

04.12.2007

**Dear Mr.Hamiti,  
Dear ERO board members,**

Please find attached a completed version of your data template ERO~ETR2 Template~19Oct07 in respect of KOSTT. The data given are not by themselves sufficient to determine allowed revenue and hence tariffs and therefore we would like to make some points in regard to both expected outcomes in 2007 and revenue requirements in 2008. We would like to discuss these points with ERO.

### **1. Maintenance expenditure**

Actual expenditure for the period January – September 2007 was:

Maintenance costs:	646.604
Capitalised costs:	<u>314,398</u>
Total:	961,002

The reasons for the low level of actual expenditure compared with plan are as follows:

- Delayed approval of tariffs: billing according to the approved tariffs began in May, and first revenue collection was in July. This has resulted in the profile of cash collection being heavily weighted to the latter part of the year, as compared with our original estimates.
- As a consequence of delayed approval of tariffs, there was delay in approving the budget and procurement plans.
- Procurement processes took time to implement.
- Most bidders could not deliver equipment until at least two months after the signing of contracts.

KOSTT's expectation is that in the final quarter of 2007, maintenance expenditure will amount to € 926,929. This will make expenditure for the 2007 year as a whole € 1,887,931.

The value of signed contracts (not realised to date) is € 1,297,039, and the value of contracts not signed until the end of 2007 is € 1,535,685.

Thus expenditure on the maintenance plan for 2007 is likely to be realised almost entirely, though implementation will continue into 2008.

Maintenance is of immense importance in improving the reliability and the capacity of the Kosovan electricity system, and it is crucial that sufficient revenue is allowed to expand the maintenance programme.



## 2. Staff costs

The allowed revenue component for personnel costs for 2007 amounts to € 1,460 k out of a total of € 13,190 k, representing 11.7% of allowed revenue. These revenues are based on 215 employees.

For 2008, allowed personnel costs account for € 1,757 k, out of a total allowed revenue of € 16,894 k. This is based on a staffing level of 230 employees.

At its meeting on 1 October, KOSTT's Board of Directors approved new pay levels, adjusting employee base payments as well as food allowances to take account of increases in prices and the cost of living.

When allowed revenues for KOSTT were determined for the three year period 2007-2009, several cost categories that are a part of staff expenses were not taken into account, though they are guaranteed to employees under employment, labour and work regulations. These include payments for holidays, work experience, and pensions.

In order to take account of these matters, an increase of € 300 k in the personnel cost component of allowed revenues is required for 2008 and 2009.

## 3. Transmission losses

For ERO's determination of allowed revenue for 2007-09 in the initial tariff review in 2006, the assumption was made that average losses on the transmission network would be around 3% for energy entering the transmission system for the supply of Kosova customers and 1% for transit losses.

More detailed modelling and reconciliation of actual volumes suggest significantly higher figures for 2007 and it is KOSTT's expectation that this will also be the case for 2008 and 2009. This difference is significant and material to KOSTT and it is our expectation that if the levels of transmission losses remain at current levels, without revenue adjustment, this will seriously impact our ability to invest further in the transmission system. KOSTT has developed a separate submission on Transmission Losses as the reasons for these deviations are complex and relate to a number of factors as follows:

- The underlying assumptions used to determine the initial loss percentages;
- Improved data quality allowing more accurate measurement of data flows;
- Improved modelling techniques using more representative MVAar flows, Resistance for overhead lines and capacitors and load duration curves; and
- Delayed investment due to lack of funds.

We would welcome a detailed discussion on this topic as a matter of urgency.



#### 4. Depreciation and cost of capital

There are two key assumptions in ERO's allowed revenues calculations for the initial tariff review in 2006, relating to depreciation and to the cost of capital, that have serious consequences for KOSTT finances.

The present position is that:

- For existing assets (as at 1 January 2006) KOSTT is not allowed to earn a commercial return or depreciation (though it is allowed to recover maintenance costs plus any actual financing costs). The regulatory asset base (RAB) was set to zero as at 1 January 2006.
- New approved capital projects are added to the RAB. KOSTT can recover their costs through a depreciation charge and an allowed return on the assets. The assumed weighted average cost of capital (WACC) used by ERO to derive allowed return is 10.8% (real).
- New donor-funded projects are included in the RAB for depreciation purposes, and on a pro-rata basis for the purposes of calculating return (to reflect the difference between actual financing cost and WACC).

In regard to existing assets, there is no provision in allowed revenue for return or depreciation. Under IAS accounting rules there has to be a depreciation charge in KOSTT's financial accounts. However, KOSTT received no direct financing for these assets and therefore has no deferred income from which to release an annual amount to the income statement to offset the depreciation charge. The effect is to depress reported earnings and thus make it difficult or impossible to borrow commercially.

ERO has estimated a WACC of 10.8% real. The debt component of this is 7.5 – 8.0 % real. However, this is well below the true cost of borrowing in Kosova: KOSTT believes that loans are not obtainable for less than 12% (nominal) and then only for relatively short terms (no more than 5 years). Thus for long-term infrastructure projects the cost of subsequent re-financing also has to be considered.

Central Banking Authority of Kosovo in its Annual Report 2006 has published interest rate of 13.37% as an average for different products and maturity, while the interest rate for business and non-financial corporations amounted at 14.32%.

ERO has suggested that loans could be obtained on international capital markets but this is almost certainly not a possibility at present (especially given the international credit crisis and the uncertainty over the political status of Kosova). Even if there is a possibility of loans from international markets, the lack of credit history and perceived low credit worthiness of KOSTT, will result in a cost much higher than assumed by ERO.

ERO's assumption on WACC also assumes a 60% gearing level. It is unlikely that this level could be achieved, at least in the short term. Gearing of 35% would be a more realistic (but still challenging) assumption.



There are thus two related problems:

- (i) the present assumed level of WACC prevents commercial borrowing because the resulting component of allowed revenue does not provide KOSTT with sufficient revenue to pay the market interest rate; and
- (ii) the present regulatory treatment of existing assets depresses reported earnings and makes KOSTT an unattractive borrower.

In these circumstances there are two requirements:

- (a) to increase the assumed value of WACC, so as to increase allowed revenues sufficiently to allow KOSTT to pay market interest rates on loans; and
- (b) to allow a depreciation element on existing assets.

The alternative is to accept that all future capital investment will be funded by KCB or international donors.

Our estimate of WACC on the basis of a gearing of 35%, a real cost of debt of 9% or 9.5% (equivalent to 12% nominal - subject to inflation), and the same return on equity as assumed by ERO (10.8 – 12.8%) is 12.83% (real) as a mid-point value.

The proposed WACC of 12.83% would have positive impact upon evaluating risk exposure that KOSTT may imply on financial institutions in obtaining commercial loans.

**Comment [MS1]:** Does this add any value to the overall text?

Note that commercial loans are only available to KOSTT on a short-term basis. There is therefore a risk that subsequent re-financing would have to be at a higher interest rate. Since ERO is pressing KOSTT to take out commercial loans, it should accept a commitment to allow sufficient future revenue to cover higher future interest rates if that proves necessary.

We would appreciate a meeting to discuss the implications of these issues with you.

Yours sincerely,