



EUROPEAN UNION

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Blueprint for the Restructuring of the Transmission Functions

ERO's Position Paper

As a general principle, our opinion is strongly in favour of a “for-profit”, asset-owning entity, working within a regulatory structure that gears profits to performance. International experience has demonstrated that such organisations are best suited to enhance the existing transmission system and to capitalise on new technologies, that will create still greater operating efficiencies and cost reductions, under a well conceived incentive regulation scheme. The results hold the promise of sizeable welfare benefits to all market participants and to society at large. On the other hand the transfer of control - but not ownership – to an agency with little incentive to maximize return on those assets, makes little sense from a business perspective. The synergies achieved through the ownership, planning, operation & maintenance and optimisation of assets (and implicitly through which the optimisation of ancillary services and losses is also achieved) are lost, when command & control rules are in place in order to regulate a non asset-owning entity that is planning and operating the assets of somebody else. It goes of course without saying that the planning decision must be surrendered to the TSO in any case, as the asset-owning “mother company” affiliated with generating interests may not wish to expand the grid because doing so will increase competition against their own generators, reducing their generation profits more than the increase in profits from an expanded transmission enterprise.

However the appropriate model of structure for a TSO can only succeed with the right kind of regulation. Cost of Service (Rate of Return) regulation is the wrong kind. “Independent” means the TSO is not owned or controlled by generating companies or others, while “Own and Operate” means the TSO has the ability to balance operating improvements against physical improvements and to choose the most economical combinations; it means the company has the responsibility and ability to plan and execute construction programs. “Incentive based” regulation means that the customers can expect a set trajectory of prices over time and the transmission company benefits when it can run more efficiently and loses out when it runs less efficiently. Under cost of service (RoR) regulation, if new line cannot be sited, there is not much incentive for a TSO to improve the volume of flows and operation through for example the installation of FACTS, as there is not going to be any return on such investment. Under Incentive based regulation however the pricing system can include a charge on the volume that goes through the system i.e. reward increased efficiency of effectively the same assets. Some technological innovation requires software rather than hardware. Software development however fits badly into the regulated framework (if RoR). It is not immediately evident if such software programme successful or not, will be included into the rate base. Under Cost of Service Regulation TSOs, make their decision not on the basis of the optimal economic or operating solution but rather on the basis of which investments they can most easily recover within the regulatory context. To conclude this aspect of analysis, in the face of lack of competition (as is the case of natural monopolies like networks), RoR regulation has distinct disadvantages, the major one being that it has no

explicit means of motivating the regulated company to invest or operate more efficiently, because in theory the system passes all cost increases and operating savings, on to customers.

Under Incentive based Regulation (or price cap regulation) the regulator sets the initial price for a period of years and then does not care how much profit an efficient utility earns as long as prices remain under control, and usually allowed to increase at a rate lower than the inflation. Thus with predetermined prices utilities can only cut operating costs, reduce spending and/or sell more output, in other words increase their efficiency. You cannot easily apply Incentive Based Regulation to a non asset-owning entity, which has no ownership in the investment process or in the benefits derived from it. Tariffs cannot specify penalties for poor performance, as there is no equity at risk.

Having set above the theoretical blueprint of an “ideal” regulated network operator, it is indeed proper to analyse it within the realistic context of the current situation in Kosovo, and KEK more specifically.

We identify two major problems in the complete separation of the TSO (including ownership of assets) from KEK.

- 1) In order for the above-described structure to realise those benefits, a considerably sophisticated Management must be in place and more important to have in place the procedures and tools to increase efficiency through sophisticated “soft” measures.
- 2) The financial position of KEK will be further deteriorated by divestment of assets, leaving it in a weakened position to raise capital in the future through corporate financing.

Another option is to form a holding company that owns the shares of the remaining Utility (KEK) and the new TSO. Moving the ownership of the transmission subsidiary from under the utility to under a holding company more clearly separates the transmission company from the operating utility, financially and managerially. The new entity might improve the debt capacity of the newly formed holding company as a result of the greater visibility the newly separated transmission entity would have. As a drawback however this arrangement obviously brings into question the independence of TSO.

In conclusion we consider necessary further investigation in order to demonstrate a comparative analysis of all the alternative structures as justification to the final proposed blueprint model for the establishment of the TSO of Kosovo.