

Pristina, 7 November 2006

## **Tariff Methodology Amendments**

### **Introduction**

During the course of the first price review of allowed revenues for KEK and KOSTT, it has proven necessary to make a number of amendments to the Tariff Methodology previously consulted on and published by ERO. These amendments fall into two categories:

- Changes required as a result of new circumstances, unforeseen at the time of development of the Tariff Methodology.
- Amendments to the revenue calculation equations contained in the Tariff Methodology, where minor errors have been identified.

The amended Tariff Methodology, with changes identified in tracked mode, has been published on ERO's website. This note summarises the most significant amendments.

### **Treatment of KEK Mining and Generation costs**

ERO had previously intended, in line with the Draft Market Rules previously published on its website, that the costs of power purchases by the Public Supplier from generators required to supply at regulated prices (in accordance with Article 8 of the Law of the Law on Electricity) would be made at simulated competitive prices. This approach was taken to avoid these regulated prices leading to distortions in the competitive power market. The Draft Market Rules set out the process for calculating these simulated prices.

It is now apparent that it will not be possible for the new competitive market to come into effect until January 2008 at the earliest. During the transitional period, until the new competitive market comes into effect, ERO will require the Public Supplier to enter into power purchase agreements (PPAs) with KEK Generation who, in turn, will be expected to enter into back-to-back fuel supply agreements (FSAs) with KEK Mining.

In order to determine an appropriate price for these transitional PPAs, ERO has calculated the necessary revenues for KEK Generation and KEK Mining to recover their reasonable costs, applying the same general principles as for other licensees whose revenues are regulated. The PPAs will allow KEK Generation to recover these costs (including the costs of fuel purchases from KEK Mining based on its reasonable costs) in full provided that it achieves target levels of availability.

The Tariff Methodology has been amended accordingly.

### **Treatment of transmission and distribution losses**

ERO has determined that KOSTT and KEK Distribution will be responsible for the costs of power purchases to cover transmission and distribution losses respectively. An allowance for the costs of these purchases, based on ERO's assessment of reasonable loss levels, will be included in the revenues recovered from regulated charges by KOSTT and

KEK Distribution. Each licensee will be required to reimburse the Public Supplier for the actual costs of power purchases to cover transmission and distribution losses and, therefore, has an incentive to reduce actual losses below those assumed at the time of setting allowed revenues.

ERO had originally intended that the Public Supplier would purchase these losses and receive a compensating payment from KOSTT and KEK Distribution. Subsequently, following further discussions on the Market Rules, ERO has instead determined that the Public Supplier will act as the agent for KOSTT and KEK Distribution in purchasing these losses, but that liability for failures to purchase will lie with KOSTT and KEK Distribution rather than the Public Supplier.

This change does not require any amendments to the allowed revenues calculation described in the Tariff Methodology but is included in this summary for completeness.

### **Recovery of commercial and collection losses**

ERO has been particularly concerned to ensure that consumers are not expected to pay for the costs of losses due to theft (commercial losses) and non-collection (collection losses), but that, at the same time, licensees are not penalized by being unable to recover their allowed revenues where these losses can be considered to be outside their control. The original Tariff Methodology, therefore, set out ERO's intention to establish a challenging but achievable set of targets for reducing commercial losses and increasing collection rates and to request subsidies to be provided from the Kosovo Consolidated Budget (KCB) to cover the difference between allowed and received revenues under these targets.

ERO has now been informed that such subsidies will not be made available. ERO will, therefore, determine appropriate levels of commercial and collection losses to include in the allowed revenues of licensees. In doing so, ERO will strike an appropriate balance between the need to allow recovery of reasonable and efficiently-incurred costs by licensees, to protect the interests of consumers and to avoid penalizing those consumers who pay their bills.

The Tariff Methodology has been amended accordingly.

### **Affordability and social tariffs**

In developing its approach to tariff regulation, ERO has considered it important that the affordability constraints facing many consumers in Kosovo are properly taken into account. The published Tariff Methodology reflected this by including an affordability test in the allowed revenues determination and in providing for ERO to require the Public Supplier to introduce a social tariff.

During the process of consultation under the price review, ERO has received strong representations from the Government of Kosovo that social considerations should be reserved to the Government and that ERO should not take them into account in reaching its decision. While ERO continues to believe that its duties require it to have regard to these considerations, it also understands that the intent of the Government is that subsidies to take account of affordability concerns will be separately determined and paid by the Ministry of Labour and Social Welfare.

Taking this into account, ERO has determined to set allowed revenues without the application of an explicit affordability test and to limit the introduction of any social tariff

to that of the possible introduction of a rising block tariff, where ERO considers this appropriate.

The Tariff Methodology has been amended accordingly.

### **Subsidies**

Discussions with the Government of Kosovo during the process of consultation under the price review have clarified that subsidies from KCB will be paid to KEK and KOSTT to cover the costs of imports and for support to social cases. KCB and donors will also cover the costs of part of KEK's and KOSTT's capital expenditure programmes through the provision of grants and 'soft' loans.

Subsidies received that are tied to imports and supplies to social cases will be treated as subsidies to the Public Supplier and used to reduce the costs of power purchases passed through to consumers. Subsidies tied to capital expenditure projects will be included in accordance with the arrangements for the calculation of allowed revenues associated with grant-financed assets already provided for in the Tariff Methodology.

The Tariff Methodology has been amended accordingly.

### **Pass-through of power purchase costs**

A number of amendments have been made to the formulae governing the pass-through of power purchase costs to clarify and correct these.

### **Revenue path**

As provided for in the Tariff Methodology, the allowed costs of power purchases will be determined annually (implying, during the transitional period, the need to annually review the costs of KEK Generation and KEK Mining). The allowed revenues of KOSTT, KEK Distribution and the Public Supplier (excluding power purchase costs) will be determined for a three-year price control period.

However, in order to provide greater predictability for licensees and consumers, ERO will also publish an indicative path for total allowed revenues and average retail tariffs over the three-year period as a whole. This is indicative only and does not imply a commitment by ERO to set allowed costs of power purchases in any one year at the levels shown in this revenue path.

The publication of a revenue path does not require any amendments to the Tariff Methodology, but is included in this summary for completeness.