asset base used for accounting purposes and revaluations of the latter will not affect the former.
- *[ERO] Please explain the large increase in network capex from 2006 to 2007.*
- [KEMA] These allowances are KOSTT's projections of future infrastructure capex requirements.
- *[KOSTT] The calculation of the purchase price for technical losses originally used €40/MWh. Why has this now been reduced?*
- [KEMA] The original calculations used forecast wholesale market prices (calculated on a simulated competitive market basis). These have now been

revised to take account of proposed allowed revenues for KEK Mining and Generation and the resulting assumed purchase costs from domestic sources. This does assume that KOSTT can enter into a direct agreement with KEK Generation to purchase at this price. KOSTT is protected by the provision for ex-post corrections for differences between the allowed and actual average power purchase price.

- *[ERO] The proposed allowed power purchase price of €21/MWh seems too low.*
- [KEMA] This is the best estimate of this stage, based on the allowed revenue calculations.
- *[Fiscal Affairs Office] Where will capex funds that do not come from donors be raised from?*
- [ERO] KOSTT will need to seek commercial financing.
- *[Fiscal Affairs Office] Is it reasonable to assume that KOSTT can borrow next year?*
- [ERO] We believe so. If the Government does not believe that KOSTT (and KEK) cannot operate commercially, then it should not have established them as commercial corporations.

Allowed revenues for KEK

- *[ERO] Why is the overheads cost allowance for KEK Mining increasing over time?*
- [KEMA] Review has concentrated on significant cost elements (maintenance and staffing). Not reviewed overheads costs in detail.
- *[KEK Generation] It's unclear why Kosovo A4 is only shown as operating from 2010. It is expected to start generating from end-2006.*
- [KEMA] KEK have advised that Kosovo A4 will only commission in 2010 following rehabilitation. An EOI seeking private investment was only issued last week.
- [ERO] This assumption is related to the capital expenditures for rehabilitation, It is possible that Kosovo A4 may operate at limited levels of output prior to 2010.
- *[KEK Generation] Please clarify what is included in operational expenses for KEK Generation.*
- [KEMA] These will include all non-lignite and non-maintenance costs.
- *[KEK Generation] Does the calculation take account of the recent addition of a further 87 staff?*
- [KEMA] The projected operational expenses were provided by KEK This will need to be clarified internally within KEK.
- *[KEK Distribution] The maintenance allowances for KEK Distribution are too low given its poor condition.*
- [KEMA] We are aware of the need for large increases in maintenance expenditures. The same principles in calculating the maintenance allowance have been applied as for KOSTT. This includes trending in an increasing maintenance

- allowance rather than immediately moving to international levels, recognising affordability concerns. We fully support the argument that a higher allowance is required, if this would be affordable.
- *[ERO] Why are overheads for KEK Supply so low in 2009?*
 - [KEMA] These projections are provided by KEK. The supply business would be expected to be a small business with very low overheads and the general trend of costs is downward over the period, consistent with this. We have supported the projected high staffing cost recognising the need for adequate staff numbers to improve collection rates. This is also reflected in the high staffing costs allowed for KEK Distribution.
 - *[ERO] Why is there a large increase in costs between 2005 and 2006?*
 - [KEMA] For both KOSTT and KEK, the reported costs for the first six months of 2006 were taken as actual expenditure and converted to a twelve-month basis using projected expenditures for the following six months. These are further uncertainties resulting from outstanding questions relating to the allocation of costs between KOSTT and KEK. These costs have not been reviewed and are shown for information purposes only. Any questions regarding them should be addressed to KEK and KOSTT.
 - *[KEK Generation] Why are projected KEK Corporate costs decreasing over the period?*
 - [KEMA] These are our assessment of appropriate costs for KEK and are not KEK projections. These costs include functions such as HR, Treasury, Marketing. Allocating costs between KEK's divisions has proven difficult and we have worked closely with KEK on agreeing the allocation. Our analysis is that the projected KEK Corporate costs are too large for the size of business. Their current level reflects KEK's historic structure as a single integrated entity rather than one excluding KOSTT and organised on a divisional basis. The successful establishment of KOSTT has shown that increasing the functions undertaken at divisional level can be expected to significantly reduce corporate costs. We have therefore proposed a declining allowance for KEK Corporate costs over the period and assumed a shift to a more efficient divisional arrangement.
 - *[KEK Generation] Do these proposals assume the engagement of further management contractors, such as ESBI?*
 - [ERO] It is not our role to determine whether management contractors are required or not. It is our policy not to allow any additional costs associated with such contractors through to customers and to expect them to be internally financed by KEK from any resulting efficiency savings.
 - *[KOSTT] The overheads allowance for KOSTT is assumed to include all KOSTT's corporate functions, while that for KEK Distribution only relates to services not provided by KEK Corporate. However, KOSTT's overheads allowance is only €1.6 million while, for KEK Distribution, it is €4.8 million and KEK Corporate it is €4.4 million, a total of €9.2 million.*
 - [KEMA] The focus has been on maintenance allowances. It's inappropriate to compare proposed cost allowances between KOSTT and KEK Distribution as

their circumstances are different and the comparison is sensitive to the assumptions made on the allocation of costs between KEK's different divisions.

- *[KEK Generation] KOSTT has a larger maintenance allowance than KEK Generation. Is this realistic?*
- [KEMA] The assessment has been undertaken using the data submitted by KOSTT and KEK, further discussions with the consultants supporting KOSTT and international benchmarking to review the needs of each division on a stand-alone basis. There is no contest between KEK Generation and KEK Distribution for allowed revenues. For KEK Generation, the decline in the maintenance allowance takes account of the completion of major expenditures on Kosovo B and the transfer of future rehabilitation and refurbishment costs to capital expenditures. This conforms with the expectation of KEK (demonstrated by the recent EOI) that new rehabilitation of Kosovo A will be undertaken by external private investors.
- [ERO] It should also be recognised that KOSTT has assumed new responsibilities and these will impact on its revenue requirements.
- *[ERO Customer Protection Dept] What happens if the Government will not cover non-technical losses?*
- [ERO] The cost of these losses is about €20 million. This is less than the sum already set aside by KCB to cover the costs of imports.
- *[ERO Customer Protection Dept] What about the costs of subsidies to vulnerable customers?*
- [ERO] This is a different issue and a separate allowance will be made for this.

Average tariffs

- [ERO] It is ERO's position that 'good' customers should not pay the costs of theft and failure to pay bills of 'bad' customers.
- [ERO] Over the next few weeks, ERO will discuss with MFE and MEM the fiscal options available to fund the costs of non-technical losses and non-collection and will take a final decision on allowances for these based on the outcome of these discussions.
- [ERO] Our consultants have estimated that an affordable tariff level in Kosovo is around €c 5.67/kWh and this will be a guide in our decisions.

Meeting closed at 12.35pm