

Minutes of the Meeting Public Hearing on Draft Electricity Tariff Methodology

Date: Thursday, 17 November 2005 from 14.00 - 17.00

Place: ERO Premises

Attendees: 31

Please refer to the handouts: Draft Tariff Methodology (26 slides).

Introduction by Nick Frydas, Chairman and Head of ERO

According to Article 46 of the Law on the Energy Regulator, the Board of the Energy Regulatory Office (ERO) shall develop and issue a Tariff Methodology. It regulates prices in the regulated sector, in compliance with the Market Model and the most modern techniques regarding efficiencies, to be reflected in the prices.

One of the major concepts of regulated electricity industry is that the customer has not to bear the whole cost of the electricity utility. Electricity companies take also risks, which are included in our incentive based Tariff Methodology.

Miss Theranda Beqiri, Member of the Board of ERO and Head of Prices and Tariff Department, introduced herself and referred to the public hearing on Pricing Rule (26 September 2005), where it was promised that we would hold a public hearing on the Tariff Methodology. Theranda is giving the presentation.

Slide 6: Methodology contents

William Derbyshire (WD): as a clarification, certificates of origin are for renewable generators. Under the law it is allowed to sell at regulated tariffs set by ERO. This tariff is higher than the market price in order to give investors incentives to invest in renewables.

Slide 7: Power purchases by the public supplier

WD: KEK dominates the wholesale electricity market and, as a consequence, the draft market rules provide for the use of a market simulation model to determine regulated market prices for KEK generation, which permit the recovery of reasonable costs. The Market Operator develops and maintains the model under the market rules. ERO is responsible for approving the market rules, including the model, and will also approve key assumptions used in the model. The intention is to use the prices resulting from the simulation model to determine that the public supplier pays a regulated price for power purchases.

Slide 8: Power sales by the public supplier

Nick Frydas (NF): We have developed an incentive mechanism on the TSO and DSO to minimise losses.

WD: The basic approach is that TSO is responsible for actual transmission losses. Supplier will pay for those losses and will be fully compensated by TSO. The latter can include a reasonable cost level allowed in their cost, in return used from user charges. If the losses are higher than the reasonable loss level set by ERO, then the difference has to be borne by TSO. If the technical losses are lower than the reasonable loss level set by ERO, then TSO can keep the difference. This creates for TSO a strong incentive to beat the loss level set by ERO.

A similar approach applies for distribution losses, which are paid by the DSO. However, given the size of commercial losses on the distribution network, the feasibility of recovering these out of user charges or by a pre-determined compensation paid from the Kosovo Consolidated Budget (KCB) needs to be investigated.

NF: There will be retail tariffs according to Kv level: 220 Kv, 110 Kv and so on.

Question: At what price are the losses in distribution valued?

Answer:

WD: At the wholesale electricity market price, which is the price paid by suppliers to purchase these losses.

Question: Has the public supplier to settle commercial losses and will the DSO compensate him?

Answer:

WD: The public supplier is not exposed to commercial losses before the customer's meter, as it is a 'pass through' to DSO and TSO. The DSO is exposed if it has not reduced commercial and technical losses.

NS: Public supplier is exposed to balancing risk and has therefore to give a forecast as accurately as possible: demand during every hour and for one year in advance.

WD: The principle is to allocate costs to parties who control it. The public supplier cannot control illegal connections but the DSO can and should take responsibility for these commercial losses. The public supplier can control collection losses as they send out the bills and collect money.

Question: Why should KCB contribute to paying for allowed losses and does this reduce incentives to cut losses?

Answer:

WD: The reason for KCB contributions is to keep tariffs lower than they would be. We cannot bring high commercial losses to zero overnight and including the full cost of those losses in the tariff would imply a big increase in customer bills. KCB's subsidy would be for a transition period only.

NF: In this methodology we decrease the percentage of allowed losses over time. If the set target is 30% for commercial losses one year, KCB has to cover this 30%. When next year the set target for commercial losses is 20% and the actual commercial losses remain 30%, then KCB will not cover the excess 10% and it will be at the cost of the DSO.

Question: Does the proposed approach imply cross subsidisation of the commercial losses in the tariff, contrary to ERO's legal duties?

Answer:

WD: There are some commercial losses in allowed costs and we believe that to bring commercial losses to 0 will take time to happen. In the meantime we accept that the enterprise cannot recover this cost.

It is true that including commercial losses in tariffs will lead to customers at higher voltage, who are likely to be commercial and industrial customers, paying a share of commercial losses, even though household customers at lower voltage largely cause these. However, this cross-subsidy element is largely offset by the use of voltage-differentiated distribution charges where customers connected at lower levels pay higher charges in recognition of the greater share of system assets that they use and the higher losses at this level.

NF: It is not an easy situation and cross-subsidisation effectively happens under any approach. If KCB pays subsidies then this leads to taxpayers, who may not cause losses, paying for the costs of these losses.

An important point is to give the incentive who bears responsibility of low collection revenues, who is DSO regarding disconnections and illegal connections; and Supplier who does not receive money for issued bills.

Question: For how many years is the incentive to DSO to reduce losses?

Answer:

WD: This needs to be determined. The Ministry of Energy and Mining has already set a proposed target. One approach might be to require losses to reduce to the levels seen in countries such as Romania over a two to three year period.

NF: The targets have to be agreed with the Government and there is a lot of effort in Task Force, Police and Court. So again, I stress this tariff methodology gives incentives for reduction of losses and also for technical losses.

Observations:

NF: Making the DSO and other licensees respond to incentives requires that they risk bankruptcy. Then the whole government and social environment should be reconsidered. Management of DSO should be released of duties if they rely only on subsidies.

WD: Management salaries should be linked to profits they deliver. Incentives require that managers respond to profits.

NF: There are other components of social policy to be considered!

Slide 10: Recovering bad debts

WD: Assumption will be that collection rates improve over time and subsidy will reflect this. If collection rate goes up, then the subsidies will go down. The difference between actual collection rate and target rate is the risk for the supplier. It is their job to collect the money.

Slide 11: Social tariff

WD: One important point is that this social tariff is only for households and cross subsidy will only take place within the household category rather than between customer categories. The Tariff Methodology establishes the principle of a social tariff using a rising block and that ERO expects to have such a tariff to be offered. The detailed design of the social tariff will be the responsibility of consultants hired under the World Bank's ESTAP III project.

Question: Will the extra earnings gained through efficiencies remain within the company? Is it not better that a part will go to the public?

Answer:

NF: Sharing additional profits will reduce incentive on managers to make the cost efficiencies required to deliver those profits. Consumers will benefit from the resulting reduction in prices to match the new efficient cost levels at the next price review in three years.

Follow-up question:

I agree in principle. However, in other countries they share efficiency gains without waiting, in order to help overcome opposition to reforms. What is the experience of the consultant?

Answer:

WD: Both views are valid. It is the job of ERO to balance the interest of the stakeholders, both the interest of the consumers to see costs reduced and the interest of companies including giving them an incentive to reduce costs. No regulatory regime will survive if companies make gigantic profits.

Profit sharing is one means of protecting against this risk. The approach adopted by the methodology is different. In the first price control period it will be difficult to make accurate forecasts of costs and volumes. Therefore, there could be a significant risk of excessively high or low profits because of forecast errors. Rather than sharing profits, the methodology provides for a reopening of the price control if profits move outside a reasonable band. This seems cleaner and protects against extreme outcomes.

NF: It should be remembered that, when discussing the proposed transmission price control, this only represents about 7 % of the final customer price. Profit sharing and similar mechanisms will have little impact on customer prices but will have major impacts on the incentives of the TSO to improve services.

Slide 14: The pre-2005/post-2005 split

WD: Pre-1999 debt used to finance KEK assets is held by EPS (the Serbian electricity utility).

NF: Correction: Slide 15: 'asset value' instead of 'asset life'.

Participant comments: The allocation of debt to KEK should be resolved during the final status talks. Note that part of the post-1999 investments was financed by KCB and not directly by donors.

Question: Is the X- factor really an adjustment and will it be constant over the period? What is the CPI measure in the adjustment formula?

Answer: WD: The X-factor represents the annual change in real costs and would generally be fixed for each price control period. CPI is the consumer price index, representing inflation (nominal cost changes). A monthly CPI is published by the Kosovo Statistics Office and could be used for this purpose or, if this is not considered reliable, a Euro-zone index could be used instead.

Slide 19: Deep and shallow connection charges

NF: According to the Tariff Methodology, the connected Party will pay the connection cost as a lump sum. It is unrealistic to expect that TSO/DSO 'lend' to customers in the current Kosovar circumstances.

Slide 20: Structure of TUOS charges - 1

NF: Level of TUOS charges should be based on an average of peak demands at a few (e.g. three) selected times rather than a single point in time.

WD: The British system applies a triad and the calculation of charges is the average of the three highest peaks of the year separated by at least two weeks in time.

NF: ERO's view is that a triad mechanism should be applied.

Slide 26: Distribution connection and DUOS charges

Question: Do all smaller customers pay a standard charge?

Answer:

WD: The General Conditions of Energy Supply to be issued by ERO give more information regarding connection to the network and when a standard charge and when actual costs will apply. The expectation is that actual costs will apply for customers for whom the costs of connection are likely to exceed the standard charge by a significant amount. The threshold will be set by ERO and is likely to include both, distance from the existing network and cost.

Observation: Generators should not pay deep connection charge in order to attract investments!

Answer:

NF: Recovering the costs of, for example, a new large generator built for export from use of system charges applied to all users, essentially means that other customers subsidise the costs of an exporting generator.

There is a free-riding concern where one user pays for a connection and a later user then connects and uses those assets without paying for it. Should provision be allowed that all users paying deep connection charges and connecting within, for example, six months or one year of each other share these costs?

WD: The typical approach is that earlier connecting party funds the necessary and is paid a compensating sum by users who connect within a reasonable time period, such as seven years, as currently referenced in the methodology, and who use the same assets.

Letter to ERO from Iber Lepenc dd. 7 November 2005

Written comments were received relating to the criteria used to establish reasonable costs of ERO and stating that these should be recovered from generators in proportion to their production, as well as asking for elaboration on the terms under which ERO licenses can be cancelled. Although submitted with reference to the Tariff Methodology, these comments appear more relevant to the ERO rules on licensing and schedule of license fees and will be dealt with during the consultation on these issues.

Comment from participant

The Albanian translation of the presentation is very bad. It is not understandable and the technical terms are wrong.

Answer:

NF: We recognise the difficulties caused by poor translation, which results from the lack of resources in this area. As the original documents are written in English, there is a provision in the Pricing Rule that in case there is a difference the English text prevails.

Conclusion by Nick Frydas

On 13 December 2005, ERO will publicly meet to vote the promulgation of the Tariff Methodology. Till then all comments on the Tariff Methodology are welcome.