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KOMPANIA KOSOVARE PËR DISTRIBUIM DHE FURNIZIM ME ENERGJI ELEKTRIKE SH.A.
KOSOVO ELECTRICITY DISTRIBUTION AND SUPPLY COMPANY J.S.C.
KOSOVSKO PREDUZEĆE ZA DISTRIBUCIJU I SNABDEVANJE ELEKTRIČNOM ENERGIJOM D.D.
KEDS - SH.A.
Nr. 17 Dt. 03.03.2023
HQ 1

Ymer Fejzullahu
Chairman of ERO Board

Alpin Dogan
Chief Executive Officer
KEDS j.s.c

03 March 2023

Subject: DSO Comments on the ERO Consultative Report on Maximum Allowed Revenues for the third regulatory period 2023-2027

Dear Mr. Fejzullahu,

This document summarizes the comments of the Distribution System Operator to the Consultative Report of the Energy Regulatory Office (ERO) on Maximum Allowed Revenues for the third regulatory period 2023-2027.

DSO appreciates the opportunity given to provide comments on the important issues raised in the consultative report and asks ERO to seriously consider all raised issues before any final decision on Maximum Allowed Revenues for the regulatory period 2023-2027.

Due to the great importance of this process, DSO is open and ready for further discussions whenever necessary.

With respect,

Alpin Dogan
Chief Executive Officer

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Comments of the Distribution System Operator to the ERO Consultative Report on the Maximum Allowed Revenues for the Third Regulatory Period (2023-2027)

March, 2023

Contents

1. Introduction

On 16 February 2023, the Energy Regulatory Office (ERO) has published the Consultative Report on the Maximum Allowed Revenues (MAR) for the Distribution System Operator within the third regulatory period (2023-2027). In this report, ERO has presented the initial assessment of the Maximum Allowed Revenues for DSO, based on the Proposal of DSO for the maximum allowed revenues for the third regulatory period submitted on 22 November 2022.

During the calculation of the maximum allowed revenues, DSO has used the input values determined by ERO for the regulatory period 2023-2027 such as: The weighted average cost of capital (WACC) determined by decision no. V_1634_2022, the efficiency factor determined by decision no. V_1635_2022 and the loss reduction target determined by decision no. V_1636_2022.

Following this document, DSO will present its position regarding ERO's proposal for the maximum allowed revenues for the third regulatory period 2023-2027, as well as the position regarding ERO's calculations for the regular annual adjustments for year 2023 according to the Consultative Report.

2. Regulatory asset base (RAB) and Investment Plan

In this section, DSO present its positions/comments on the adjustment of capital investments made in the second regulatory period, as well as the capital investments proposed for the third regulatory period.

2.1. Adjustments for capital investments in MYT2

The energy regulatory office for the second regulatory period 2018-2022 has allowed investments in the amount of 131 million €. During this period, on an annual basis, DSO has notified ERO of all investment plans in the network and their necessity.

We have witnessed that in recent years as a result of rapid developments in urban areas, the increase in demand/load has constantly overloaded the existing exits, as a result some exits have reached the maximum capacity of the line at peak hours. In order to avoid interruptions due to overloads, DSO had to take the necessary steps to fulfill the obligation to offer all users of the system quality energy and the possibility of connection, in accordance with the Law on electricity and the distribution network code.

During the last 5 years, DSO has faced many challenges that have affected the implementation of the approved investment plan for the period 2018-2022, but which were beyond DSO's control. The

5-year investment plan (2018-2022) was approved by ERO in the last quarter of 2018 due to the lack of quorum on the ERO board. During almost the entire year 2018, DSO was not aware of which projects ERO would approve, but in the absence of the interruption of investments, due to the needs of the network, DSO invested according to its assessment in the projects necessary for security and network expansion. During 2020, DSO was affected by the spread of the Covid-19 pandemic, while during 2021 and 2022 DSO was affected by the energy crisis, which not only caused delays in the implementation of investment plans, but also increased the costs of their implementation. Despite these challenges, DSO has managed to invest 107.28 million euros for the period 2018-2022, from the 131 million euros that the regulator had approved for the same period.

The investments made by DSO in the second regulatory period were also reflected in DSO's initial proposal for the maximum allowed revenues for the third regulatory period. However, ERO, in the consultative report published on 16 February 2023, has decreased the investments made in the amount of 29.7 million euros under the reasoning that they are investments that have not been approved by ERO.

Capital investments	**€000s**
MYT2 approved	131,443
MYT2 realized	107,277
Additions in the opening of RAB for MYT2	**77,577**

In addition, for the same ERO has adjusted the allowed depreciation and the allowed return by applying the compound rate of interest and inflation, concept which cannot be applied in real investments.

However, ERO has qualified these projects as necessary investments and they are carried over to the last 4 years of the third regulatory period, although the same have been energized and customers are benefiting from these investments.

DSO has notified ERO either through the annual investment report, or through the official meetings regarding the implementation of these projects, and DSO has not officially accepted any official letter from ERO that requires their termination. Therefore, knowing their importance and necessity for the distribution system, these investments should be recognized. By postponing recognition to the next regulatory period, the DSO is left to bear the investment costs without the corresponding revenue, putting the day-to-day operation of the DSO at risk.

It is important to note that the realized and unrecognized investments, which are being used by customers, are amortized and require continuous maintenance, a cost which is not allowed to DSO in this regulatory period, reducing the asset base in fictitious way.

Considering the above-mentioned arguments and economic and financial principles, DSO requests from ERO to recognize these investments as they were realized in the period of their realization.

2.2.Investment plan for the next regulatory period (MYT3)

As required by the legislation in force, DSO has prepared the investment plan for the years 2023-2027 together with the cost and benefit analysis (Cost/Benefit analysis), which have been submitted to ERO for approval.

The criteria for the selection of the 5-year investment plan were mainly focused on projects where there is a drop in voltage, network load, losses, outage indices, electricity demand, consumption growth, the age of the distribution network and the number of customers.

OSSH in the five-year investment plan for the regulatory period 2023-2027 has proposed capital projects in the amount of 167 million €, which were made based on technical analysis and with the aim of achieving the loss target determined by ERO.

ERO with decision number V_1636_2022 has approved the allowed loss target for the third regulatory period. It is paradoxical that after the decision on the loss target, ERO reduced investments unilaterally, making it impossible for DSO to achieve the loss targets set for the third regulatory period.

ERO in the consultative report has assessed the capital projects for the next regulatory period in the amount of 122.1 million €, decreasing projects focused on low voltage and electric meters, directly related to the loss target.

In the investments of the third regulatory period, as argued above, ERO has also included the projects realized in the second regulatory period in the amount of 29.7 million €. Consequently, the final value of investments for the third regulatory period is 151.7 million € as shown in the table below:

€000s	Totali	-------------- MYT3 --------------				
		2023	2024	2025	2026	2027
		Proposed	Proposed	Proposed	Proposed	Proposed
Submitted by DSO						
Capital expenditure	**166,868**	31,705	35,100	35,883	32,476	31,706

ERO proposals						
Capital expenditure	**151,771**	28,571	37,695	36,056	29,384	20,065
- Projects from MYT3	**122,071**	28,571	30,348	27,221	20,775	15,156
- Projects carried over from MYT 2	**29,700**	-	7,347	8,836	8,609	4,908

It is important to note that ERO estimates for the investment plan 2023-2027 are not in line with the technical analysis and network needs, specifically in the last 2 years, hence they are not in line with the Implementation Agreement dated 17 October 2012, signed between the Government of the Republic of Kosovo, Investors, KEK j.s.c. and KEDS j.s.c.

As argued above, DSO in its proposal has included the projects of the second regulatory period in 2023 presented as follows:

€000s	**Totali**	- - - - - - - - - - - - - - MYT3 - - - - - - - - - - - - - -				
		2023	2024	2025	2026	2027
		Proposed	Proposed	Proposed	Proposed	Proposed
Submitted by DSO						
Capital expenditure	**166,868**	31,705	35,100	35,883	32,476	31,706

Based on DSO's proposal for the third regulatory period, the value of the final RAB for DSO is summarized in the following table:

€000s	- - - - - - - - - - - - - - MYT3 - - - - - - - - - - - - - -				
	2023	2024	2025	2026	2027
	Proposed	Proposed	Proposed	Proposed	Proposed
RAB in the opening	236,012	248,636	262,751	275,642	284,235
Investments (Additions)	31,705	35,100	35,883	32,476	31,706
Deprecation	19,080	20,986	22,991	23,883	25,408
RAB in closing	248,636	262,751	275,642	284,235	290,533

3. Operating and maintenance expenses (OPEX)

Operating and maintenance expenses consist of maintenance costs, operating costs and other costs related to distribution operations. In the consultative report, ERO has allowed lower levels than those proposed by DSO, thus putting at serious risk continuation of DSO's operations for the next five years.

Maintenance costs represent the cost of price and materials. As it was emphasized in the proposal for the maximum allowed revenues for the third regulatory period, the increase in the prices of materials has been an important factor that affected the increase of costs for the categories Repairs, maintenance & materials.

The following table shows only a few examples of price changes between 2018 (the first year of the second regulatory period) and 2022.

Description of the commodity	**November 2018**	November **2022**	Changing Ratio in **%**
Aluminum	1,966.00	2,391.00	21.62%
Cooper	6,826.55	8,110.00	18.8%
Concrete (m3)	56.05	64.90	15.79%
Fuel	1.21	1.73	42.98%
Brent Petrol	67.29	88.26	31.16%

Since the trend of increasing prices is continuing and they are beyond the control of DSO, the non-recognition of these costs and the application of the efficiency factor in this line is unreasonable for DSO. Therefore, a review of costs is necessary.

Law No. 06/L-005 on real estate tax, approved in 2018, foresees that in the 5^{th} tax year (2023) there will be no general deduction for property tax, in contrast to previous years when the deduction was applied, as determined in the law. Thus, the year 2023 is the first year that the full invoicing of the property tax is done. Moreover, ta rates have also increased. In this view, since the costs from property tax are costs outside the DSO's control, we request from ERO to reflect these costs when deciding on OPEX for the next regulatory period.

Also, the prices for insurance of assets and third parties have increased by 24.45% and considering that the same are out of the control of DSO, the same should be reflected in the final OPEX.

In the proposal for the maximum allowed revenues for the period 2023-2027, DSO has also requested from ERO to carefully assess the issue of salary increases for its employees, which is not harmonized with the salaries of other operators in the electricity sector in Kosovo. DSO has argued that as a result of the increase in inflation, the budget of the company's employees has been overburdened, by increasing the pressure for salary increases.

The inflation that is adjusted in OPEX is at the European level and does not correspond to the inflation of Kosovo, the costs of which are paid by the employees. Moreover, the application of the efficiency factor in the salary line damages even the recognition of inflation that the company can reflect.The non-reflection of DSO salary leveling in the electricity sector in the country clearly endangers the operational sustainability of DSO, which is facing continuous departure of professional employees. Moreover, the increase in salaries in the public sector and the aid provided in this sector in order to reduce the impact of inflation has increased the dissatisfaction of the DSO’s employees.

Considering the abovementioned, DSO's proposal for the category of operating and maintenance expenses must be accepted in total and without limitation. By allowing the Distribution Operator to recognize the increased costs in its OPEX, it will help the operator to be able to retain a competent and skilled workforce, which is essential to its ability to provide reliable and efficient service. In addition, this helps the operator in the longer term to be able to manage its operating costs more effectively, which can lead to improved services and financial stability.

4. Losses and unregulated revenues

4.1.Costs of energy losses

ERO in November 2022 approved the loss reduction target for the third regulatory period as follows:

Allowed losses	Unit	2023	2024	2025	2026	2027
Allowed losses for DSO	%	15.1	14.7	13.3	12.1	11.1
Losses reduction target	%	-	0.4	1.4	1.2	1.0
Losses sharing factor	%	50/50	0	0	0	0

Since the costs of losses are not a fixed parameter during the regulatory period but are subject to regular annual adjustments, ERO in Consultative Report has presented the proposal of the cost of losses only for the year 2023.

In ERO's proposal for the costs of losses for the year 2023, it is foreseen that the energy entering into distribution level is 6,220 GWh, while the purchase price is 86€/MWh. Regarding the energy in entry of distribution (EED), ERO has used the same methodology as in previous years, considering only the allowed level of losses at the distribution level. Even in the past, DSO has not agreed with the methodology used since it is not in accordance with the methodology approved in the Energy Balance and the methodology defined in the DSO Pricing Rule and as a result it gives wrong conclusions. DSO agrees that for tariff purposes it must use the approved level of losses when calculating the allowed cost of losses, however the lower energy in entry forecast at the distribution level means subsidizing a part of the costs by DSO in a relevant year and respectively larger adjustments during the next year, creating financing problems.

DSO in this application has updated energy purchases to cover losses based on the approved energy balance for 2023. In forecasting the energy purchases, similar to ERO, DSO has taken into account the KEK-KESH exchanges, as well as the decision of the Government of the Republic of Kosovo no. 01/117 and 02/117 dated 29.12.2023. However, in its application, DSO also presented the capacity costs for energy from KESH, which costs are necessary using this energy, otherwise, not recognizing the capacity costs endangers bringing the energy from KESH, risking that this energy is further covered through intraday, which has higher and not-recognized cost in tariffs in the relevant year.

The uncovered energy from local production is expected to be covered through electricity imports, which prices since the energy crisis are high and unstable. Forecasts in international markets are also expected to be unstable also during 2023, therefore forecasting them rightfully, including capacity costs is necessary. As a result of not reflecting correctly the high import costs, DSO during the last two years has operated below cost, therefore, in order to ensure sufficient liquidity in this document, DSO has forecasted expected import prices as per the current forecast in international electricity exchanges, by applying also the capacity costs, as additional costs which are added to the final import price.

Based on the above, DSO's proposal for the cost of losses for 2023 is as follows:

€000s Inputs for calculation	Unit	2023 Proposed - ERO	2023 Proposed - DSO
Entry energy in distribution	GWh	6,220	6,287
Allowed losses	%	15.1%	15.1%
Losses	GWh	939	949
Purchase price	€/MWh	86	95
Total Costs	**€000s**	**80,906**	**90,457**

4.2.Unregulated revenues and excluded costs

ERO in the proposed MAR for the third regulatory period has deducted excluded costs in the amount of €0.4 million, by not providing any argument regarding this decrease.

According to the DSO Pricing Rule, the maximum allowed revenue must not cover the costs of performing any service (including services around power lines or power plants) that is designated as an exempt service under Appendix 5, including a) services from which any third party who requests the service benefits in particular and b) the same is covered by fees or other taxes and not by fees for the use of the distribution system.

Considering that ERO has deducted unregulated revenues in the amount of 5 million euros, which include revenues from the services defined in appendix 5 of the rule, the deduction of excluded costs related to the provision of this service is unreasonable. As a result, the same should not be deducted from the maximum allowed revenues

5. Regular annual adjustments 2023

Regular annual adjustments mean adjustments of current costs based on current revenues, respectively the correction factor. Any over or under allowance of costs in relation to revenues must be adjusted during the regular tariff process.

In the adjustments for inflation of operating expenses, ERO did not consider the total OPEX approved for 2022. Taking into account that the DSO pricing rule defines precisely the adjustment for inflation rates, DSO in this report will make adjustments to the total operating costs allowed by ERO for 2022.

DSO in its application requested to recognize the costs of the imbalances for the months of July-September, which were caused as a result of the impossibility of purchasing the electricity needed to cover the losses, due to the extraordinary event, and only after undertaking all actions for their prevention. In addition, DSO has argued that it requested from Transmission System Operator to take all the necessary steps to prevent deviations in the system, which were not applied correctly, thus allowing the imbalance in the system. However, ERO has not addressed the same in the consultative report.

In this report, DSO in the average price of purchasing losses has included the costs for imbalances for the period July-September and requests from ERO to recognize them in the adjustments of the costs of losses for 2022, otherwise it will be impossible to pay these costs to third parties as long as they are not recognized in the tariffs.

Taking into account the abovementioned, the corrective factor of the DSO for the year 2022 is 28.5 million euros from 24.94 as proposed by the ERO in the Consultative Report.

Revenues correction factor - KREV	Unit	ERO	DSO
AAC_{at-1}	mil€	189.00	192.28
ARR_{t-1}	mil€	166.02	166.02
I_t	%	8.51	8.51
KREV = ($AAC_{at-1} - ARR_{t-1})*(1+I_t)$	**mil€**	**24.94**	**28.50**

ERO, in the consultative report, has divided the correction factor for 5 years and has distributed the same throughout the third regulatory period in equal amounts, treating them similar to the corrections made during the regulatory period.

It is important to note that the purpose of setting the correction factor is to adjust the costs that are above or below the actual costs in relation to the revenues, and the same must be adjusted during the regular tariff process, the purpose of which is to return the benefits or losses from costs allowed to the operator.

The costs of additional 28.5 million €, which were not recognized in the tariff for year 2022, were covered by the operator during the relevant year, therefore, their distribution in 5 years is unfair and endangers the financial position of DSO.

The treatment of corrections for the regulatory period divided into 5 equal years is the right approach, since the same are allowed and adjusted for 5 years, but using of the same method for the correction factor is contrary to the logic of placing the correction factor in the DSO Pricing Rule, which is applied during regular tariff adjustments.

Therefore, we ask the regulator to correctly apply the adjustments, not penalizing and putting further burden to the financial position of the distribution system operator, which has covered these costs within the relevant year.

6. Maximum Allowed Revenues (MAR) for the regulatory period 2023-2027

The following table summarizes the Maximum Allowed Revenues requested by DSO for the third regulatory period 2023-2027 taking into account the justification for the cost components presented in the above sections of this document.

€000s	2023 Proposed	2024 Proposed	2025 Proposed	2026 Proposed	2027 Proposed
	MYT 3				
Opex Basis	33,843	34,611	35,304	35,927	36,463
Cost of losses	90,457	80,690	73,499	67,492	62,648
Depreciation	19,080	20,986	22,991	23,883	25,408
Allowed Return	17,312	18,557	19,812	20,854	21,643
Excluded costs	-	-	-	-	-
Non-tariff revenues	-5,000	-5,000	-5,000	-5,000	-5,000
Obligations to OS and OT	1,934	1,934	1,934	1,934	1,934
License tax	90	90	90	90	90
Initial MAR	**157,716**	**151,867**	**148,628**	**145,180**	**143,186**
Adjustments 2022 and MYT2	29,699	(3,998)	(3,998)	(3,998)	(3,998)
Total proposed MAR	**187,414**	**147,869**	**144,630**	**141,182**	**139,188**

Considering the challenges that await the energy sector and especially the Distribution System Operator during the next five years as a result of the energy transition process, then it is more than necessary for ERO to reflect before making any final decision regarding the maximum allowed revenues for the third regulatory period 2023-2027. DSO believes that its requests are fair and most importantly necessary for the distribution system to function properly.

The purpose of the DSO is to provide better services to its customers, however to do this the necessary operating costs must be allowed and enabled by the Regulator.