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Pristina, 21 September 2006

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Energy Regulatory Office (ERO)

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ERO Board Members

Subject: **Electricity Price Review – Impact of KCB contributions to final Retail Tariffs**

Dear All,

ERO is currently undertaking the First Price Review for electricity licensees to determine allowed revenues and approve tariffs for implementation on 1 January 2007. At a public hearing on 12 September, the proposed allowed revenues were presented by ERO for comment (please see attached Table). Decisions on the allowed revenues and on the new tariffs will be taken by ERO on respectively 29 September and 6 November 2006.

The purpose of this letter is to seek confirmation of the availability, for the three year period of the price review starting in January 2007, of KCB subsidies to KEK JSC, in particular to cover:

1. The cost of the distribution commercial (also referred to as non-technical) losses based on a target (pre-specified) loss rate;
2. The cost of the bills not collected by KEK Public Supply, again estimated at a target rate;
3. The cost of importing electricity; and
4. Subsidies for vulnerable customers.

Information on the first three items above is needed for ERO to determine the allowed revenues.

Commercial and Collection Losses

The level of commercial losses (resulting from illegal connections, faulty meters, meter-tampering) in Kosovo, while trending downwards, is still very high; commercial losses for 2006 are expected to be in the vicinity of 31% of energy metered into the distribution system. The Tariff Methodology issued by ERO provides KEK Distribution with an incentive to further reduce these losses. Under the Methodology, KEK Distribution will be allowed to recover the cost of purchasing energy to cover a pre-specified level of commercial losses, set equal to a target percentage of energy metered into the distribution system. The target percentages proposed by ERO for 2007 to 2009 of respectively 22%, 17% and 13%, shown in the table below, represent large reductions on the current estimated rate of commercial losses and are based on the KEK Financial Recovery Plan.

The level of collection losses is also high; in 2005, only 67% of the amount billed was collected. ERO is proposing that target collection rates will increase over the period of the price review, from 70% in 2007 to 80% in 2009 (the target established in the Energy Strategy issued by the

Ministry of Energy and Mining), as shown in the table below. Regardless of the source (KCB, KEK or paying customers) of the funding of the uncollected bills, the use of a target collection rate will provide KEK Public Supply with an incentive to improve collection rates.

Target Loss Rates and Cost of Energy Purchase

Distribution commercial losses	***Units***	**2007**	**2008**	**2009**
Target distribution commercial loss percentage	*%*	22	17	13
Cost of purchasing energy for commercial losses	*M €*	20.0	15.0	13.4
Collection Losses				
Target collection percentage *(Share of revenues billed in year)*	*%*	70	80	80
Cost of uncollected bills *(assumes that customers do not pay for commercial losses)*	*M €*	32.1	21.1	27.1

Normally, in other tariff regimes, the cost of commercial and collection losses is recovered from all customers. However, as the levels of these losses are so high in Kosovo, the impact on consumers of this would be very large; the combined cost of funding the target commercial and collection losses in 2007 is estimated to be **52.1 million euro**, as is shown in the above table.

Without including the costs of these losses in tariffs, it is estimated that the average household tariff in 2007 would need to be approximately €c4.4/kWh. However, in the absence of a subsidy to KEK recovering these losses, it would not be possible for KEK to finance its operations and investments if the tariff is set at this level.

Putting the cost of commercial and collection losses onto paying customers by adjusting KEK's allowed revenues upwards to compensate for these would result in an increase in the average estimated household tariff to €7.3 c/kWh, as shown in the attachment to this letter. This level is above ERO's estimate of affordable electricity tariffs (around €c5.7/kWh). It also raises issues about the fairness of paying-customers having to cover the costs of supplying the non-paying consumers of electricity. Both the higher tariff and the perceived inequity of this arrangement will tend to hinder current efforts by KEK to reduce commercial losses and improve collection rates.

ERO's preferred solution, therefore, is for subsidies to be provided by KCB on a declining basis to cover these losses for a period while KEK improves its performance. By basing the subsidies on a target level for losses, the requirements on KCB would be fixed and known in advance while KEK would retain appropriate incentives to try and beat these targets. Where KEK supply recover debts (collection losses) at a later stage from customers, these will be shared between KEK and the KCB according to Tariff Methodology.

Subsidies Tied to the Cost of Importing Electricity

In order to avoid double counting when calculating the allowed revenues, ERO also needs confirmation as to whether any subsidies will continue to be provided to KEK JSC over the three year period starting in 2007 for the purchase of electricity from imports. This includes any access to subsidy monies provided in previous years and not spent. The allowed revenues presented by ERO at the public hearing of 12 September, and underlying the tables included in this letter, assume that there will be **no such** subsidies.

Subsidies to Vulnerable Customers

At present, KEK Public Supply provides free of charge to certain registered social welfare cases the first 500 kWh/month of electricity consumed. It is understood that MEF has received a proposed budget from KTA for 2007 of 4.6 million euro for the cost of financing this scheme. ERO needs to know whether these funds will be available in order to approve the new tariffs. If the funds are not available, either the scheme would need to be funded by higher-consuming consumers or it would need to be stopped.

Timing

Confirmation on the availability of the above subsidies is sought by **25 September** in order for ERO to issue a decision on the allowed revenues on **29 September 2006.**

ERO remains at the disposal of the Ministries and FAO to arrange a meeting to discuss the points made in this letter in more detail. In any case, please feel free to contact ERO for any questions or comments relating to this letter.

I look forward to your reply. This letter and the responses will be published on ERO's website.

Sincerely yours,

Dr Nick Frydas

Chairman of ERO Board

Attachment: Average Tariff (€cents/kWh; 2006 prices; no VAT)

Assumptions – does the customer pay for: **- Distribution non-technical losses?** **- Cost of uncollected bills?**	**Average estimated Tariff**		
	2007	**2008**	**2009**
	€c/kWh	***€c/kWh***	***€c/kWh***
Scenario 1: Customer does not pay for distribution non-technical losses			
1a – Customer does not pay for uncollected bills	**4.4**	**4.2**	**4.4**
1b – Customer pays for uncollected bills, assuming collection rates : 70%; 80%; 80%	**6.2**	**5.3**	**5.5**
Scenario 2: Customers pay for all non-technical losses (at target rate)			
2a – Customer does not pay for uncollected bills	**5.2**	**4.8**	**4.9**
2b – Customer pays for uncollected bills, assuming collection rates : 70%; 80%; 80%	**7.3**	**6.0**	**6.1**