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ETR2 – Allowed Revenues Calculation Guidance

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1 Introduction

This note summarises the general approach to calculated allowed revenues as part of the regulated tariffs applications to be submitted by licensees (KEK JSC and KOSTT JSC) to ERO under the second electricity tariff review (ETR2). A separate note describes the calculation of proposed tariffs.

2 Calculation of allowed costs

2.1 General approach

The Tariff Methodology established the following key principles for the calculation of allowed costs of regulated businesses:

- Allowed costs are calculated under a 'building block' approach, where the total allowed costs are equal to the sum of efficient *operating expenditures (opex)* + *depreciation* + *allowed return*.

- Depreciation and allowed return are calculated with reference to a *regulatory asset base (RAB)*.

- Assets for which the licensee incurs no financing costs are not included in the calculation of the allowed return. The regulatory asset base used for this calculation is, therefore, calculated as *RAB less the value of 'free' assets (RABf)*. Free assets are defined as those assets:

  - Purchased prior to 2006 and which were, therefore, either inherited from the pre-1999 regime[1] or financed from subsequent grants made available to the industry.

[1] If, following final status negotiations, licensees are required to either make compensating payments for these assets or assume part or all of existing loans used for the purposes of purchasing these assets, then

  - Purchased in 2006 and subsequently using grants made available to the industry.

- The allowed return is calculated as a *pre-tax weighted average cost of capital (WACC) * RABf*. The WACC used for this purpose represents ERO's estimate of the financing costs of an efficient business, rather than the actual financing costs of the licensee.

- All assets in the RAB are included in the calculation of allowed depreciation. For this purpose, a *weighted average remaining asset life* is applied. This is calculated from the statutory accounts.

- Allowed efficient *capital expenditures (capex)* are added to the RAB in the year in which they occur[2].

2.2 Retail supply costs

The exception to this approach is the calculation of the allowed (non-power purchase) costs of KEK Supply. The costs of this business are calculated as:

- A *retail cost*, expressed as a cost per customers, to compensate for the customer account management costs assumed by KEK Supply.

- A *supply margin*, expressed as a percentage of power purchase costs passed-through to regulated customers, to compensate for market risks assumed by KEK Supply and its working capital needs.

Bad debts are not considered a legitimate cost of KEK Supply and are not included in the allowed costs for this business.

2.3 Power purchase costs

The allowed power purchase costs of KEK Supply are calculated as:

- Allowed costs of KEK Mining, calculated as above

plus

- Allowed costs of KEK Generation, calculated as above (excluding the costs of fuel purchases from KEK Mining)

ERO has committed to allowing an appropriate share of these costs to be included in the allowed revenues to be recovered from regulated tariffs.

[2] For the purposes of calculating the depreciation allowance and allowed return, the average of the opening and closing RAB for the year is used.

plus

- Projected power import costs

plus

- Allowed costs of ancillary services purchases by KOSTT

less

- Allowed costs of losses paid by KOSTT and KEK Distribution

2.4 Losses

KOSTT and KEK Distribution are respectively responsible for the purchase of losses incurred in the transmission[3] and distribution of energy. For this purpose, distribution losses are defined as the difference between metered electricity entering and exiting the distribution network (ie, including theft and other commercial losses).

The allowed costs for KOSTT and KEK Distribution include a provision for the purchase of losses. This is calculated as the *weighted average power purchase price * energy entering the network * allowed loss rate* (expressed as a percentage).

2.5 Ancillary services

The projected costs of ancillary services are included in the allowed costs of KOSTT.

2.6 Allocation of Head Office costs

KEK Head Office costs are calculated in the same way as those for other businesses. These are then allocated across KEK's individual businesses in proportion to the share of staff numbers in each business.

3 Conversion to allowed revenues

3.1 Non-regulated activities

Converting allowed costs to allowed revenues involves the deduction of projected revenues from non-regulated activities from the allowed costs of each business:

- Projected revenues from lignite sales to customers other than KEK Generation deducted from the allowed costs of KEK Mining included in the allowed power purchase costs of KEK Supply.

[3] Including transit losses.

- Projected revenues from power exports and from sales of energy to eligible customers are deducted from the allowed power purchase costs of KEK Supply.

- Projected revenues from the Inter-TSO Compensation (ITC) mechanism are deducted from the allowed costs of KOSTT.

- Projected revenues from transmission and distribution charges paid by eligible customers are deducted from the allowed costs of KOSTT and KEK Distribution, respectively.

- Projected revenues from connection charges (where these are used to finance new network assets) are deducted from the allowed costs of KOSTT and KEK Distribution, as appropriate.

- Operating subsidies (ie, excluding grants for capital expenditures) paid to KOSTT and KEK from the Kosovo Consolidated Budget (KCB) are deducted from the allowed costs of the appropriate business.

3.2 Corrections and compensating adjustments

Allowed revenues are also adjusted for:

- Underspends on allowed capex in the preceding period, where the associated investment was not made and is not included in planned investments in the coming period. Where the investment is still planned, then no correction is made but no additional capex allowance is provided.

- Differences between forecast and actual revenues and costs in the preceding period, that are outside the control of licensees. These adjustments include:

  - Differences in the costs of purchasing losses by KOSTT and KEK Distribution that result from differences between actual and projected power purchase prices and energy transported (but not due to differences between actual and allowed loss rates).

  - Differences between actual and projected net revenues to KOSTT under the ITC mechanism.

  - Differences between actual and projected operating subsidies paid to KOSTT and KEK from the KCB. The difference is added to allowed revenues.

  - Differences between actual and projected grant funding for new investments paid to KOSTT and KEK from the KCB. The difference is converted from an assumed free asset to an asset eligible to earn a return.

In each case, the difference is multiplied by one plus the one-year lending rate charged by commercial banks in Kosovo. This reflects the assumption that the licensee is either required to borrow to compensate for shortfalls in allowed revenues that are outside its control, or can deposit surpluses and receive a return on these.

4 Changes from ETR1

The first electricity tariff review (ETR1) envisaged that allowed revenues incurred by KOSTT and KEK Distribution in their role as network owners would be set for a three-year period. ERO has subsequently determined that it would be more appropriate for review allowed costs and revenues for these businesses as part of ETR2, in the same way as for other regulated businesses (ie, for one year ahead). This recognizes the significant uncertainties at the time of ETR1 and the unreliability of much of the data submitted by licensees during the course of that review.

It will, therefore, be necessary to adjust allowed revenues for KOSTT and KEK Distribution to compensate for the under-recovery of allowed costs in 2007 as a result of the application of revenue 'smoothing' over the period 2007-09.

It is also proposed to use the nominal cost of assets for the purposes of determining the RAB and to determine a corresponding nominal WACC to use in calculating the allowed return. Previously, a real asset value and WACC were used, with an inflation adjustment being applied through indexation. This change is consistent with the intent of setting allowed revenues for each business under ETR2 for a one-year period.