
***Proposal for Input Values 2022-2024 for
Universal Service Supplier***

November, 2021

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1. Introduction

Energy Regulatory Office through its official letter no. 497/21 of the date on 12th of October 2021 addressed to KESCO as Universal Service Supplier (USS) has re-opened the process for reviewing the Input Values and Operating Expenses for period 2022-2024.

ERO had initially opened the process for determining the input values on September 10, 2020, considering that since the end of 2016 and the beginning of 2017, when the legislation in the electricity sector has changed to meet the legal requirements deriving from the EU Third Energy Package, we had no revaluation of input values for the USS. Although USS submitted its proposal on October 8, 2020, the process of determining the input values was not completed due to the lack of a functional Board of ERO.

Input Values are key parameters that are used in the calculation of the regulated revenues of Universal Service Supplier. Conform Rule on Determination of Revenues for Universal Service Supplier (USS Pricing Rule), Article 9 paragraph 2, an input value review shall be held at the initiation of the Regulator. Input values comprise of the following:

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

Conform Article 12 paragraph 4, retail margin, bad debt allowance and imbalance sharing factor are input values set for a period of 3 years.

ERO through its letter has requested from KESCO to present also allowed and actual costs, operating and maintenance costs as well as capital costs for the period 2017-2021 as well as the proposal for the next three years 2022-2024. In the following document we have presented the request and justifications regarding the regulatory parameters and operating costs for the Universal Service Supplier.

2. Economic Lifetime of Assets and CAPEX Request for USS

In accordance with the USS Pricing Rule, the depreciation costs are calculated using the Economic Lifespan of Assets, determined for different asset classes as approved by the Regulator during the determination of the input values.

Universal Service Supplier (USS) has limited capital investments, which is mainly limited to office equipment and Information Technology (IT). ERO since the first regulatory period has applied depreciation for capital expenditures of USS with a lifespan of 5 years.

In 2017, ERO opened the reviewing process of input value for distribution and transmission operators. For equivalent category of working equipment, IT equipment and software which are applicable to the supplier, ERO has decided that the asset life for system operators should be 5 years.

Considering the actual lifespan of assets and developments in the IT sector, we believe that ERO shall set the lifespan of work equipment for 5 years, similar to distribution and transmission operators. However, regarding IT equipment and software, KESCO proposes that the life span shall be determined for three years to respond to the modern requirements of power systems. The following table shows the average of the years that various international companies use to depreciate software:

Average depreciation of software programs	
Company	Lifespan of assets
Apple	3-5 years
Microsoft	3-7 years
Facebook	2-5 years
Johnson&Johnson	3-8 years
Proctor and Gamble	3-5 years
NVIDIA	3-5 years
Home Depot	3-6 years

Source : Company data base on research of Andrew Sather
 Link: <https://investingforbeginners.com/computer-software-depreciation-accounting/>

We believe that five years period for IT equipment and software is long, and these devices will not have the economic and technical value to respond to the contemporary requirements of the ever-changing environment, so we ask ERO to consider sharing the life expectancy of USS assets in two groups, as presented in the following table:

Depreciation groups	Lifespan of assets
Office Equipment	5 years
Computer programs	3 years

Actual data show that the division of USS capital investments over the years are over 60% in the category "Office Equipment". The following table shows the distribution of costs between office equipment and IT in the last three years:

Depreciation groups	2019	2020	2021
Office Equipment	63%	67%	73%
Computer programs	37%	33%	27%

However, due to developments since the legal and functional unbundling from the distribution operator, the supplier KESCO has consistently faced major changes in day-to-day operation, including market opening,

unregulated customer, operation self-consumers, operation of balancing mechanism, etc. Considering the limited budget allowed for capital investments and the marked increase in the need to update the supplier's operating system, in the coming years it is necessary to allow a higher budget to enable the necessary investments in the operating system (billing and CRM). The following table summarizes the actual CAPEX for the period 2019-2021 and the requirements for 2022-2024.

	në '000 €	Year 1	Year 2	Year 3
Actual costs (2019-2021)		250	182	218
Requested Budget (2022-2024)		1,614	1,514	1,314

3. Retail Margin

Universal Service Supplier (USS) is the supplier whom the Public Service Obligation is imposed by the Regulator. In exchange for granting the exclusive right to sell electricity in a given service territory, Regulator determine what are the allowed costs of operation, how much it can charge, and what its retail margin can be.

Universal Service Suppliers worldwide are regulated companies that don't operate in a normal free market system where prices and profits are determined by the willingness of consumers to pay. Instead, Regulators guarantee a monetary return by setting a retail margin, but at the same time protect end consumers by setting regulated prices for them.

Article 17, paragraph 8 of the USS Pricing Rule define that: *'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.'*

Considering the market conditions before privatization, Regulator has set the retail margin at 3%, which was applicable up to date.

A study performed by Energy Community Regulatory Board (ECRB) in December 2013 shows a similar approach being applied in all neighboring countries in relation to the application of retail margin¹. As market

¹ ECRB, December 2013, Status Review of Main Criteria for Allowed Revenue Determination for transmission, distribution and regulated supply of electricity and gas, https://www.energy-community.org/dam/jcr:f0feeb6e-96c9-48fd-b72e-d6cc7d8b0ef1/ECRB_revenue_determination.pdf

conditions and policy priorities have changed over the years, so have changed the methods for calculation of retail margin. In this view, also retail margins applied for universal service suppliers in the neighboring countries differs, e.g. In Albania retail margin is a fixed percentage applied to the allowed wholesale energy costs, which is allowed by Regulator (determined at 3%), whereas in Macedonia the retail margin is set through an auction (similar to EU countries) which was organized in 2019 and the winning margin was 11.5%².

A report conducted from European Commission on Energy Prices and Costs in Europe in 2019, show that in Member States generally regulate retail energy prices by using hybrid systems, where regulated prices exist within a liberalized market with competition among suppliers and opportunities for supplier switching. In regulated markets, the retail margin is also determined by regulation and sometimes the tendency of the regulators is to set their retail margin very low compared to actual net costs and too low to enable effective competition³. Respectively, Regulated Suppliers should have higher profit margins in order to promote market opening and enable competition.

The Progress Report for 2021, estimates that Kosovo is at an early stage of development of a functioning market economy and that the business environment still faces many challenges.⁴ It should also be noted that although there are several licensed suppliers, only one of them is active and compared to other neighboring countries Kosovo has the lowest supply rate for eligible active customers.

Country	No. of customers	Supply ratio for eligible active customers
Kosova	630,454	10%
Shqipëria	1,270,591	15%
Maqedonia	876,466	45%
Serbia	3,690,708	50%
Mali i Zi	404,785	96%

Source: Energy Community, Facts and Figures of Electricity for State 2020

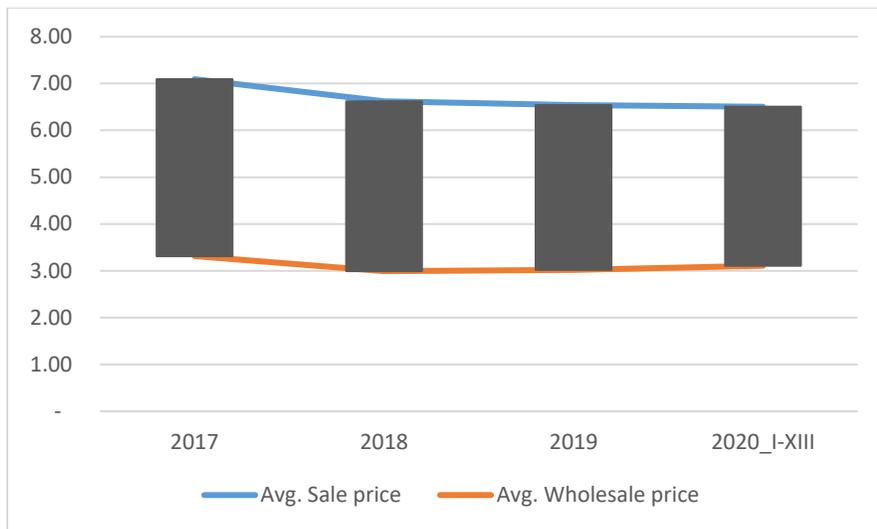
It should be noted that the unregulated of consumers in 2017 has affected the net gain of the universal service supplier, as wholesale costs account for about 50% of the approved MAR, while industrial consumers in the unregulated market account for 10% of consumption in Kosovo.⁵ Respectively, the ratio between the average purchase price and the average selling price has decreased since 2017 when industrial customers connected to the transmission level are supplied in a competitive market, as shown in the following figure:

² Balkan Green Energy News, 2019, Austrian EVN outbids ELEM to become universal supplier <https://balkangreenenergynews.com/austrian-evn-outbids-elem-to-become-universal-supplier/>

³ European Commission 2019, Energy prices and costs in Europe, <https://ec.europa.eu/transparency/regdoc/rep/10102/2019/EN/SWD-2019-1-F1-EN-MAIN-PART-5.PDF>

⁴ Progress Report for Kosovo, 2021, https://ec.europa.eu/neighbourhood-enlargement/kosovo-report-2021_en

⁵ Actual data for 2021



Considering future deregulation as per ERO’s guidance, the actual net gain for the universal service supplier will be even lower. In this view, considering the abovementioned, we believe that at this period, retail margin shall be determined as 3% for the next 3 years. Setting the retail margin as 3% will provide incentive for the universal service supplier to continue its supply activities although customer with good paying ratios are leaving, while at the same time will provide sufficient gap for other suppliers to compete and increase the interest of customers to switch into the deregulated market.

4. Bad Debt Allowance

Bad debt is an estimate and reasonable level of bad debts incurred by the Universal Service Supplier during a relevant year. 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. The difference between final MAR (which includes bad-debt calculation) and initial MAR represents allowed bad debt costs for the relevant year.

In the first regulatory period, ERO through decision no. V_399_2012 has determined Bad debt Allowance at 5% for 3 initial years, and at 4% for 3 forthcoming years (2012-2017). The same percentage of 4% continued to be applied up to date, although USS in each tariff review has requested a higher allowance with the justification that the allowed bad-debt allowance is lower than actual incurred one.

The common mistake when calculating actual bad debt is considering all KESCO revenues. It is important to emphasize that KESCO receive payments which are not related to energy billed, whereas bad debt allowance is given on initial MAR base, and shall be calculated only on billed amounts for the relevant year. The following table shows the collection power of the Universal Service Supplier since 2017:

Collection %	2017	2018	2019	2020	2021*	Total
MAR Based	94.7%	94.8%	95.9%	92.2%	96.9%	94.8%

* Expectation at the end of the year

As seen in the table above the actual level bad debt since 2017 has resulted in an average of 5.2%. It should be noted that the year 2020 is an extraordinary year due to pandemic spread and quarantine effects, which has resulted in a lower level of collection. However, even 2021 as such cannot be taken as a basis since the highest level of collection results due to the recovery of 2021. In this sense, to see more clearly the collection potential, we have analyzed the collection for energy billed during a year which does not exceed the level of 80%, while if we include the debts of previous years we reach the average of 94.8%, as presented below:

	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total
2013	65.7%	25.1%	1.9%	1.1%	0.7%	0.5%	0.2%	0.1%	0.1%	95.5%
2014		75.1%	15.8%	1.8%	1.0%	0.8%	0.5%	0.2%	0.2%	95.4%
2015			76.2%	14.7%	1.7%	1.2%	0.7%	0.3%	0.3%	95.2%
2016				75.4%	15.6%	2.0%	1.1%	0.5%	0.4%	94.9%
2017					78.1%	14.1%	1.8%	0.7%	0.6%	95.3%
2018						77.5%	14.9%	1.3%	0.9%	94.5%
2019							79.3%	12.9%	1.8%	94.1%
2020								76.7%	19.4%	96.1%
2021									76.9%	76.9%

Since the level of bad debts is an estimate and a reasonable level of bad debts incurred during a respective year, it should be noted that when setting the base level in the first regulatory period, the Regulator has considered the existing situation at that time in terms of collection, as well as without considering any further changes in the electricity market. At the time of setting these parameters for the first regulatory period, customers connected to the 220kV and 110 kV levels and industrial customers connected to the 35kV and 10 kV levels, with a collection history of 100%, were considered in the final calculation. Since market conditions have changed and the market is gradually opening up these consumers are moving towards deregulated tariffs. Connected customers at 220 kV and 110 kV levels are already being supplied in the deregulated market. According to ERO Instruction on Market Liberalization in the Energy Sector in Kosovo approved in 2017 and further amended in 2018 and 2019, and the official announcement issued during 2020, customers connected to the 35 kV and 10 kV levels are expected to be supplied with deregulated tariffs from April 2022. In this sense, when calculating and determining the allowable level of bad debts for the next regulatory period (2022-2024), the Regulator should also consider the departure of these customers along with their ability to pay, namely the indirect subsidy should be eliminated. Their removal from total revenues does not change the level of bad debts that is necessary for the normal functioning of the Universal Service Supplier, therefore the allowable level of bad debts should be increased to reflect the lower collections.

Although the list of customers who meet the criteria to be supplied by the supplier with universal service for customers connected at the level of 35 kV and 10 kV, as defined in Article 37, paragraph 2 of the Law on Electricity, has not yet been provided by ERO, KESCO as a Universal Service Supplier has used a list of customers identified during 2020 and has recalculated the level of collection for the years 2020-2021 without the inclusion of these potential customers who are expected to be supplied with unregulated tariffs from April 2022. The change in this effect was also considered when forecasting the level allowed for bad debts for the next regulatory period.

Considering the above, KESCO as a Universal Service Supplier has made an analysis on the revenue collection expectation (receivables) and has reviewed its collection potential for the next three years (2022-2024), which is comfortable with new expectations and taking into account the information available at the time such as: historical data on the possibility of payments from consumers, the number of businesses closed on an annual basis, the effect of the pandemic and the opening of market and the final proposal is as follows:

	2022	2023	2024
Request for the level allowed for bad debts	5.2	4.8	4.6

Please note that this request does not consider the opening of the market at the level of 0.4kV, as well as customer's right to switch suppliers every 21 days, and their right to return to the universal service supplier (in case they fulfill the criteria), respectively misuse of potential customers to change suppliers in order to avoid their last payments in order avoid a pending disconnection. This phenomenon is very present and disturbing in countries with developed electricity markets and such concern is expected to be present in our country as well.

Last but not least, the Supplier during its forecast for the years 2022-2024 has not considered a change of final tariffs for customers who have the right to be supply with universal service. Respectively, taking into account the energy crisis and actual import prices, including the long-term overhaul plan of generating units B2 and B1 in the next two years, the expectation for an increase in final tariffs is evident, however the supplier has without prejudice the decisions of ERO considered final tariffs unchanged. Although, it is important to note that the eventual increase of final tariffs will have a direct impact on the supplier's collection, so it is very important that when determining the allowable level of bad debts for the regulatory period 2022-2024, the regulator takes this into account this fact, in order to ensure financial stability for the regulated supplier, which for two years in a row is closing the financial year with a loss.

5. Balancing Sharing Factor

Article 17 of the USS Pricing Rule defines that wholesale energy costs that are related to supplying regulated customers, among others are comprised of net imbalance costs, which are subject to imbalance sharing factor. Paragraph 5 of the same article defines sharing factor as follows:

“The Imbalance Sharing Factor shall be a fixed percentage that is applied to net imbalance costs to determine the sharing of these costs between the USS and regulated customers, where a value of 0% means that all net imbalance costs are allocated to the USS and a value of 100% means that all net imbalance costs are allocated to customers.”

Considering that Conform Article 12 paragraph 4, Imbalance sharing factor is an input value determined for 3 years period, Article 17, paragraph 6 highlights that when determining Imbalance Sharing factor, Regulator shall consider the extent to which USS is able to manage imbalances and, especially, the balance between supply from domestic generation and sustainable import, as well as demand fulfilled by USS.

There is always uncertainty in predicting customers’ future demand, and therefore in buying the correct amount of energy for this. Customer demand varies throughout the year, month and across the day. If suppliers have purchased less energy than customer demand, they incur additional costs, in addition to the direct costs of purchasing wholesale energy. If suppliers have purchased more energy than customer demand, they may accept payment but that may be different and lower than their wholesale. In this view, there is a risk of loss and / or gain for suppliers, depending on market conditions. In order to avoid suppliers' exposure to a higher risk, through which suppliers would find it impossible to recover their operating costs, Regulators support the supplier by introducing the dividing factor of imbalance. By creating a historical trend over the years, suppliers can better anticipate and manage these costs, and the Regulator may decide to change the fixed percentage that applies to net imbalance costs (the imbalance allocation factor), as it is assumed that allowing a the division between the supplier and the customers will increase the incentives for the supplier to more accurately manage its balancing.

Since the functionalization of the balancing mechanisms in Kosovo in June 2017, the imbalance sharing factor was applied as 100% respectively any benefit and/or loss from the imbalances was fully returned to or recovered from customers. The total amount that customer benefited in tariffs since then equals to €2.27 million, as shown in the table below:

Year	Benefit/Loss in '000€
June - December 2017	785
2018	(698)
2019	26
2020	3,489
I-IX 2021	(1,328)
Total	2,274

Although there is a benefit for the supplier to require the application of the imbalance separation factor and that such a requirement is in line with international experience, due to the limited number of market participants, the issue of balancing still remains complex in Kosovo. Changes in the requirements set by market participants, in a system 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 generating units that are outdated and inflexible, limits the ability of the system to be balanced and to have minimal costs. Furthermore, taking into account market developments (self-consumers, market opening and the possibility of switching suppliers), we believe that the unbalance sharing factor should continue to be applied as 100% at least until the next periodic review.

6. Other Factors that determine Allowed Revenues for USS

ERO through its letter has asked KESCO to present also the actual costs and the forecast for operating expenses, expected purchases and sales, which are essential for determining the Maximum Allowed Revenues (MAR).

ERO has not yet approved the 10 years energy balance (2021-2030) nor the annual energy balance for 2022, and has not yet submitted the updated list of customers connected at level 35 kV and the list of customers connected at level 10 kV to be supplied with unregulated tariffs from April 2021, in accordance with the Instruction on Energy Market Liberalization and its amendments. Considering the abovementioned, Supplier KESCO has presented the actual costs for the years 2017-2021. The sales forecast is presented in volumes in accordance with the request provided by the supplier submitted for the 10-year energy balance forecast, while purchases can be presented once we have the official balance sheet accepted by the Transmission System Operator or ERO.

In terms of 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 costs, without providing for the sharing of common services.

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. Since the functional and legal unbundling from the distribution activity in 2015, the average operating and maintenance costs allowed for the Universal Service Supplier are € 5.6 million on average, which are in line with the actual average costs incurred by the Universal Service Supplier, as shown in the table below:

<i>(in milion €)</i>	2017	2018	2019	2020	2021	Mesatarja
Approved	5.79	5.96	6.06	4.59	4.61	5.40
Actual	5.60	6.14	5.56	5.37	5.33	5.60
Differences	0.18	(0.19)	0.50	(0.77)	(0.73)	(0.20)

** Please note that actual OPEX costs do not include costs for unregulated customers*

ERO approves the total operating costs for the Universal Service Supplier and they do not comply with the annual requirements of the supplier over the years, as the allowed costs are a continuation of the forecasts made during the first regulatory period and do not reflect the change in prices over the years. However, USS operates within the allowed budget, creating efficiency whenever possible in certain items in order to be able to cover the increased costs in other items. It was therefore unacceptable for the USS when in setting operating costs for 2020, ERO unilaterally decided to reduce costs for the shared service without first giving the USS the right to provide explanations regarding the shared services and as such unjustly obstructed the USS's right to respond and argue on the matter. This phenomenon which continued to be treated equally during 2021, creating a difference of about € 1 million between the allowed operating costs and the actual ones for the regulated activity.

ERO in adjusting the common costs did not take into account the rental costs that the supplier KESCO pays to the Distribution System Operator, which due to changes in accounting principles in the Financial Statements are presented separately. Therefore, it is very important to consider actual and justifiable costs when determining operating costs before making adjustments that affect over 25% of total operating costs, just as it is important to seek clarification and justification from licensees in advance. The reduction of operating

costs by 25% has put the Universal Service Supplier in a very unfavorable financial position, especially due to the fact that USS closed 2019 with a loss and at the same time during 2020 faced collection problems, as a result of the spread of the global COVID-19 pandemic. Moreover, the financial crisis that spread during 2021, with the highest prices among the years marked by imports, while the final tariffs remain unchanged, negatively affected the financial strength of the supplier, thus jeopardizing the payments included in operating expenses (such as are insurance, loan interest and employee salary).

It should also be noted that despite the fact that the number of customers is constantly increasing, which further results in increased costs for providing services to these customers, despite the fact that customer service is improving, and despite the fact that costs for customers have increased over the years, ERO did not allow extra budget to cover operating costs, although the need to increase operating costs has been constantly requested and justified by USS. The table below shows the annual loss of FSHU per capita in recent years:

	2017	2018	2019	2020	2021
Number of active customers (No.)	561,827	579,963	605,694	630,454	646,385*
Allowed OPEX (in mil €)	5,787,503	5,957,047	6,060,104	4,594,113	4,606,095
Average OPEX cost per customer (€/customer)	10.30	10.27	10.01	7.29	7.13
Change in allowed OPEX cost per customer (%)		-0.3%	-2.5%	-27.2%	2.2%
Actual OPEX (€)	5,603,000	6,143,000	5,556,232	5,367,580	5,332,977
Actual OPEX cost per customer (€/customer)	9.97	10.59	9.17	8.53	8.25
Change in actual OPEX cost per customer 2018 vs 2021 (%)					22%

* Actual number of customers until September 2021

As we can see from the table above, from 2017 the average loss of USS is almost 9% based on allowed operational cost, which increased notable after the unilateral decrease of operational costs in 2020. However, even if we compare actual operational costs from 2018 in 2021 we notice a 23% difference, which proves that USS has achieved maximum optimization, which losses have not been compensated through the given OPEX and which will be problematic to achieve in the future if ERO does not take into account the requirements of the USS.

Taking into account the above, as a result of the continuous increase in the number of customers and in order to reflect the increased volume of duties / responsibilities in the workplace, USS predicts an increase in salaries. The salary increase also aims to level them with other licensees in the energy sector and at the same time will reflect their value to the company, keeping them competitive in the electricity market.

Considering the above-mentioned and the needs analyzed in detail regarding the requirements for the expected developments in the next three years, the OPEX proposed by USS to ensure stable and functional operation during the years 2021-2023 is as in next:

	2022	2023	2024
Request for Operating and Maintenance Expenses	6.80	6.87	6.89

The detailed OPEX request is given in the Appendix, however it should be noted that the increase in request results from several factors, summarized as follows:

1. Investing in the new billing system means additional training for supplier employees
2. The need of the supplier to be equipped with vehicles, which since the legal unbundling as assets have belonged to the distribution operator. Using cars also means extra costs for safety, maintenance and fuel
3. The spread of the Covid-19 pandemic has fluctuated insurance prices and increased the need for additional security
4. In order to benefit from lower import costs, including longer-term import agreements, the need for bank guarantees and their financing costs increases.
5. The constant change of the market and the introduction of new requirements in line with European developments is also increasing the need for internal consulting as well as better information of citizens about changes in the services provided.
6. Salary leveling

Please note that this budget does not consider operating costs for deregulated customers expected to be supplied with unregulated tariffs from April 2022. Given the uncertainties of market opening, due to the disadvantaged position of businesses as a result of the spread of COVID-19, for clarification KESCO has allocated 120,000 euros from the expected operating expenses for deregulated customers, which have been calculated in accordance with the expected number of employees allocated for unregulated customers and these expenses have been deducted from the initial request for operating expenses. As soon as the market is enabled and the connected customers at 35 and 10 kV level start operating in the open market with unregulated tariffs, KESCO plans to hire new employees who will deal directly with deregulated customers. This will also enable easier monitoring of regulated and unregulated costs, as required by the KESCO license and other applicable primary and secondary legislation.

7. Conclusion

We are witnessing that in the last two years as an energy sector we have faced unexpected situations such as pandemics and energy crises, which directly affect the regulated business of USS. Recovery from these events until stabilization is taking time. Therefore, before any decision-making, ERO must keep in mind that in the coming years we will have out of function a generating unit of Kosovo B- which will increase dependence on imports, market opening - which will leave out of USS regular payers, until the stabilization of electricity prices (import and / or final prices), respectively their impact on the expected behavior of consumers and the purchasing and collection capacity of USS should be addressed.

KESCO as a Universal Service Supplier has presented its proposals and justifications regarding the input parameters for the period 2022-2024. Along with the above justifications, USS submits the completed models with actual costs and forecasts and kindly asks ERO to consider all comments and arguments presented during the determination of input values for the next regulatory period of USS.