KES|CO

Ndërtesa e Elektrokosovës
Bulevardi Bill Klinton nr 3
Prishtinë 10000
Republika e Kosovës

Elektrokosova Building
Bill Clinton Boulevard no.3
Prishtina 10 000
Republic of Kosovo

KOMPANIA KOSOVARE PËR FURNIZIM ME ENERGJI ELEKTRIKE SH.A.
KOSOVO ELECTRICITY SUPPLY COMPANY J.S.C.
KOSOVSKO PREDUZEĆE ZA SNABDEVANJE ELEKTRIČNOM ENERGIJOM D.D.
KESCO - SH. A.

Nr. 31 Dt. 21.10.2024
HQ I

Ymer Fejzullahu
Chairman of ERO Board

Mesut Serhat Dinc
Chief Executive Officer
KESCO j.s.c

21 October 2024

Subject: Proposal for Input Values and Operating Expenses for the Universal Service Supplier for the period 2025-2027.

Dear Mr. Fejzullahu,

The Energy Regulatory Office (ERO) has opened the process for reviewing the input values and operating expenses for the Universal Service Supplier (USS) for the three-year period 2025-2027.

In accordance with the requirements of official letter no. 1066/24 dated 25 September 2024, USS has prepared the proposal for input values and operating expenses for the period 2025-2027 and through this letter we are addressing ERO for the purpose of review.

The data presented are argued in written form and are supported through appendices (sent in electronic form). Due to the sensitivity of the information, the appendices must remain confidential and for ERO use only.

Considering the great importance of this process let us emphasize that we are open and ready for further discussions whenever necessary.

ZYRA E RREGULLATORIT PËR ENERGJI
ENERGY REGULATORY OFFICE
REGULATORNI URED ZA ENERGIJU
Nr. 607/24
Data. 21.10.24

Sincerely,

KOMPANIA KOSOVARE PËR FURNIZIM ME ENERGJI ELEKTRIKE SH.A. KOSOVO ELECTRICITY SUPPLY COMPANY KOSOVSKO PREDUZEĆE ZA SNABDEVANJE ELEKTRIČNOM ENERGIJOM D.D.
KESCO SH.A.
HQ

Mesut Serhat Dinc
Chief Executive Officer, KESCO j.s.c

Appendices:
KESCO Template MYT 2025-2027
Bad debt allowance and retail margin for KESCO - ECA Report
KESCO Bad debt calculation_ECA
KESCO_Retail Margin calculations_ECA

UNIVERSAL SERVICE SUPPLIERS'S PROPOSAL FOR INPUT VALUES AND OPERATING COSTS FOR THE PERIOD 2025-2027

October, 2024

Content

1. Introduction

The Energy Regulatory Office, through the official letter no. 1066/24 dated 25 September 2024, addressed to KESCO as the Universal Service Supplier (USS), has initiated the process for reviewing the input values and Operating Costs (OPEX) for the period 2025-2027.

The input values are the key parameters used for calculating the regulated revenues of the Universal Service Supplier. Conform Rule on Determination of Revenues for Universal Service Supplier (USS Pricing Rule), the input values consist of:

1. Economic USS Related Assets Lives;
2. Retail Margin;
3. Bad Debt Allowance;
4. Balancing Sharing Factor, and
5. Any other input parameters that the regulator may deem necessary.

The Energy Regulatory Office (ERO), through the letter, has also requested KESCO to submit a proposal for the operational and maintenance costs for the next three years, 2025-2027. In the following document, we have presented the requests and justifications regarding the regulatory parameters and operating costs for the Universal Service Supplier.

2. Economic Lifetime of Assets and CAPEX Request for USS

According to the USS Pricing Rule, the depreciation of the Regulated Asset Base (RAB) is calculated using the economic lifespan defined for different asset classes. The Universal Service Supplier (USS) has limited capital investments, primarily focused on office equipment and Information Technology (IT). During the determination of the input values for the second regulatory period, the ERO categorized assets such as: work equipment, vehicles, computers, IT equipment, and software with a depreciation period of 5 years, while office furniture and equipment for a depreciation period of 7 years.

However, rapid technological development has caused information technology and related equipment to have a shorter lifecycle, requiring more frequent updates and replacements. For example, software and IT equipment often become unusable within a short period due to new upgrades and security requirements.

The depreciation lifespan of assets, especially IT equipment, should reflect current technological advancements and usage patterns. Historically, a 5-year depreciation period for computers and office equipment was suitable, but ongoing developments in IT now shorten their functional life. Many studies and even practices in some other countries suggest reducing this period. For example, the IRS (Internal Revenue Service) in the U.S. allows a 3-5 year depreciation for computers and technology equipment, recognizing their faster obsolescence. Similarly, in the UK, depreciation models for IT have been adapted to account for technological improvements[1]. According to the 2024 Global Capital and Fixed Assets Guide by EY (Ernst & Young Global), the lifespan for hardware and software is categorized as 3 years in several countries worldwide, such as Argentina, China, France, Germany, Japan, Kuwait, Mexico, Portugal, Singapore, etc.[2]

Considering these trends, a 3-year depreciation period for technological equipment along with software is more appropriate. In this context, a 3-year depreciation period for the USS would also enable it to invest more quickly in new technologies, effectively managing the increasing demands of customers.

Office furniture and equipment also require more frequent replacements to meet modern work standards. By reducing the depreciation period for furniture and office equipment to 5 years, the USS would be able to renew its work environment, enhancing staff comfort and efficiency, which is crucial for maintaining productivity.

Investments in office equipment at the customer care office and cash registers in Pristina have already demonstrated improved customer satisfaction, a key indicator of the company's success that also ensures compliance with supplier quality standards. By reducing the depreciation period for office furniture from 7 to 5 years, the faster adoption of better tools and office equipment models can be facilitated, enhancing interactions with customers and ultimately contributing to stable or improved levels of customer satisfaction. A shorter depreciation period also stimulates ongoing investments in customer care infrastructure, ensuring continuous improvements in service quality.

Taking the above into consideration, the USS proposes the economic lifespan as follows:

Depreciation groups	Lifespan of the assets
Computer programs (Software)	3 year
Office equipment	5 year

[1] Tax Simplification Office, 'Accounting Depreciation or Capital Allowances? -Simplification of the tax relief for real assets' Disclosure rate, https://assets.publishing.service.gov.uk/media/5b222b6c40f0b634b73dbf2f/Accounting_depreciation_or_capital_allowances_web.pdf

[2]Ernst Young, Worldwide Capital and Fixed Assets Guide 2024 (*https://www.ey.com/en_gl/tax-guides/worldwide-capital-and-fixed-assets-guide*)

Current data shows that the allocation of the USS's capital investments is 64% for software programs and 36% for office equipment, while in the next three years (2025-2027) the allocation of costs between IT and office equipment will to be 95% with 5%, as shown in the following table:

Depreciation groups	2025	2026	2027
Computer programs (Software)	95%	97%	95%
Office equipment	5%	3%	5%

It is important to note that with the change of the energy markets in recent years, the need for updating the operating system of the supplier has increased significantly, especially in advanced software systems to manage a large volume of data, as well as in the measures of cyber security which are essential for protecting data and infrastructure from attacks and potential misuse.

USS's billing system is an inherited system that does not meet the latest data management and best practices. The changes in the energy sector, such as the opening of the market, the functioning of the balancing mechanism and the beginning of the operation of prosumers, have made it difficult to operate with the current system. Therefore, it is imperative that in the coming years a higher budget is allowed to enable the development and implementation of a new billing system. The following table presents USS's request for the necessary investments, which will ensure high quality and security in the services provided.

in '000 €	2025	2026	2027
Requested Budget (2025-2027)	2,308	3,573	2,749

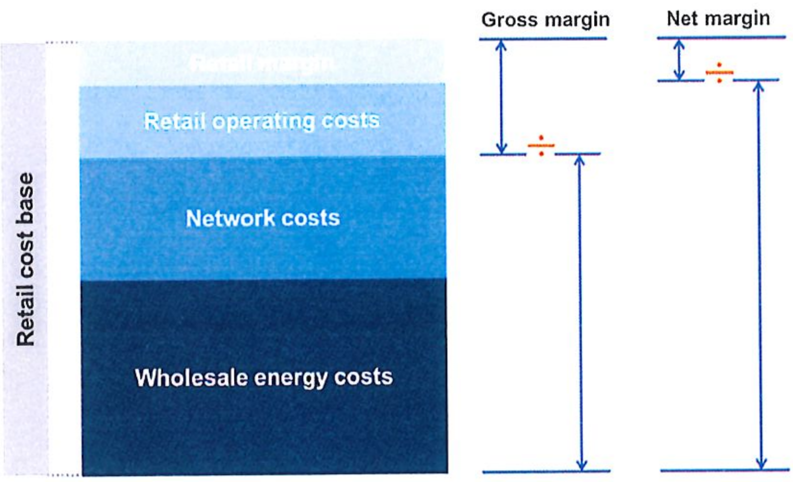
3. Retail Margin

Universal service suppliers are regulated companies, where prices and profits are determined and evaluated by a regulatory authority. This authority sets a retail margin to ensure a reasonable financial return for the companies while also providing customer protection through the establishment of the prices they pay.

The rule for determining the revenues of the universal service supplier (USS Pricing Rule), approved by ERO in 2017, represent the basis for the determination of the retail margin. According to article 17, paragraph 8: '*Retail Margin shall be a fixed percentage that is applied to allowed wholesale energy costs and allowed wholesale capacity costs. It shall be set at such a level such that it: 8.1. Provides the USS with a reasonable profit that compensates it for the risks it assumes in providing the standard service for regulated customers. This shall be calculated with reference to the margins earned by similar utilities in countries elsewhere in Europe, taking account of the* *similarities between the electricity industry in those countries and that of Kosovo; and 8.2 Provides the USS with a reasonable return on its net fixed assets used in providing Standard Service to Regulated Customers. This shall be calculated with reference to the cost of capital of other licensees in Kosovo.'*

We note that the Rules make explicit reference to the need to provide the USS with a "reasonable profit," which is commensurate with the risk profile it faces, taking into account that it provides a public service with regulated conditions. According to the rule there are two distinct approaches to be applied, (a) benchmarking with comparable entities in Europe and (b) a corss-check whether the margin reflects a reasonable return on the asset base, taking into account the Weighted Average Cost of Capital (WACC) applied to other regulated licensees in Kosovo.

Although 'comparison with other economies' is the most commonly used approach among suppliers, caution must be applied when applying benchmarks, as retail margins can refer to gross or net margins. As shown in the Figure below, a gross margin includes the operating costs of suppliers, while a net margin excludes such operating costs.



Source: ECA

The Rules require consideration of margins earned by "similar utilities" in Europe, taking account of "the similarities between the electricity industry in those countries and that of Kosovo". From our analysis, we note that the sample of suitable comparators within Europe is small, given a majority of European markets have liberalized electricity retail markets, and as a result there is no explicit regulation of the supply company's margins.

ERO, during the past review of the retail margin, initially reviewed a wide range of European comparative standards, however, the approach taken to determine the margin was as a ratio of the average margin cost for the period 2017-2021 compared to the forecasted net wholesale energy purchase costs for 2022. As a result, ERO estimates resulted in a decrease in the retail margin from 3% to 2.4%, not taking into account recent trends such as the fluctuation of wholesale energy prices, supply chain challenges, geopolitical risks (such as the ongoing energy crisis in Europe), etc.

The reduction of the margin is intended to reflect a more stable market environment or less volatility in costs. Therefore, the decision of the ERO did not coincide with the reality, which is constantly reported in the annual Progress Reports, where Kosovo continues to be assessed as at an early stage of developing a functioning market economy and that the business environment still faces many challenges.

Moreover, the energy crisis that began in 2021, continuing into 2022, according to the ACER Report 'Energy Retail and Consumer Protection Market Monitoring'[3] emphasized that supplier all around struggled to manage their margins due to rising wholesale energy prices. This increase in costs for purchasing energy in the wholesale market could not be immediately translated into higher prices for customers due to the restrictions and regulations imposed by regulatory authorities. As a result, suppliers have experienced a reduction in their profit margins, making it more challenging for them to maintain financial stability and effectively manage their operations.

Given these dynamics, as well as the supplier's continued dependence on imports, which exposed it to prices beyond its control, the restoration of the margin to 3%-3.5% is reasonable and necessary to ensure that USS remains financially stable and able to effectively manage its risk profile. In countries like Great Britain [4] and Germany [5], retail margins have been set higher, around 3-5%, to ensure that companies can withstand these risks without compromising service quality[6].

But, the above experiences show that there is little consistency in the way margin is set and the levels are determined. These changes are driven by various factors and considerations, including (but not limited to) changes in the regulatory environment, risks borne by regulated suppliers, customer base characteristics and demand patterns, level of market maturity and competition, as well as metering and billing systems, and other operational technologies that may affect efficiency and required margins.

[3] ACER - CEER Energy Retail and Consumer Protection Market Monitoring Report 2023, September 2022
[4] Ofgem, "Default Tariff Cap – Decision Overview" (2022)
[5] Bundesnetzagentur, "Monitoring Report on the German Electricity and Gas Market" (2021).
[6] ACER/CEER Annual Report on the Results of Monitoring the Internal Electricity and Natural Gas Markets (2020).

The second approach of the rule also provides for the imposition of a margin based on the return on KESCO's asset base and the cost of capital imposed on other licensees in Kosovo. Considering the asset-light nature of KESCO's business, it is essential to estimate the return on capital employed, factoring in both fixed assets and working capital. Although the rule currently allows compensation for working capital (according to the prescribed formula) it may not accurately reflect the timing mismatch of cash flows in KESCO's operations.

To estimate a reasonable retail margin, we considered the opening of the Adjusted Asset Base (RAB) in 2017, according to the current data presented in the Financial Statements, which we supplemented based on historical and projected capital expenditures. It should be re-emphasized that KESCO's capital employed is increasing, with significant capital expenditures planned for the modernization of customer systems, therefore working capital is also expected to increase due to the increase in capital expenditures and the anticipated increase in electricity demand.

The rule requires that return is calculated referring to other licensees in Kosovo. While the WACC for other Kosovo licensees such as KEDS and KOSTT is 7.69% (before tax, real value), KESCO's business with a lighter asset structure would have a higher gearing ratio (75% debt, typical for supply companies). Adjusting the WACC for inflation and other factors, the estimated nominal pre-tax WAC for KESCO is 8.68%.

Calculations, based on historical data and forecasts as per KESCO's request for the next period, result in a difference between 6.9 and 7.8 million euros, which, using the assumed future wholesale purchase costs, is equal to a margin of 3.2%-3.4%.

Table: The estimated return and retail margin for KESCO for 2025-2027

Item		2025	2026	2027
Capital employed	a	106,683	112,704	118,460
Cost of capital	b	8.68%	8.68%	8.68%
Total return	c = a x b	9,261	9,784	10,284
Estimated WCLC	d	2,373	2,428	2,501
Net required return	**e = c – d**	**6,888**	**7,356**	**7,783**
Estimated WHPC	d	217,907	224,187	230,746
Margin	**e / d**	**3.2%**	**3.3%**	**3.4%**

Source: ECA analysis[7]

Note: All amounts are in thousand euros.

[7] The detailed analysis is provided in Appendix

This margin would ensure that KESCO is adequately compensated, provides a reasonable return on fixed assets, and supports the broader goals of providing reliable and sustainable energy services to regulated consumers. In addition, for competition to take place, the regulated prices of USS should not be set at a level that prevents the entry into the market of new efficient electricity suppliers. In an open electricity market, supply companies compete primarily on the retail margin, which reflects their profitability and ability to cover operational risks. A higher retail margin for regulated customers is essential to create space for other suppliers to be more competitive with their prices, while enabling USS to be financially sustainable by continuing to meet its public service obligations.

4. Bad Debt Allowance

The level allowed for bad debts is an essential component for Universal Service Suppliers (USS), given the legal obligation to supply electricity to all consumers, including social cases and other categories that may have difficulty paying their bills on time or not at all. Since USS has costs for electricity supply, such as payments to generators and network operators, non-payment of bills by end consumers can significantly affect its financial sustainability. To address this issue, regulators allow a bad debt allowance as part of revenues for suppliers, ensuring they can recover some of the costs associated with non-paying customers.

According to article 16 of the USS pricing Rules, Bad debt allowance shall be set by the Regulator during the determination of input values and shall be calculated by applying this allowance in the initial MAR calculation.

During the period from 2022 to 2024, the Regulatory Office (ERO) has allowed the bad debt level from 2.4% in 2022 to 2% in 2024, using the average realized level for the period from 2017 to 2021 as a reference according to the Financial Statements. The bad debt considered by the regulator is based on the provisions presented in the Financial Statements, which are prepared according to accounting principles (IFRS). However, USS has not agreed with this approach, considering bad debt as an input parameter in the regulatory framework, which evaluates the power of collection in accordance with the time and behavior of customers against their obligations. The current regulatory approach, which bases bad debt allowances on financial provisions in accordance with International Financial Reporting Standards (IFRS), underestimates real market conditions and does not adequately reflect the current collection strength of USS. Provisions recorded in the financial statements represent the incremental change in uncollectible income, rather than the total bad debt exposure.

In estimating an appropriate allowance for bad debt, several approaches are possible, namely (a) the approach based on historical experience, examining past data for receivables and uncollectible invoices to predict bad debt in the future, or (b) econometric modeling, which assesses the relationship between consumer defaults and factors such as income levels, affordability and vulnerability. However, for the purposes of this application we rely on historical data.

Analysis of old debts shows that the total amount of debt has increased over the years, with a larger percentage of invoices outstanding for more than 12 months. On average, nearly 48% of USS's outstanding receivables are overdue for more than a year. It is important to note that when analyzing non-payments, most of them are caused by consumers' inability to pay rather than their refusal to do so. This is evident not only in the electricity supplier but in all municipal services, where Kosovo's arrears are among the highest in Europe[8]. Moreover, the other causes are also disputes and delays in their handling by the competent legal bodies (3-5 years on average), or certain circumstances such as the pandemic and the energy crisis.

The latter have severely affected suppliers, leading to an increase in unpaid obligations. Restrictions on movement, suspended activities and economic disruptions forced many businesses to make payments, shifting lawsuits, suspensions for non-payment, etc. As a result, many liabilities were created which also lose the right to collection through legal channels, thus increasing the level of unpaid liabilities. High inflation further reduced purchasing power, making it more difficult for households to pay their bills, resulting in increased amount outstanding and operational challenges for suppliers. In the UK, energy regulator Ofgem reported a record high energy debt, driven by high prices and living costs. Similarly, the Central Bank of Kosovo[9] highlighted a decline in debt repayment capacity due to rising costs, reinforcing the need to increase bad debt allowances to mitigate risks.

Although old debts provide an indication of the amount of bad debt that USS is expected to write-off, the aging profile of accounts receivable does not necessarily translate directly into the actual amount of bad debt. In this regard, it is noted that this requires tracking billing rates based on the time of billing, as opposed to simply dividing collection by the total amounts billed in a given year. This method provides a more accurate picture of how collections correspond to specific billing periods, mainly due to: time delays in payments, seasonal variation and economic changes (economic downturns, the COVID pandemic, etc.). The following table summarizes the receipt of invoices based on the time of invoicing:

[8] As reported in the European Commission's Energy Poverty Advisory Centre https://energy-poverty.ec.europa.eu/epah-indicators#

[9] Financial Stability Report No. 19, https://bqk-kos.org/wp-content/uploads/2023/08/BQK_FSR_19-1.pdf

Table KESCO collection rates 12 months from the corresponding billing period

Timing	2019	2020	2021	2022	2023	2024	Average
Mid-year	91.7%	91.7%	91.8%	93.0%	93.8%	94.8%	**92.8%**
End-year	93.5%	92.5%	94.0%	95.1%	95.9%	n/a	**94.2%**

We believe that it is reasonable to assume that invoices unpaid for more than 12 months have a low probability of being paid in full, taking into account the time limits defined in Law No. 04/L-077 on the Obligation Relations, and the longer a debt remains uncollected, the higher the likelihood that it will be classified as bad debt. The analysis on collection capability shows that USS is able to fully collect all receivables up to 12 months old, but once they become older than one year, the collection rate drops to 75% (or in other words, 25% of old debts are not collected). Although initially this value seems alarming, the data show that even in the developed countries such as USA (where higher collection rates could be expected compared to Kosovo) enterprises recover less than 10-20% of receivables after they become due for more than 12 months. However, USS actively seeks to recover consumer debt beyond 12 months and has had some success in recovering some of these long-standing liabilities through the 'enforcement/bailiff' process.

Based on the reasoning and assumptions above, an average level of bad debt equal to 4.8% of billed revenue is estimated, as shown in the following table:

Table: Estimated bad debt assuming a 75% collection rate for aged (>12 months) debt

	2018	2019	2020	2021	2022	2023
a. Uncollected debt (EUR)*	12,731,126	13,532,855	15,352,193	16,028,788	16,684,575	17,438,895
b. Billed energy (EUR)	263,609,110	278,206,817	289,678,215	324,061,322	357,162,725	419,929,658
c. Bad debt (%) = a / b	4.8%	4.9%	5.3%	4.9%	4.7%	4.2%

Source: ECA analysis

Another method of assessing bad debt is through expected credit loss (ECL) modeling, which segments receivables by age and assigns default rates based on past collection performance. This method provides a more nuanced assessment, taking into account the different risks of default at different stages. The final bad debt estimate using this approach is 4.9% of billed revenue.

In addition to the analyzes explained above[10], during the next periodic review for bad debt levels consideration should be given also to the increasing material risks. Prices are likely to increase compared to historical levels as a result of (but not limited to): the growth of the story in the Albanian Energy Exchange (ALPEX), which will lead to higher electricity prices; Renovation of Kosova B Thermal Power Plant, which would lead to further imports and as a result to increased prices; the expected opening of the market, which will increase the level of bad debts considering that household consumers represent the largest part of uncollected debt.

In light of these arguments, it is critical that ERO reassess the bad debt parameter for USS. Setting the level of bad debt based on accounting provisions does not adequately reflect the real risks and challenges faced by USS in terms of collection power, legal constraints and consumer behavior. The analysis provided, based on historical data to estimate bad debt for the next regulatory period, provides an allowance range between 4.8% and 6.2%. This recommendation is based on multiple analytical approaches and takes into account remote risks that may further affect KESCO's ability to recover unpaid invoices. By adopting a more realistic approach that takes into account market conditions, consumer payment behavior and economic pressures, ERO ensures that USS remains financially stable while continuing to provide reliable services to the majority of Kosovo households.

5. Balancing Sharing Factor

According to Article 12, paragraph 4, of the USS Pricing Rule, the Imbalance Sharing Factor is an input value determined by the Regulator for a three-year period. The Imbalance Sharing Factor is a fixed percentage applied to the net imbalance costs to determine the sharing of these costs between USS and regulated customers.

Forecasting customer demand is always challenging and is influenced by variations in demand over different periods, including the year, month, and day. When suppliers purchase less energy than customer demand, they face additional costs that are outside the direct costs of purchasing wholesale energy. If they buy more energy than the demand, they may receive payments, but these payments can vary and be lower than their wholesale sales. This creates a risk of loss or profit for suppliers, depending on market conditions.

To reduce this risk and assist suppliers in covering operational costs, regulators support suppliers by introducing the Imbalance Sharing Factor. This factor helps create a historical trend that allows suppliers to better forecast and manage these costs.

[10] Detailed Report provided as Appendix

USS in Kosovo holds the largest market share, placing it in a unique position compared to other suppliers in more competitive markets. With 85.7% of its household customers, USS operates under the obligation to provide affordable and reliable electricity to a wide segment of society. This high percentage of household customers means that USS is fulfilling a public service obligation, making the financial security of the company essential.

Household customers generally have low price elasticity, meaning they are less able to adjust to price fluctuations by reducing consumption. As such, it is important for USS to maintain stable tariffs, and transferring the Imbalance Sharing Factor fully to the customers is essential for keeping the company financially sustainable. In countries in the region, including Bulgaria and Romania, where a significant portion of the customer base consists of household customers, imbalanced costs are also passed on to customers to ensure that service companies can meet their obligations without compromising service quality.

Since the functionalization of the balancing mechanisms in Kosovo in June 2017, the imbalance sharing factor was applied as 100%. This means that any profit and/or loss from imbalances has been fully returned or recovered from end consumers. Due to the limited number of market participants, the issue of balancing remains complex in Kosovo. Changes from the requirements imposed by market actors, in a system that is not well advanced from an infrastructure perspective, are very difficult to implement in practice. Limited access to the number and variety of resources, and dependence on generation units that are old and inflexible, limits the ability of the system to be balanced and have minimal costs. Moreover, taking into account market developments (customer producers, the possibility of market opening and the possibility of switching suppliers), we believe that the imbalance sharing factor should continue to be applied as 100% at least until the next periodic review. Otherwise, shifting this burden to the USS would create unnecessary financial costs, harm service delivery and ultimately lead to higher costs for customers in the long run.

6. Operating Costs and other Costs

Through its letter, ERO has asked KESCO to present, among other things, the actual and forecasted costs for operating expenses, expected purchases and sales, which are essential for determining the Maximum Allowed Revenue (MAR).

In the absence of an approved 10-year energy balance (2024-2033) and the annual energy balance for 2025, KESCO has presented the actual costs for the years 2022-2024. The sales forecast is presented in volume according to the demand forecast submitted by the supplier for the 10-year energy balance forecast, while purchases will be able to be presented as soon as we have the official balance accepted by the Transmission System Operator or ERO.

Regarding operating and maintenance costs, taking into account the determination of input values for the next three years and possible changes in the market, KESCO will present below its proposal for operating and maintenance costs.

6.1 Operating and Maintenance Costs

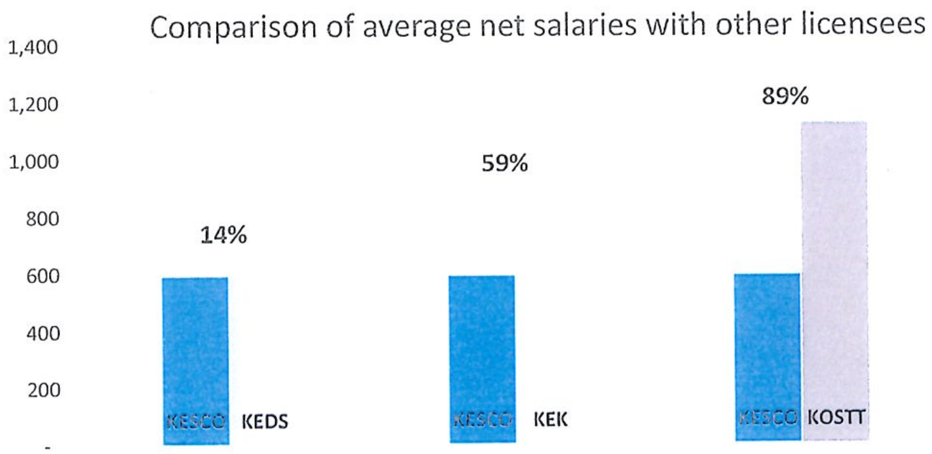
In accordance with the USS Pricing Rule, the USS is permitted to incur reasonable costs, such as operating and maintenance costs (OPEX), which are necessary to enable the supplier to operate. The operating and maintenance costs for the period 2022-2024 were determined by analyzing the average costs incurred during the years 2016-2020. This method of determining costs based on historical data, without taking into account future factors that impact operating and maintenance costs, has risked maintaining a stable level of operation for USS over the past three years.

Historical costs do not reflect the possible risks and uncertainties that the market may face in the future, such as market price volatility, inflation, or geopolitical factors. For example, the unforeseen energy crisis of 2021 had a significant impact on operating costs. In the ERO model, by reviewing the average costs of past years, since 2021 was incomplete, the increased costs resulting from the energy crisis were not accurately reflected. A model that considers only past costs, overlooks the need for an emergency compensation to address such risks in the future. Moreover, the energy market is rapidly evolving, with increasing digitization, customer expectations, and sustainability objectives. Historical costs do not account for future investments required to maintain a competitive advantage and ensure compliance with new green energy mandates. By focusing only on past costs, the ERO methodology proved to inhibit the growth and development of the USS.

Globally, regulatory practices are shifting towards models that account for future investments and risk-based allowances. For example, Ofgem in the UK allows "predictive" adjustments to operating costs based on anticipated changes in market conditions, technology, and regulatory compliance needs. If ERO continues to base costs purely on historical data, these improvements may be limited, potentially leading to a decline in service quality.

One of the main challenges for USS in determining operating and maintenance costs for the 2022-2024 period has been the lack of recognition of higher salary levels for its employees. During this period, the increase in inflation rate has made it significantly more difficult for employees to meet their living costs. Although salaries reflect the rate of inflation growth, the fact that the Regulator adjusts costs according to the European rate and not the country rate, results in the adjustment being low, i.e. they are not adjusted at the same rate as the increase in prices for goods and services, leading to dissatisfaction and ongoing requests for salary increases. Although USS has made efforts to adjust salaries to inflation over the years, these measures have not been sufficient to meet employee expectations or to harmonize them with the salaries of other licensees in the energy sector. The salaries inequality between USS employees and those of other licensees in the energy sector has led to USS employees feeling wage discrimination over a long period.

The following chart presents the change in average net salaries between USS and other licensees KEDS, KEK, and KOSTT for the year 2022, based on data from the financial statements regarding staff costs.



According to the data presented in the graph, during 2022 the average salary in KEDS was 14% higher than in KESCO, while in KEK it was 59% higher. In KOSTT, the average salary for 2022 turned out to be 89% higher than that in KESCO for the same year.

Also, according to the data in the Statistics Agency of Kosovo (ASK), during the year 2022 the average net salary according to economic activities in the category: Supply of electricity, gas, steam and air conditioning was 804 euros net [11], which is 35% higher compared to the average net salary in USS.

According to the data from the supplier, 60% of employees provide cashier and customer care services, 11% of them provide services through information channels, while the rest belong to the administrative sector. If we look at similar sectors in Kosovo, we notice a trend of increasing salaries in these sectors, specifically in 'financial and insurance activities' and 'information and

[11] Kosovo Statistics Authority, Salary level in Kosovo 2022, https://askapi.rks-gov.net/Custom/085019af-7367-4166-966f-87cfcecf3852.pdf (page 14)

communication,' with an average salary increase of around 10% between the years 2021/2022[12], This percentage is expected to be even higher if we consider salary increases during the years 2023-2024.

As a result, the supplier during the last years has been faced with turnover of employees, mainly qualified ones. A study conducted by the Riinvest Institute shows that since 2016, about 1% of the population of Kosovo has immigrated to Germany with a work permit, or around 12,000 individuals of working age[13]. The report " The Impact of Visa Liberalization on the Labor Market in Kosovo" prepared by EPPC shows that 60% will be the impact of liberalization on Kosovo companies, respectively, 22% will experience higher staff turnover, while 40% will be a decrease in new applicants for jobs and 64% will increase the requests for salary increases from current employees, as a result of the increase in workload. According to surveys conducted with the workforce, the main reasons for migration are wages and better working conditions. Such movements have continuously affected the supplier and are expected to impact even more, both in terms of workforce mobility and quality, as well as in terms of attracting new employees.

The following table shows the turnover of employees during the years 2021-2024:

Year	Turnover
2021	10.96%
2022	8.77%
2023	10.21%
2024*	10.21%

The analyses from the World Bank highlight the lack of workforce as one of the main concerns for businesses in the Western Balkans. Meanwhile, a recent study conducted by the GAP Institute published in January of this year shows that 27.9% of the population plans to emigrate in the first quarter of 2024, dominated by young people motivated by the expectation of higher wages and better working conditions in destination countries. According to ASK, by July, around 600,000 non-residents had been registered. This figure is quite high and indicates the immigration of citizens from the country over the years. These factors have significantly increased the challenges for USS in retaining and attracting qualified staff, raising pressure to address issues related to salaries and working conditions.

---

[12] Kosovo Agency of Statistics, https://askdata.rks-gov.net/pxweb/sq/ASKdata/ASKdata__Labour%20market__Niveli%20i%20Pagave/tab03.px/

[13] Riinvest Institute, November 2023 "A model for sustainable economic growth. Labor market dynamics: current and future challenges",link: https://www.riinvestinstitute.org/uploads/files/2023/November/13/19_-_Forumi_Ekonoik_Vjetor_-_ALB021699882724.pdf (date of access 03.01.2024)

In addition to these, USS has continuously requested and justified the need for increasing operating costs due to the ongoing growth in the number of customers, which is resulting in a request for staff expansion and infrastructure improvements. To meet these challenges, it is essential to develop specialized training and recruit qualified staff. Investments in training and recruitment will not only ensure a well-prepared staff, but also guarantee quality and safety in services. Additionally, the continuous market changes and the introduction of new requirements in line with European developments are also increasing the need for training, consultants, and better public information regarding changes in the services offered. These investments are essential to maintaining high standards and ensuring the efficient and safe operation of USS.

The energy market in Kosovo is going through continuous changes, including shifts towards digitalization. Investments in IT infrastructure and customer service platforms require significant operating expenses to ensure efficient operations. Digitization enhances the customer experience and interaction with the supplier, improves data accuracy and reorganizes operations.

KESCO supplier recently has been penalized by the Data Protection Agency for not sending bills in envelopes, although the same has explained that these costs are not recognized in the MAR of USS. The costs for sending bills in sealed envelopes that show the necessary information for the customers without violating the data protection law, exceed the value of € 2 million/year. These costs are included in USS's request for OPEX for the years 2025-2027, emphasizing the need for transparency and legal enforcement in the billing process.

In USS's request for OPEX, a significant increase in security expenses is also foreseen, including the security of the building and the cash in transit. This increase in costs is closely related to the recent increase in the minimum wage in Kosovo in the amount of €350[14]. The minimum wage increase is expected to have a direct impact on the provision of these services by contractors, causing them to increase the costs of the services they provide, in line with the new wage requirements and insurance needs. This increase in costs is necessary to maintain the integrity of operations and meet the required safety standards. Another factor that has influenced the increase in the operational costs of USS are the obligations for financial guarantees according to the Market Rules and the Procedure for Financial Guarantees.

Considering the above, the increase in operating and maintenance costs for the 2025-2027 period is necessary to address all the aforementioned challenges. The OPEX proposed by USS to ensure

[14] Decision No. 02/2018 of the Government of the Republic of Kosovo, https://gzk.rks-gov.net/ActDetail.aspx?ActID=96573

stable and functional operation, meeting high quality and safety standards for the years 2025-2027 is as follows:

in '000 €	2025	2026	2027
Operating and maintenance costs	9,710	10,087	10,453

7. Conclusion

In conclusion, the USS proposal, based on the rationale of the components for the regulatory parameters presented in this document, is fair and, most importantly, necessary for the successful operation of the USS

In accordance with Article 15 of the Law on the Energy Regulator, the Regulator is obliged to balance the interests of customers and licensees and cover the real cost of electricity supply, including generation costs, short-term marginal costs, reflecting the full generation portfolio, necessary investments, the appropriate rate of return, import costs, supply service costs, as well as bad debts.

Considering the financial difficulties of USS, caused by the energy crisis, USS requests an assessment and reflection of input values and operating costs during the next three years, in order to guarantee the operation and stability of the electricity supply.