ZYRA E RREGULLATORIT PËR ENERGJI
ENERGY REGULATORY OFFICE
REGULATORNI URED ZA ENERGIJU

Third Electricity Tariff Review 2009 – Consultation Paper

3 March 2009

DISCLAIMER

This Consultation Paper has been prepared by ERO in order to obtain comments and views from stakeholders. It is not a decision document and should not be considered to represent a decision by ERO.

Adresa: Rr. Hamdi Mramori nr. 1, 10000 Prishtinë, Kosovë
Tel: 038 247 615 lok.. 101, Fax: 038 247 620, E-mail: info@ero-ks.org, web: www.ero-ks.org

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1 Introduction

The Energy Regulatory Office (ERO) is currently conducting its third review of retail electricity tariffs to be charged by KEK JSC[1] and transmission charges applied by KOSTT JSC[2] from 1st April 2009. The review covers both the level of allowed revenues to be recovered by KEK and KOSTT ("the licensees") in 2009-10 from regulated tariffs and charges and the structure of those tariffs and charges.

ERO received final tariff applications from KEK and KOSTT on 18th February 2009. This paper sets out ERO's views on these applications and proposals on the new tariffs to take effect from 1st April 2009. Comments on these proposals and the applications are invited from stakeholders. Comments will be accepted until 13th March 2009, and will be considered by ERO in reaching its final decision. Comments on these proposals will be accepted until 13th March 2009 and should be sent either by email to ero.pricing-tariffs@ero-ks.org, with the subject line "ETR3 Comments", or in written form to the address indicated on the cover, marked for the attention of "Pricing and Tariffs Department".

At this stage, ERO has taken no decisions on the tariffs which will be approved. The proposals in this paper should be considered to be preliminary only, and are provided as a basis for comment.

2 Approach

ERO's approach to reviewing the applications has been as follows:

- ERO initially verified that the calculations of allowed costs and revenues in each application conform to the methodology and accompanying revenue model issued by ERO. Where this was not the case, ERO made corrections to the applications. The most significant changes were required in the calculation of depreciation provisions and returns for KEK.

- In conformity with ERO's methodology, adjustments were then made for differences between actual and allowed capital expenditures in 2009, for differences between actual and allowed volumes of transmission losses purchased by KOSTT and to compensate for the delay in effectiveness of new tariffs in 2008, which resulted in the previous tariffs continuing to be applied in April and May of that year.

[1] For conciseness, in the remainder of this Paper, references to KEK JSC omit the JSC, and similarly for KOSTT.

[2] The independent owner and operator of the electricity transmission system in Kosova and the operator of the wholesale electricity market.

- Following these adjustments, ERO has then carefully reviewed each element of the applications submitted. The review has considered the reasonableness of the requested revenues. This review has led ERO to make adjustments in the following areas:
  - Assumed import and export costs
  - Assumed asset lives
  - Allowed transmission and distribution losses for KOSTT and KEK respectively
  - Allowed maintenance expenditures for KOSTT
  - Allowed personnel expenses for KEK and KOSTT
  - Allowed materials and services expenses for KEK's Headquarters division.
  - Inclusion of bad debts and working capital for KEK

These various adjustments are summarized below.

3 Adjustments for differences between actual and allowed expenditures

ERO's tariff methodology establishes that licensees are expected to complete all investments for which allowances have been made in regulated tariffs. This recognises the importance to Kosovo of these investments. Where this is not the case, ERO adjusts allowed revenues in the subsequent period downwards to recover depreciation provisions and returns associated with capital expenditures that were allowed but not made in the preceding year. This adjustment has been applied to the applications submitted by KEK and KOSTT. The effect is to reduce allowed revenues by approximately €7.9 million for KEK and by a small amount for KOSTT.

ERO also made a small adjustment of approximately €0.1 million to compensate KOSTT for additional transmission losses that it was required to purchase in 2008 relative to allowed levels, as a result of higher than expected energy volumes using the transmission network[3].

Lastly, as set out in its decision last year, ERO increased allowed revenues for KEK and KOSTT to compensate for the difference between allowed and actual revenues in April and May 2008 resulting from the delay in new tariffs taking effect. This added approximately €0.5 million to KEK's allowed revenues for 2009 and €0.25 million to those of KOSTT.

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[3] The adjustment only compensates for changes in transmission volumes and does not compensate for any change in losses resulting from differences between the allowed loss rate (in %) set by ERO for 2008 and that actually achieved by KOSTT.

The net impact of these adjustments and the corrections to the calculations of allowed revenues in the tariff applications is to reduce total allowed revenues by around €5 million.

4 Adjustments following review

While ERO's review of the applications covered all elements, only those where significant amendments are proposed by ERO are discussed below. While ERO has not proposed amendments to the capital expenditures contained in the applications, ERO would like to draw the attention of licensees to the need to deliver on the planned investment programmes in order to avoid large compensating deductions being made from allowed revenues in 2010. ERO will also continue to monitor the ability of KEK and KOSTT to deliver on the proposed investment programmes given their failure to do in 2008.

ERO also notes that it has not, at this time, proposed amendments to the allowed cost of capital, maintaining this at 13.8%, given the uncertainties around the impacts of the ongoing global financial crisis and how this will impact on financing costs in Kosovo. European Central Bank interest rates have been heavily cut and further reductions are likely, which will tend to reduce financing costs. However, these reductions may well be offset by the increasing costs of raising finance for emerging markets.

4.1 Assumed import and export costs

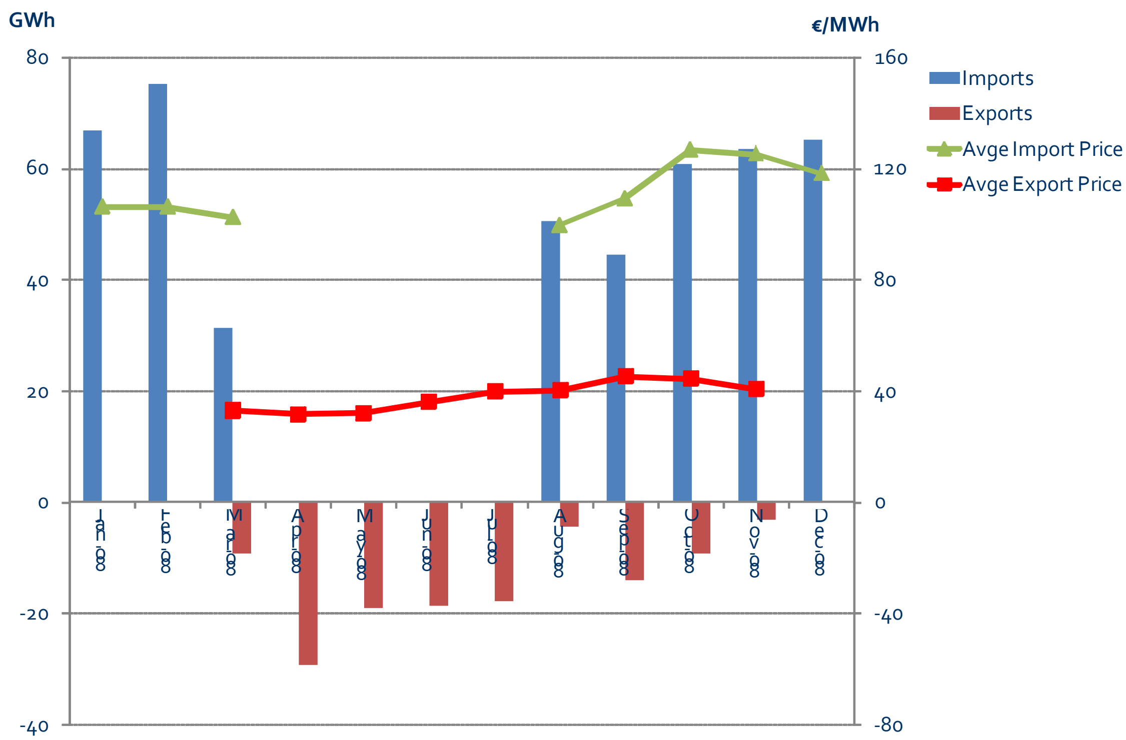
In their application, KEK has assumed that it will need to import 521.5 GWh in 2009, at an average price of €125/MWh. KEK has also assumed that it will export 182.5 GWh at an average price of €45/MWh.

In 2008 and previous years, KEK has met part of its import needs through short-term energy exchanges arranged at little notice in response to changing system conditions. We expect that it will continue to do so, although the volume of these exchanges is unknown given their ad hoc nature. The cost of these exchanges is effectively the production cost of electricity in Kosovo adjusted for the 'exchange rate' (the ratio between exports and imports under energy exchanges). This cost will be far below the cost of contracted imports[4].

For comparison, the cost of imports as reported by KEK in 2008 averaged €112.5/MWh, increasing towards the end of the year as shown in Figure 1, below. The price received for exports averaged €36.6/MWh.

[4] It is not possible to replace contracted imports with energy exchanges, as the latter are not firm and may not be available when imports are required. They are generally provided as part of co-operation between neighbouring systems to manage short-term situations and are not expected to provide continuing imports to meet base demand.

Figure 1: 2008 imports and exports



Notes:
Exports are shown as negative imports.
Exchange trades are not included in the above figures.

For the last quarter of 2008, KEK reported its average cost of imports was €123/MWh. At that time, the average cost of baseload power on the European Energy Exchange (EEX), the main EU benchmark, was €68/MWh[5]. In mid-January 2009, baseload spot prices on EEX have averaged €65.5/MWh. Assuming the same relationships hold, this would imply that import prices would be around €120/MWh, although this figure might be expected to decline as the gas supply difficulties resulting from the Ukraine-Russia dispute ease, the weather warms and the ongoing economic difficulties impact on demand. For 2010, the most recent settlement prices for EEX Pelix futures are €53.4/MWh for baseload (or around €108/MWh if previous Kosovo price relationships to EEX hold).

Taken together, the evidence on the role of energy exchanges and on EEX prices suggests that KEK's projected average import price for 2009 of €125/MWh appears somewhat excessive. ERO, consequently, proposes to adjust the allowed import price downwards to €112.5/MWh, equal to the realized average import price in 2008. This leads to a reduction in allowed revenues of €6.5 million.

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[5] Average of Phelix baseload prices. Data available from www.eex.com.

4.2 Assumed asset lives

In its application, KEK has proposed reductions in the asset lives used for determining depreciation provisions as follows:

- Mining – a reduction from 35 to 16 years (matching the proposed reduction in generation asset lives).
- Generation – a reduction from 30 years to 16 years.
- Networks (Distribution) – a reduction from 40 years to 30 years.
- Supply – no change from the current 5 years.
- Headquarters – a reduction from 8 years to 5 years.

Reducing asset lives will increase the present value of depreciation charges but reduce the present value of returns (as assets will be fully depreciated earlier). The present value of the sum of depreciation charges and returns should remain unchanged. A reduction in asset lives will, therefore, tend to increase allowed revenues and tariffs in earlier years while offsetting this by reducing tariffs in later years.

ERO understands that KEK's proposal is based on its expectations of the useful (economic) lives of each group of assets. ERO agrees that it is appropriate to link asset lives used for depreciation purposes to their useful, rather than technical life. However, ERO does not accept all the changes proposed by KEK.

ERO's proposed amendments to asset lives are as follows:

- Mining – no change. ERO considers that mining assets will continue in service to supply the New Kosova power plant following the closure of Kosovo A and B power plants.
- Generation – a reduction to 16 years, matching the retirement date of Kosovo A and B power plants. This is subject to confirmation of the expected retirement dates of these plants. ERO notes that, previously, KEK has indicated that these plants would retire in 2027 (ie, in 18 years time).
- Networks – a reduction to 35 years, matching the assumed asset life for transmission assets, for reasons of consistency.
- Supply – no change.
- Headquarters – a reduction from 8 years to 5 years for consistency with the assumed life of supply assets.

This leads to a total proposed reduction in allowed revenues across KEK and KOSTT of approximately €2 million.

4.3 Allowed losses

Both KEK and KOSTT have requested increases in the allowed losses to be recovered from regulated tariffs. KEK has requested that allowed non-technical (commercial[6]) losses are increased to 22.7% compared to the level of 20% allowed in 2008 and the reported actual level of 25.8% in 2008. Allowed technical losses requested for 2009 are 17.1%, equal to the reported actual level for 2008 and slightly below the level of 17.4% allowed for 2008. KOSTT has requested allowed transmission losses of 4.6%[7], equal to the actual level for 2008, compared to a previous allowed level of 3.9% in 2008.

ERO's view is that losses on the transmission and distribution networks should not be expected to increase. Ongoing investment programmes, the costs of which are provided for in allowed revenues, should be expected to reduce losses. While there may have been delays in implementing these programmes, this is the responsibility of licensees and the impacts of these delays should not be recovered from customers.

Given this, ERO proposes to set allowed losses equal to the levels allowed for 2008 (ie, a total of 37.4% for KEK and 3.9% for KOSTT). This represents a reduction in requested losses for both KEK and KOSTT.

4.4 Allowed maintenance expenditures for KOSTT

In 2008, allowed revenues for KOSTT included provision for maintenance expenditures of €6.5 million. In actuality, KOSTT only spent €2.7 million[8]. For 2009, KOSTT has requested an allowance of €5.1 million.

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[6] Non-technical losses are those losses that cannot be attributed to resistance in lines and transformers used to transport electricity (these technical losses occur in all systems, although their level increases on badly maintained and near-capacity networks). Non-technical losses result from theft, metering problems and billing errors.

[7] For consistency with the Market Rules, KOSTT's allowed losses are expressed as a Transmission Loss Factor (TLF) rather than a percentage loss allowance. The latter is used here for ease of understanding. The loss allowance can be converted to the TLF using the following formula: *1 / (1 – loss allowance in %)*.

[8] This includes €1.6 million of expenditures that were subsequently reclassified from maintenance to capital expenditures. In adjusting for differences between allowed and actual capital expenditures in 2008, ERO has taken into account this reclassification.

ERO is concerned that KOSTT will again fail to spend the full requested allowance. Therefore, ERO proposes to reduce the maintenance allowance to €3.9 million, or the approximate average between requested expenditures in 2009 and actual expenditures in 2008, representing a reduction in allowed revenues of €1.2 million. This still represents a significant increase on actual expenditures in 2008. ERO will monitor closely KOSTT's actual expenditures against this allowance.

4.5 KOSTT personnel expenses

The application submitted by KEK shows an increase in total staffing numbers to 7,899, which is 365 above those allowed in 2008 and 390 above actual 2008 staffing levels. ERO finds it difficult to understand why such a large increase is required.

Given this, ERO proposes to cap allowed staff numbers at the levels allowed in 2008[9]. ERO will also investigate the reasonableness of current staffing levels further—in particular comparing them with staffing levels at regional comparators.

ERO notes that KOSTT's tariff application proposes significant increases in average personnel expenses from the levels allowed in 2008, of around 11%. This appears excessive. It exceeds the increase in average personnel expenses at KEK, even though KOSTT's personnel expenses per employee are already significantly higher than those of KEK. KOSTT's application also shows an increase on the staffing levels allowed for 2008, which were set at KOSTT's expectations of long-term staffing requirements.

ERO, therefore, proposes to cap the increase in allowed average personnel expenses for KOSTT at the same level as those for KEK, and to similarly cap staffing levels at the 2008 allowed number.

The resulting total reduction in allowed revenues is around €2.5 million.

4.6 KEK Headquarters materials and services expenses

In its application, KEK has requested €3.2 million in materials and services expenses in its Headquarters division. For comparison, allowed expenses in 2008 under this category were €0.6 million and actual expense around €1 million.

Such a large increase in requested expenses appears unreasonable. As with KOSTT's requested maintenance expenditures, ERO has, therefore, allowed a sum broadly equivalent to the average of actual expenditures in 2008 and those requested for 2009 of €2.1 million. This represents a reduction in allowed revenues of €1.1 million

[9] In some cases this leads to allowed staff numbers for individual businesses exceeding those proposed by KEK. These cases are more than offset by those cases where allowed staff numbers are below those proposed.

4.7 Bad debts and working capital

The application submitted by KEK includes a requested provision of €3.2 million for bad debts and €0.7 million for the costs of financing working capital through short-term loans. In accordance with its tariff methodology and preceding decisions, ERO proposes to disallow both these costs. It has been previously determined that the costs of collection losses, including bad debts, should not be recovered from those customers paying their bills. With respect to working capital costs, in its decisions on allowed revenues, ERO already provides for a supply margin which includes the recovery of these costs.

Together, these result in a reduction in allowed revenues of €3.9 million.

5 Summary of allowed revenues

A comparison of allowed revenues is provided below, showing:

- Allowed revenues as approved by ERO for 2008
- Requested allowed revenues for 2009 as contained in the tariff applications submitted by KEK and KOSTT
- Allowed revenues for 2009 following corrections and adjustments for over and underspends in 2008 applied by ERO
- ERO's proposed allowed revenues for 2009, following application of the further adjustment described above.

Following these various adjustments, ERO's proposal is that allowed revenues will increase by 2.5% between 2008 and 2009, compared to the requested total increase of 18.3% submitted by KEK and KOSTT.

This proposal includes the subsidy of €42 million to be provided by the Government of Kosovo to KEK. This subsidy has a very substantial impact in reducing the revenues to be recovered from regulated tariffs. If it was not provided, allowed revenues would need to increase by more than 30%, even following the reductions applied by ERO.

Table 1: Allowed revenues summary

Regulated tariff revenues		2008 Allowed	2009 Requested	2009 Corrected	2009 Proposed
KEK (excluding cross-charges / including HQ costs)					
Mining	€000s	46,324	59,397	53,506	50,309
Generation	€000s	37,692	41,953	43,404	42,226
Network	€000s	24,298	24,823	24,832	23,446
Supply	€000s	16,866	22,062	21,776	12,108
Sub-total	€000s	***125,180***	***148,235***	***143,517***	***128,089***
KOSTT (excluding cross-charges)	€000s	11,290	13,251	13,223	11,828
Total	€000s	**136,469**	**161,486**	**156,740**	**139,917**
Change from 2008 allowed revenues			18.3%	14.9%	2.5%

6 Proposed tariff adjustments

The applications received do not propose any change in current tariff structures, although KEK has proposed an alternative means of determining cost-reflective tariffs for customer groups to that currently applied by ERO. It is ERO's intention to review this proposed methodology in more detail prior to the next tariff review.

KEK has proposed that tariffs for all non-residential customer groups should rise by the same percentage, but that those for residential customers should rise by a higher percentage as these are furthest from cost-reflective levels (as calculated by KEK). KEK has also proposed that household customers may only remain on an unmetered tariff (category 7) for no more than 90 days.

ERO proposes that, until it has investigated the proposed methodology for determining cost-reflective tariffs submitted by KEK, it would be appropriate to increase all tariffs by the same percentage amount. ERO will continue to review the different cost allocation methodologies and may make adjustments to this proposal, prior to its decision on final tariffs.

In determining what increase in tariffs is required to meet allowed revenue requirements, it is also necessary for ERO to determine what change it expects in sales volumes. ERO considers there is a high level of uncertainty over sales volumes in the current year given the impacts of the economic crisis and a large increase in sales volumes is unlikely. While estimated energy balances have been received from KEK and KOSTT, ERO has concerns that these may be unrealistic.

Based on the overall review of the application and considering the adjustments and corrections made, ERO proposes to set the increase in tariffs equal to the percentage increase in allowed revenues as proposed by ERO (ie, 2.5% for all tariffs). ERO will continue to assess the assumed energy balance, as amended for changes such as the planned reduction in output by Feronikeli, and may make adjustments to this proposed approach prior to determining the final tariff for 2009.

Proposed tariff adjustments

During 2010, ERO may review and adjust allowed revenues to allow for over or under-recovery of allowed revenues that may result from this as a result of differences between allowed and actual volumes sold[10].

[10] ERO recognises that it will be important to retain incentives for KEK to reduce losses and that any adjustment should not unduly reduce this incentive.