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KOMPANIA KOSOVARE PER 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. 38 Dt. 08.12.2021
HQ 1

Ymer Fejzullahu
Chairman of ERO Board

Mesut Serhat Dinc
Managing Director,
KESCO J.s.c

08 December 2021

SUBJECT: USS Comments to ERO Consultative Paper on Input Values and Operating Expenses for Universal Service Supplier

Dear Mr. Fejzullahu,

This report summarizes response of the Universal Service Supplier (USS) to the ERO's Consultation Paper on Input Values and Operating Expenses for period 2022-2024, published on 25 November 2021.

USS appreciates the opportunity to provide its comments on important issues raised by ERO in the Consultation Paper and requires from ERO to consider standpoints on issues raised in this report prior to any final decision on Input Values and Operating Expenses for USS.

We express our readiness to cooperate and discuss with ERO, all issues raised and counter-arguments provided in this report.

Sincerely,

KESCO SH.A.

Mesut Serhat Dinc
Managing Director, KESCO J.s.c

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Comments of Universal Service Supplier towards Consultation Report about Input Values and Operating Expenses 2022-2024

December, 2021

Content

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1. Introduction

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

In accordance with the requirements of the letter, USS has foreseen and completed the data according to the reporting formats sent by ERO for Input Values and Operating Expenses for the period 2022-2024 and has submitted comments and arguments through official letter no. 31, November 1, 2021.

ERO on November 25, 2021 published the Consultation Report, which contains the initial proposals for Input Values, to which all stakeholders have the opportunity to analyze and comment, so that the final assessment is accurate.

In accordance with the requirements set out in the proposal on input values and the deadline set in it, USS in the following document presents counter-arguments and justifications regarding input values and operating expenses for the Universal Service Supplier, respectively in the points for which ERO has a different stance from USS requirements.

2. Retail Margin

The retail margin represents the return required by the electricity supplier to raise the capital needed to provide the retail service to regulated customers. According to the USS Pricing Rule, the retail margin is a fixed percentage which aims to provide USS with a reasonable benefit to compensate for the risks it undertakes in providing standard service to regulated customers.

Given the pre-privatization conditions, ERO set the retail margin at 3% and as such was applicable up to date as input value. Although USS argued that the same level should be continued in this regulatory period, ERO in the proposal of input values proposed a margin of 2.54%, which took into account the average margin costs to wholesale net costs, as presented in the following table:

Year	Unit	Costs of margin	Gross Costs with wholesale	Net Costs with wholesale
2017	€000	3,724	127,844	124,133
2018	€000	3,471	119,160	115,700
2019	€000	3,521	120,899	117,367
2020	€000	3,795	130,298	126,500
2021	€000	4,730	162,396	157,667

Calculation	Unit	Amount
a) Average Costs of Margin 2013-2021	€000	3,848
b) Trend of Margin in year 2022	€000	151,663
c= a/b Margin	%	2.54%

However, the methodology used for setting the retail margin can give different results and is not coherent in different time periods, and at the same time does not take into account the factors that directly affect the determination of wholesale energy market costs.

Assuming that ERO has chosen to use this methodology of determining the retail margin, then we must take into account the trend of previous years to have a more reliable trend, which is based on more historical data. Based on the methodology used by ERO, results that the retail margin should be set at 3.45%, as presented in the following tables.

Year	Unit	Retail margin Costs	Wholesale Gross Costs	Wholesale Net Costs
2013	**€000**	4,816	165,353	160,537
2014	**€000**	4,724	162,183	157,459
2015	**€000**	4,738	162,679	157,940
2016	**€000**	4,547	156,110	151,563
2017	**€000**	3,724	127,844	124,133
2018	**€000**	3,471	119,160	115,700
2019	**€000**	3,521	120,899	117,367
2020	**€000**	3,795	130,298	126,500
2021	**€000**	4,730	162,396	157,667

Calculation	Unit	Amount
a) Average margin costs 2013 -2021	€000	4,230
b) Margin in 2022	€000	122,538
c= a/b Margin	%	3.45%

ERO can use more historical data if such data are available to ERO in order calculate the retail margin. It is worth noting that 2021 is the year where the whole world is faced with an energy crisis, which have caused a state of emergency that has resulted in rising cost of wholesale prices. Therefore, the use of 2021 in the analysis should be taken with reserve.

It is also important to note that the Universal Service Supplier in Kosovo faces much greater risks than supplier in other countries, especially comparative countries such as Europe, Turkey or Ireland, which ERO has used in its comparisons. 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.[1] Moreover, the methodologies used in the comparative countries differ from those applied in Kosovo, e.g. Turkey reviews regular adjustments over 3-month periods. Also, only the determination of the retail margin in the comparative countries used by ERO without considering all the regulatory frameworks and socio-economic and political situations of the countries in question is deficient and as such can not be used as a comparative basis. The same is cited in the USS Pricing Rule, Article 13, point 3.3 "comparisons with similar enterprises in Kosovo and other countries in Europe, taking into account the similarity between the electricity industry in those countries with that of Kosovo ".

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

ERO argues that the Supplier has safe operations even though all costs are covered through tariffs and that USS buys production from KEK with priority. However, it is important to note that KEK's production is not sufficient to cover the growing consumption, respectively the supplier is exposed to imports and prices that are out of his control. Moreover, the old power plants of the generating units also result in unplanned outages, which also expose the supplier to the need for import. During the middle of 2021 we witnessed an increase in import prices, which exceeded any predictability. This enormous increase in import prices negatively affected the daily operations of the supplier.

Moreover, the deregulation of consumers in year 2017 has affected the net profit 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.[2] Respectively, the ratio between the average purchase price and the average sale price has decreased since 2017. Considering the next deregulation according to ERO's instruction, the current net profit for the Universal Service Supplier will be even lower.

In this view, based on the abovementioned, we believe that in this period, the retail margin should be set at 3% for the next 3 years. In addition to providing incentives for USS to continue its operations, this percentage will provide sufficient space for competition between new suppliers and increase consumer interest in entering the deregulated market.

3. Bad Debt Allowance

Bad Debt is an assessment 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.

In the first regulatory period, ERO has set the allowable level for bad debts at 5% for the first 3 years and at 4% for the next 3 years (2012-2017). The same level of 4% continued to be applied until now, while in the last proposal the ERO proposed the allowed level of debts from 2.4 in 2022 to 2% in 2024, using as a reference the average level realized for the period 2017-2021 according to the Financial Statements.

Components of bad debt	Analyze	2022	2023	2024
a. Drop in value of LI/A for years 2020-2021	2.21%			
b. Influence of deregulation of customers (35kV and 10kV)	0.15%			
c=(a+b) Proposal for allowing the bad debt	**2.36 %**	**2.4%**	**2.2%**	**2.0%**

ERO in its proposal states that non-collection on time and in pre-determined conditions does not represent bad debts, but in fact it should be considered that electricity supply is not the same with other businesses, it is a business that needs constant liquidity and confident of meeting its financial obligations for the entire electricity sector. Bad debt considered by the Regulator is based on the provisions presented in the Financial Statements, which are presented according to accounting principles (IFRS), while bad debt in the regulatory framework is an input parameter that assesses the power of collection, taking into account time and behavior

[2] Actual data for year 2021

of consumers against their obligations. When assessing bad debts, the decrease in collection power over the years should be taken into account, as presented in the table 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%

As can be seen in the table above, the collection power falls below 0% after the 4th year, respectively does not exceed the value of 96% even over the years, a fact that appears in the total collection taking into account the billing in the respective year. It is a fact and very clear that the maximum collection has matured and the possibilities for further improvement are negligible. Therefore, they should be considered as bad debts, in accordance with the definition given in the USS Pricing Rule, while maintaining incentives and minimizing the risk of increasing bad debt.

The actual debts that consumers have to the KESCO supplier until November 2021 are over 121.4 million € and some of them are uncollectible, such as social cases in the amount of € 16.5 million. As can be seen from the table below about 50% of such debts are over 37 months old and according to the table above, the collection opportunity is very small.

Months	Receivables ('000 €)	Report of receivable (%)
0-2	18,720	15.4%
3-6	11,799	9.7%
7-12	11,218	9.2%
13-24	11,639	9.6%
25-36	9,503	7.8%
37+	58,551	48.2%
Total	121,430	100%

During the final assessment it is important that the ERO also takes into account the expected changes in the tariff structure and their impact on bad debts, as well as the opening of the market, which in its proposal the ERO has taken into account only in the first year but not in subsequent years. According to the guideline, the market opening will be gradual and the impact should be considered in increasing rates, as KESCO argued in its initial proposal.

Considering the factual statements, KESCO as a Universal Service Supplier requires the regulator to re-evaluate bad debts in accordance with the regulatory framework, as argued previously in the USS proposal for input values and presented in the following table:

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

4. Operating and Maintenance Costs

In the proposal for Input Values and Operating Expenses, USS has foreseen a slight increase on an annual basis of operating and maintenance costs (OPEX) in order to reflect price inflation over the years and to reflect changes in the market, legislative requirements and a reflection of actual costs.

ERO in the Consultation Report has forecasted operating and maintenance costs for the period 2022-2024 according to the average costs incurred in the years 2016-2020. Considering that in 2018 'other' operating expenses are at levels outside the expense trend for the period 2016-2020, the same have not been considered in the final estimates of ERO. However, it is important to clarify that management costs (within the item 'other costs') referred by ERO are attributed to the market liberalization process. The market liberalization process has increased the need for external consulting, staff training and systems within the company, which has resulted in a more pronounced increase in costs compared to other years. The removal of such costs from the assumed average gives erroneous conclusions considering that other processes are waiting for us, for which the need for consultancy, as management support may increase.

This average realized according to the above explanations, is assumed by ERO as the expected continuation of operating expenses for the next regulatory period, over which ERO has applied an efficiency factor.

In estimating operating costs, the Regulator initially divided them into two categories: controllable costs and uncontrollable costs. In uncontrollable costs, which depend on market prices and to which USS can not have a significant impact, ERO has included only costs for shared services and rent, leaving in the category of controllable costs asset insurance, employees, etc., which are also determined by market prices, e.g. Insurance expenses during 2021 have increased by 34%, costs which are beyond the control of USS. While the efficiency factor of 0.5% has been applied to all controllable costs (including insurance), resulting in the final proposal of ERO for operating expenses of about 5 million € / year, as shown in the table below:

Description	2022	2023	2024
Effectiveness	-	-0.47%	-0.47%
Controllable OPEX	3,671	3,688	3,705
Uncontrollable OPEX	1,499	1,499	1,499
Total	**5,169**	**5,187**	**5,204**

It is important to note that unlike the OST / MO and DSO Pricing Rules, the USS Pricing Rule does not provide the efficiency factor as an input value. We agree that the efficiency factor promotes efficiency for savings of operating expenses, but USS in the proposal sent to ERO for regulatory parameters has emphasized that it operates within the allowed budget by creating efficiency whenever possible in certain items in order to be able to cover the increased costs in other items.

In the proposal of input values, USS argued that the average loss of USS according to the allowed operating expenses per customers is about 9% for the period 2017-2021, this is due to the fact that the number of customers has increased continuously while operating expenses have not increased to reflect this increase in the number of customers. ERO in the proposal of input values states that there are few reasons to assume that the costs of basic OPEX should increase due to the increase of the number of customers, however, the OPEX allowed by the regulator since 2011, adjusted further only for inflation rate and a small increase during 2018, are not enough to cover operating costs that include: modernization of the call center, improvement of customer service (which is achieved through new equipment and programs, training of employees, etc.). So, even if we compare the current operating costs from 2018 to 2021 we have a difference of 23%, which proves that USS has reached the maximum optimization, for which losses USS is not compensated through the given OPEX and which will be problematic to achieve if ERO applies the efficiency factor.

ERO in its estimates did not take into account the request of USS for salary increase, with the reasoning that the costs of KESCO staff were updated during the tariff review in 2018 in order to be comparable to the costs of staff other licensees. USS reiterates that the update of these costs did not reflect the leveling of salaries with other licensees, which are at least 25% lower when compared to other public licensees in the energy sector. Considering the importance of the process we are in and the impact that the determination of parameters is expected to have for the next three years, we ask ERO to reflect the costs required by USS as we consider that the difference in salaries for employees is unfair in relation to other licensees and at the same time it will prevent qualified employees leave the company.

Considering the above-mentioned and the analyzed needs 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 2022-2024 is as presented below, which justified also in the proposal for input values by USS:

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

ERO should consider that the next regulatory period that awaits USS will be quite challenging, taking into account the increase in prices for each sector of the economy, which will be reflected in the increase in operating costs necessary for normal operation of the company therefore USS asks ERO to base its judgments taking into account the expected costs, in accordance with the information known at the time of application.

5. Conclusion

Considering the justification of the components for the regulatory parameters presented in this document, USS believes that the submitted requests are fair and most importantly necessary for the Universal Service Supplier.

ERO in accordance with Article 15 of the Law on Energy Regulator has the obligation to balance the interests of consumers and licensees and to cover the real cost of electricity supply, including generation costs, shortterm marginal cost, reflecting the full generation portfolio, necessary investments, proper rate of return, cost of imports, cost of supply services, as well as bad debts.

Considering that Universal Service Supplier has closed 2019 and 2020 with financial losses, has faced collection problems during the COVID-19 pandemic, and is challenged with the financial energy crisis during 2021, it needs time to recover in order to of creating financial stability. Therefore, the lack of proper reflection of input values and operating expenses during the second regulatory period will seriously jeopardize the smooth running of operations and, respectively, the endurance of electricity supply.

The purpose of USS is undoubtedly to provide high quality services to its customers and USS is constantly working in this direction, so to further meet its purpose and objectives, USS needs costs required for operation to be permitted by the ERO.