KEDS
KOMPANIA KOSOVARE PËR DISTRIBUIM DHE FURNIZIM ME ENERGJI ELEKTRIKE SH.A
KOSOVO ELECTRICITY DISTRIBUTION AND SUPPLY COMPANY J.S.C
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KEDS - SH.A.
Nr. 96 Dt. 22.11.2022
HQ 1

Ymer Fejzullahu
Chairman of ERO Board

Alpin Dogan
Chief Executive Officer
KEDS j.s.c

22 November 2022

**Subject: Proposal for the Maximum Allowed Revenues for the Third Regulatory Period (2023-2027)**

Dear Mr. Fejzullahu,

Through this letter, we are sending you the Proposal for the Maximum Allowed Revenues for the Third Regulatory Period in accordance with the Rule for the Maximum Allowed Revenues of the Distribution System Operator (Rule on DSO Revenues), and the notice of the Energy Regulatory Office (ERO) for opening the process according to the indicative schedule determined by ERO.

The energy crisis, price increases and inflation are expected to have a negative impact in the coming years, so to avoid any risk that would damage the stability, sustainability and efficient operation of DSO, we request ERO to consider DSO's proposal.

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

*Appendix:*
*Proposal for the Maximum Allowed Revenues for the Third Regulatory Period*

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# Proposal for the Maximum Allowed Revenues for the Third Regulatory Period (2023-2027)

October, 2022

Ndërtesa e Elektrokosovës
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## Contents:

## 1. Introduction

The Energy Regulatory Office (ERO) based on the responsibilities given by the Law on the Energy Regulator, as well as in accordance with the Rule on Distribution System Operator Revenues (DSO) has started the third multi-year tariff review (MYT3) to set the Maximum Allowed Revenues (MAR) for TSO/TO and DSO licensees for the period 1 April 2023 to 31 March 2028.

The Distribution System Operator has prepared the Proposal for the Maximum Allowed Revenues for the Third Regulatory Period in accordance with the Rule on Maximum Allowed Revenues of Distribution System Operator (Rule on DSO Revenues), and the notice of the Energy Regulatory Office (ERO) for opening the process conform indicative schedule determined by ERO.

The following chapters provide the necessary explanations and justifications for all required costs, which are necessary for the proper operation of the distribution system.

## 2. The methodology for determining the maximum allowed revenues

The Distribution System Operator is responsible for operating and investing in the distribution network in order to distribute electricity directly to network users. Since DSO is a regulated company, ERO assesses the allowed revenues based on operating cost, depreciation and a fair rate of return, together with cost of energy and other associated costs.

The maximum allowed revenues are the revenues covered by DSO through tariffs for the performance of distribution system services as well as all other revenues determined by ERO. The maximum allowed revenues are determined for a five-year period with the possibility to make annual adjustments every year for the differences between the allowed and realized costs as well as the revenues that are under the control of DSO.

## 3. Distribution System costs

DSO service costs are categorized as capital costs related to the value of the regulatory asset base and operating costs. Capital costs are the sum of depreciation costs and allowed return on capital, while operating costs may also include the costs of network losses, or losses may be treated as a separate category of costs. All these categories of costs are subject to evaluation and recognition by ERO as reasonable costs and are covered through network tariffs.

## 3.1. Capital costs

### 3.1.1. The Regulatory Asset Base

The concept of the Regulated Asset Base was developed in Great Britain to provide certainty for investors of privatized grid enterprises by defining the principles for calculating the price limit. The RAB concept aims to ensure full recovery of the investor's capital investment with a fair level of return. In this way, the RAB serves as a protection for investors, especially in privatized grid enterprises, as it protects their investments from being unfairly treated.[1]

The regulatory asset base is the regulated value of the amount of fixed assets used and beneficial in the provision of distribution system services and is divided into different asset categories.

During the second regulatory period, 131.4 million euros of investments were allowed, of which about 50% are capital investments at the low voltage level and 35% at medium voltage. However, the second regulatory period was characterized by some unusual events, such as the pandemic and the energy crisis, which were beyond the control of the Distribution System Operator and directly affected the daily operations of DSO. The difference between allowed and approved projects will be subject to adjustments, which as such are included in the final calculations of the maximum allowed revenues for the third regulatory period.

As for the third regulatory period, DSO has already sent 5-year investment projects for approval, in the amount of 156.4 million euros. The primary objectives of the DSO Investment Plan address issues such as ensuring stable and qualitative electricity supply and supporting load growth, compliance with operations and performance standards, reduction of technical and non-technical losses, and rehabilitation and modernization of electricity metering.

The same were used to add the regulatory asset base for the purpose of calculating depreciation and return for the third regulatory period.

### 3.1.2. Depreciation

Allowable depreciation costs are calculated on a straight-line basis, as a function of the economic or technical life of the assets and the regulated asset base for different asset categories.

In order to calculate the depreciation, the categorization and life expectancy of the assets was used according to the parameters approved by the regulator through decision V_1020_2018. DSO has also used the ERO model through which depreciation values for the second regulatory period are calculated.

Taking into account as above stated, depreciation costs for the third regulatory period are calculated on average as 22 million euros per year. Considering that, investment plan is subject to ERO's approval, any

[1] Dalibor Muratovič, Final Report "Technical Assistance for the Development of Policy Guidelines for Distribution Network Tariffs", November 2017

eventual adjustments shall be reflected in the calculation of the depreciation for the third regulatory period.

### 3.1.3. Allowed return

Allowed return on capital costs is calculated as a function of regulated asset base and weighted average cost of capital.

DSO in its proposals has requested the increase of WACC compared to the second regulatory period, as a result of the increase in the parameters used in the calculation of WACC. Nevertheless, the ERO Board for the third regulatory period 2023-2027 has approved the weighted average of the cost of capital in the value of 7.69%, respectively 0.6 percentage points lower than the WACC used for the second regulatory period.

DSO during the calculation of the allowed return for the third regulatory period took into account the WACC level allowed by the regulator and for the period 2023-2027 and 5 year's investment plan. By using the ERO's model, the allowed return for the third regulatory period results to be an average of 20 million euros per year.

## 3.2. Operation and maintenance costs

### 3.2.1. Base Opex

In regulated companies, operating and maintenance costs are recognized by the Regulator as reasonable costs since these costs enable the companies to provide services and maintain these services at an appropriate level. Operation and maintenance costs (OPEX) include several categories of costs such as: maintenance costs, operating costs and other costs that are beyond the control of DSO.

Over the years, the operating expenses of DSO and the number of services provided have increased greatly. A detailed analysis of operating expenses (OPEX) was carried out only in 2011, when the costs of the first regulatory period were examined and evaluated. Since then, despite some minor changes in operating expenses, which were mainly legal requirements, ERO has used the base level of OPEX even during the second regulatory period.

DSO has achieved efficiency over the years, where in the first regulatory period has reduced operating expenses by 11% cumulatively, while in the second regulatory period another 8%. It is important to note that maximizing efficiency beyond the capabilities of the DSO may negatively affect the quality of services. The quality of service provided by the Distribution System Operator is undoubtedly high cost considering that specific and specialized system programs are required.

The number of customers is constantly increasing from 470,000 active customers in 2013, the number has increased to over 670,000 active customers, which has also resulted in increased expenses for providing services to these customers.

The increase in the number of customers over the years has also influenced the increase in the volume of work for DSO employees. The increased volume of work, together with a very stressful working environment, and the big difference in salaries between DSO and the public electricity sector, has increased the turnover of employees, hence DSO is facing a shortage of qualified staff. DSO has continuously requested reflection of salaries for employees at the same level as other operators in the similar industry, but this request didn't found the necessary support.

Salaries make up 80% of total OPEX considering that most of the other costs within OPEX are out of DSO's control, hence the application of efficiency factor in the salary line will worsen further the situation. The energy crisis, as a result of the war in Ukraine, has influenced the increase in the costs of services and material goods. Due to the energy crisis, the inflation rate continues to increase every month, increasing the cost of living index. Only in September of this year, according to the Statistics Agency of Kosovo, the harmonized index of consumer prices has reached 12.7%[2]. This should serve as a basis for raising salaries for the company since there is no doubt that the increase in the consumer price index is expected to further burden the budget of the company's employees, which will then result in dissatisfaction and pressure on the company for salary increases.

During 2022, DSO has faced protests due to requests for salary increases, which are estimated to be the lowest in the sector. At the beginning of 2023, the next protests have been announced in case of non-reflection of the salary increase. The increase in salaries and benefits in the public sector, the protests announced by the KEK generation, have only increased the arguments of the employees. The non-reflection of the leveling of salaries of the DSO with the electricity sector in the country clearly endangers the operational stability of the DSO, who are facing the continuous departure of professional employees. The latter has a direct impact on the quality of services provided.

Similarly, the maintenance costs represent only the cost for price and materials, since most of the work is done through internal employees, whose costs are already included in the salary lines. Both of these are outside the control of DSO. Data from Eurostat shows that between 2000 and 2021 prices in the EU have increased by 46%[3] overall. The inflation rate in August 2022 in the EU area reached 9.1% compared to July 2022 of 8.9%[4], which gives signals of continuous price increases.

Therefore, in these circumstances, the risk of sustainability of DSO's operations is more than evident if ERO does not take into account the aforementioned facts during the assessment of operating and maintenance

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[2] Harmonized consumer price index, Kosovo Statistics Agency, fq.4

[3] Eurostat 2022, https://ec.europa.eu/eurostat/cache/digpub/european_economy/bloc-1c.html?lang=en (last visited on 27.09.2022)

[4] Eurostat 2022 https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Inflation_in_the_euro_are (last visited on 27.09.2022)

costs, especially taking into account the fact that the Board of the Energy Regulatory Office has set a operational expenditure efficiency target of 1.5% on an annual basis.

When determining the maximum allowed revenues for the third regulatory period, DSO has taken into account the number of employees, and for the same during calculation of salaries has estimated a necessary increase in the salary level, in order to reflect the current costs in the energy sector (compared to other operators). Also, during the calculation of the final OPEX were reflected the actual prices for providing the distribution services such as: maintenance, asset insurance, gas, etc. In conclusion, the necessary OPEX for the stable operation of DSO for the third regulatory period is about 30 million euros.

## 3.3. Cost of Losses

The distribution system operator is a market participant only for the purchase of electricity to cover losses in the distribution network and although it is responsible for the purchase and sale of balancing energy, the last one is not included in its tariffs. Electricity to cover network losses is normally purchased in a market-based procedure.

Considering that the Universal Service Supplier has priority in purchases from KEK's production, the distribution system Operator's dependence on imports is high. As a result, the cost of electricity for covering distribution losses are greatly affected by prices on European electricity markets.

Electricity prices in international markets since the second half of 2021 have been very high and unstable. Initially, the reason for this increase was the extremely fast recovery of the global economy after the Covid pandemic, which resulted in a great demand for energy, while it took a big boost after the start of the war between Ukraine and Russia, marking the highest values in the last decades. As a result of this DSO during 2021 and 2022 has faced enormous costs for the procurement of electricity to cover the losses.

In the 2022[5] Progress Report, it was mentioned that the delays in recognizing the actual costs of losses in the network tariff, caused a severe liquidity crisis for DSOs that was exposed to market prices, hence jeopardizing their ability to provide reliable and continues electricity supply for consumers. Even in one of the letters published by the Coordinating Group of Energy Community Distribution System Operators "The Impact of the Recent Energy Crisis on the Operation and Sustainability of Electricity Distribution System Operators in the Energy Community" it is mentioned that the delays in recognizing the actual costs of losses in the network tariff caused a severe liquidity crisis for DSOs exposed to market prices, jeopardizing their ability to provide reliable and continuous electricity supply to customers.

In order to avoid such scenarios, which would further endanger the financial stability of the DSO, the ERO must accurately reflect the costs foreseen in the international electricity exchanges, which until 2025 do not foresee import prices below €300/ MWh as annual average at peak time[6].

[5] European Commission, Progress Report 2022, Brussels 12.10.2022, fq. 110
[6] HUDEX international electricity market forecast, https://hudex.hu/en/market-data/power/daily-data#year

As for the volumes, they are in accordance with the expected energy entering into the distribution system submitted for the multi-year review of the energy balance.

DSO, in accordance with the Rule on DSO Prices and ERO's decision has applied the sharing factor of 50%, which are adjusted in the calculation of the Maximum Allowed Revenues for the year 2023.

## 4. Others

Components of the maximum allowed revenues (MAR) are also non-tariff revenues, obligations to the market operator and the transmission system operator, as well as annual adjustments.

### 4.1. Non-tariff revenues and excluded costs

ERO, during the approval of the maximum allowed revenues, deducts the revenues from the unregulated activities carried out by DSO. Taking into consideration that such costs change throughout the years, DSO has forecasted non tariff revenues from other unregulated activities based on the assumption used in the second regulatory period.

The same are deducted from the maximum allowed revenues and any potential difference between forecasted values and actual values during the relevant year, are subject of the regular adjustments during annual adjustments processes.

### 4.2. Obligations to the Market Operator and the System Operator

The Distribution System Operator is obliged to pay the tariffs of TO and SO, as determined by ERO for the volumes necessary for DSO. Although these costs are pass through costs, the same for the purposes of calculating the final MAR in this report, are calculated based on current prices. Any difference between the current prices and those estimated by the ERO must be used in the final report, before the MAR determination for the third regulatory period.

### 4.3. Regular adjustments

DSO during the calculation of MAR for the third regulatory period has also applied the regular annual adjustments, in accordance with the rule for DSO prices.

ERO during the forecasts for 2022, despite the requests of DSO, has foreseen both a smaller volume of energy entering into the distribution system and a lower price compared to the annual average price. Taking into consideration that the new tariffs have been reflected only with 9 February 2022, has calculated a positive adjustments, which is reflected in the MAR calculations for the year 2023.

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(date reference 20.10.22)

Since the year 2022 at the same time marks the end of the second regulatory period, DSO has also adjusted the investment level, respectively has calculated the actual depreciation and return. Taking into consideration that such adjustments belong to the 5 years period (2018-2022), adjustments are applied in the final calculations of MAR for the third regulatory period.

## 5. The maximum allowed revenues for the period 2023-2027

After presenting all the components and justified costs in the previous sections, DSO has calculated the request for the maximum allowed revenues for the third regulatory period 2023-2027, as follows:

**Third Regulatory Period**

| DSO | Unit | 2023 | 2024 | 2025 | 2026 | 2027 |
|---|---|---|---|---|---|---|
| Operating expenses | €000s | 35,912 | 34,611 | 35,304 | 35,927 | 36,463 |
| Depreciation | €000s | 20,205 | 20,685 | 22,658 | 23,585 | 25,345 |
| Return | €000s | 18,369 | 18,205 | 19,375 | 20,256 | 20,871 |
| Purchases | €000s | 277,063 | 211,944 | 146,312 | 136,984 | 129,207 |
| Excluded revenues | €000s | -3,500 | -3,500 | -3,500 | -3,500 | -3,500 |
| Obligations to OT and OS | €000s | 1,889 | 1,841 | 1,804 | 1,779 | 1,757 |
| Adjustments | €000s | 13,578 | -3,759 | -3,759 | -3,759 | -3,759 |
| **Total** | **€000s** | **363,515** | **280,028** | **218,193** | **211,273** | **206,384** |

The DSO's request for the above-mentioned Revenues is for the purpose of the stable operation of the distribution system operator and the provision of quality services to customers during the third regulatory period. Any tendency to reduce DSO's demand will endanger DSO's financial liquidity and the sustainability of electricity supply in general.