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Comments related to: ERO Consultation Paper on the Efficiency Factor

Issue for comment:

Response to the issues raised by ERO in the Consultation Paper regarding the Efficiency Factor

The comment:

1.0 INTRODUCTION

This document presents the response of KOSTT to the issues raised by ERO in its Consultation Paper concerning the Efficiency Factor dated 13 September 2022.

KOSTT would like to thank ERO for acknowledging and responding to the issues raised by KOSTT in its 29 July 2022 Efficiency Factor Recommendation Report.

KOSTT still considers that its recommendation in the 29 July report is a reasonable one based on the situation it faces in the energy sector of Kosovo, however, we realize the difficult situation that ERO is in, given the political and social barriers that prevent market-based prices being passed along in tariffs on a timely basis to households and small businesses in Kosovo. The “Harmonized Inflation Europe (HICP) 2022” value for the most recent 12-month period is 9.1% and growing each month. This is far greater than any retail price increase ever granted by ERO.

Since several of the input parameters (including the Efficiency Factor) are based on “soft” data and academic exercises, as opposed to hard data specific to Kosovo, it is not surprising that ERO needs to utilize those parameters in such a manner to hold retail prices as low as possible. If we think of the efficiency of producers as a way to partially offset the effects of inflation on energy, it is understandable that ERO is concerned about this parameter since the inflation rate is 9.1% and growing.

With the above considerations in mind, KOSTT submits its responses to the Consultation Paper in this document.

2.0 RESPONSES TO ISSUES RAISED BY ERO IN THE CONSULTATION PAPER

KOSTT appreciates that ERO responded to each of the points that KOSTT raised in its 29 July submission concerning the Efficiency Factor. We will address those responses as well as the new approaches that ERO introduced related to determining the efficiency factor.

A. Points on which ERO and KOSTT Agree

ERO noted that when it sets the base allowed for OPEX, it would specifically include five of the issues raised by KOSTT (points 5 – 9) as follows:

- Increases in the asset base of KOSTT to fulfil Kosovo's electricity needs.
- New planned capital projects for the following 5 years which will increase O&M costs.
- New regulations on compliance with Governmental regulations, environmental standards, and health and safety standards increase costs.
- The latest ENTSO-E report requests from KOSTT to increase staff and to increase operational costs, considering new duties and requirements stemming from ENTSO-E.
- Limits in cash-flow in the past that have impacted KOSTT, resulting in cancelation or postponements of O&M projects. The further electricity crisis will worsen the situation at KOSTT.

B. Points Raised by KOSTT that ERO did not Incorporate in its proposal

KOSTT maintains that the level of the Efficiency Factor was set arbitrarily at 1.5% in prior tariff reviews using a methodology mainly designed for highly developed countries. Furthermore, as a state-owned company, KOSTT does not have enough flexibility to manage costs, such as number and salary of employees, negotiating prices with suppliers etc. ERO did not take those points into consideration in arriving at its position.

KOSTT made the point that the Efficiency Factor is not significantly used in ERRA (Energy Regulatory Regional Association) Member States, and a value of 1.5% is not typical for member countries. That issue is addressed in section C below.

During the previous regulatory period, there is minimal correlation between allowed OPEX and the actual OPEX.

C. The Efficiency Factor is not significantly used in ERRA (Energy Regulatory Regional Association) Member States

In its 29 July submission to ERO, KOSTT made the point that most ERRA regulators **do not** utilize efficiency factors to establish tariffs. As support for this assertion, KOSTT referenced the April 2020, Economic Consulting Associates report to ERRA titled “Regulatory Approaches to Revenue Setting for Electricity Transmission and Distribution System Operators”. That report indicated: “among ERRA Member Organizations, there is currently limited use made of efficiency factors either at the level of the tariff or revenue control or in setting cost allowances.” Of the 20 regulators included in the study, 50% (10) do not utilize efficiency factors. Of the remaining 10 regulators:

- 2 did not disclose the value
- 3 use a 1% factor
- 4 use 1.5% (including Kosovo)
- 1 uses 4% (Nigeria, an outlier)

Based on that study, KOSTT stated that the use of a 1.5% factor is not typical among ERRA countries. KOSTT asserts that this is still the case. In fact, in its consultation paper, ERO stated that: “...there is limited implementation of efficiency factors utilized in different countries”. However, despite the fact that the majority of ERRA members do not make use of such factors, ERO presented the data in Table 1 below.

Table 1: ERO Selection of Countries Presented in the Consultation Report

	TSO	DSO	Reference
Austria	Depends on Company	1.25% - 4.4%	ERRA database
Bhutan	2.0%	2.0%	ERRA database
Czech Republic	1.0%	1.0%	ERRA database
Finland	2.2%	2.2%	WIK-Consult, Cost Benchmarking in Energy Regulation in European Countries.
Georgia	1.5%	1.5%	ERRA database
Hungary	1.5%	1.5%	ERRA database
Lithuania	1.0%	1.0%	ERRA database
Moldova	1.0%	1.0%	ERRA database
Netherlands	1.5%	1.5%	WIK-Consult, Cost Benchmarking in Energy Regulation in European Countries.
Nigeria	4%		ERRA Study on Regulatory Approaches to Revenue Setting, 2017
Northern Ireland	0.80%	0.80%	Utility Regulator, Real Price Effects & Productivity RP6, Final Determination, 2017
Norway	1.5%	1.5%	WIK-Consult, Cost Benchmarking in Energy Regulation in European Countries.
Oman	1%	1%	ERRA Study on Regulatory Approaches to Revenue Setting, 2017

Poland	1.50%	1.50%	ERRA Study on Regulatory Approaches to Revenue Setting, 2017
Romania	1 - 1.5%	2%	ERRA database
Slovakia	3.5%	3.5%	ERRA database
Turkey		1.17%	ERRA database
UK	1.25%	1.25%	OFGEM – RIIO-2 Final Determination, 2020

KOSTT strongly objects to the use of the above biased sample of 18 countries to consider in setting an efficiency factor for KOSTT. Our objections are based on the following:

- Six of the countries are not ERRA members (Bhutan, Finland, Netherlands, Northern Ireland, Norway, and the UK). It is curious that Bhutan (an isolated Himalayan country) was chosen, other than the fact that its factor of 2% is definitely high. The other 5 are highly developed countries in Western Europe that are not comparable to Kosovo in size or level of management and technical expertise.
- The remaining 12 countries are members of ERRA. Given that ERRA has 34 Full Members and 14 Associate Members¹, this strengthens KOSTT's position that the majority of ERRA full members (65%) do not utilize efficiency factors. Also consider that there are 14 associate members that were not included in the table.

Based on the above facts, KOSTT stands by its assertions in the 29 July submission that efficiency factors are not utilized by the majority of regional countries.

D. ERO Presented Complex Academic Theories but decided not to use them

Efficiency factor theories were referenced in the consultation Report related to Catch-Up Efficiencies (using benchmarks and Virtual Reference Networks) as well as Frontier Shift Efficiencies). These concepts appear to come from a 2018 report developed by Europe Economics for Ofwat, the UK water and wastewater regulator, titled “Real Price Effects and Frontier Shift”. After describing these complex theories, ERO concluded they were not applicable to Kosovo. KOSTT agrees.

E. ERO Used Accounting Data to Attempt to Show Efficiency Gains

Since benchmarking could not be used, ERO looked at summarized accounting costs over a 5-year period related to operating data (transmitted electricity, coincident peak, cable lengths, and transformer capacity). Although those operating parameters can be considered significant determinants of technical losses, they are not necessarily drivers of operating and maintenance costs. There was no mention of labor productivity, maintenance management practices,

¹ Source: ERRA website

procurement efficiencies, equipment utilization, technical and IT innovations, etc. that would drive cost efficiencies.

In addition, cash constraints have impacted KOSTT in the past, resulting in deferring or canceling maintenance projects. This is due to the fact that when there are cash shortages, maintenance is the primary component of OPEX that is reduced. Most other operating costs cannot be reduced since the system must be up and running. Since the impact of maintenance cost reductions are primarily felt in the future, the hard decision is to defer projects. Of course, deferring maintenance is not a prudent management practice and it will eventually impact service levels and result in higher cost in the future if equipment prematurely fails.

F. KOSTT Proposed Way Forward

KOSTT still considers that its recommendation in the 29 July report that the efficiency factor be set at zero is a reasonable one based on the situation it faces in the energy sector of Kosovo. The material in this report further confirms that recommendation.

We are aware, however, that political and social barriers prevent ERO from passing market-based prices along in tariffs on a timely basis to households and small businesses in Kosovo. The “Harmonized Inflation Europe (HICP) 2022” value for the most recent 12-month period is 9.1% and growing each month. This is far greater than any retail price increase ever granted by ERO.

As discussed herein, the Efficiency Factor has been determined based on “soft” data and academic exercises, as opposed to hard data specific to Kosovo. ERO’s position in the Consultation Paper is that the efficiency factor be set at 1.5% to 2%. The 2% value is definitely not supported on any rational basis. Increasing the factor from the current level of 1.5% would simply be an arbitrary attempt to reduce the level of Allowed Revenue at the expense of KOSTT.