

KEK's Comments on ERO Consultation Paper

For these comments, the section of the ERO's Consultation Paper is first shown followed, in indented bold letters, by KEK's comments.

3. Adjustments for differences between actual and allowed expenditures

ERO's tariff methodology establishes that licensees are expected to complete all investments for which allowances have been made in regulated tariffs. This recognizes the importance to Kosovo of these investments. Where this is not the case, ERO adjusts allowed revenues in the subsequent period downwards to recover depreciation provisions and returns associated with capital expenditures that were allowed but not made in the preceding year. This adjustment has been applied to the applications submitted by KEK and KOSTT. The effect is to reduce allowed revenues by approximately €7.9 million for KEK and by a small amount for KOSTT.

KEK's Comments:

- 1) It is difficult to determine the calculations and evaluate the ERO's adjustments. Will the ERO please provide its calculations on the €7.9 million reduction for KEK and indicate how much is a "small amount for KOSTT" (including the calculations for this KOSTT item also)?**
- 2) Also, is it the intent of the "adjustment" to incorporate a REFUND to customers in 2009 because KEK did not spend one component of the forecasted costs for 2008 in the prior tariff case? If ERO wants to use RETROACTIVE tariff setting, it should adjust all elements of the 2008 Allowed Revenues to their actual values.**
- 3) On the other hand, if the intent is to adjust the beginning balance of the Regulatory Asset Base to the actual 01 January 2009 amount, then KEK would agree to that concept. Again, the amount of the adjustment cannot be assessed since ERO provided no supporting calculations.**
- 4) KEK wants to make it clear that one of the reasons that the 2008 capital expenditures were so far below the forecasted amounts is that the Government loan for mining and generation equipment was expected to be in place early in 2008, allowing KEK to contract for the equipment (the procurement rules do not allow KEK to tender for equipment prior to the funds being allocated). In fact, the loan was not in place until the 3rd quarter of 2008, thereby delaying most expenditures until 2009. The procurement delays were also accentuated by the instruction issued by the Government of Kosovo in January 2008, which requested that KEK suspend all procurement projects funded by the Kosovo budget until further notice. This instruction was also communicated to other competent bodies, such as the Public Procurement Agency, thereby hindering procurement for key KEK capital projects. The Government's restriction was not lifted until July 2008.**

- 5) The combination of the above did not allow KEK to enter into contracts for planned projects until late 2008, with initial payments not due until 2009.

4.1 Assumed import and export costs

Taken together, the evidence on the role of energy exchanges and on EEX prices suggests that KEK's projected average import price for 2009 of €125/MWh appears somewhat excessive. ERO, consequently, proposes to adjust the allowed import price downwards to €112.5/MWh, equal to the realized average import price in 2008. This leads to a reduction in allowed revenues of €6.5 million.

KEK Comments:

1. KEK's forecast for the 2009 average import price is based on the contract prices in effect for January through March 2009. KEK disagrees with ERO's method of basing the price on a prior year amount rather than a readily available current contract price. Following an appropriate competitive tendering process, KEK currently has signed contracts for imported energy at €125/MWh. If KEK follows the ERO's recommendations, then during 2009 KEK should not purchase imports when the costs exceeds €112.5/MWh even if it means additional load shedding.
2. If the reduction in allowed revenues is €6.5 million, then perhaps the Energy Balance also has to be modified to reflect the concurrent reduction in MWh available for sales, which would then result in less revenues; thus, the overall reduction that the ERO is proposing for KEK is even a greater amount.

4.2 Assumed asset lives

ERO's proposed amendments to asset lives are as follows:

- Networks – a reduction to 35 years, matching the assumed asset life for transmission assets, for reasons of consistency.

KEK Comment: KEK suggests that the ERO means "Distribution assets" and not "transmission assets". KEK's proposed average life of 30 years is based on Distribution assets which generally must be replaced more often than transmission assets. Given that a significant portion of new distribution investment consists of meters (which have a life significantly shorter than 30 years), KEK's proposed 30 years is much more realistic than the 35 years used for transmission

This leads to a total proposed reduction in allowed revenues across KEK and KOSTT of approximately €2 million.

KEK Comment: It is not clear what portion of the €2 million is KEK's and what portion is attributed to KOSTT. KEK respectfully request the information on calculations and the bases for reaching this conclusion.

4.3 Allowed losses

Both KEK and KOSTT have requested increases in the allowed losses to be recovered from regulated tariffs. KEK has requested that allowed non-technical (commercial) losses are increased to 22.7% compared to the level of 20% allowed in 2008 and the reported actual level of 25.8% in 2008.

ERO's view is that losses on the transmission and distribution networks should not be expected to increase.

KEK's comments:

- 1 KEK is not requesting an increase as stated in the Consultation Paper. KEK's tariff application indicates a decrease from the *actual 2008* results, not the ERO *allowed* portion; KEK has been making steady progress towards reducing the non-technical losses. (e.g. Actual 2008 was 25.8%, requested for 2009 is 22.7%).
- 2 ERO includes energy delivered to enclaves in the non-technical losses. Yet, KEK has no control over this consumption and is not allowed to disconnect the enclaves or enter these areas by KFOR. Though the Government of Kosovo and KEK support and are prepared to assimilate the enclaves into normal metering, billing, collections, and disconnections, the international stakeholders expressly admonish KEK not to do so. The ERO's help in this regard would be appreciated.

4.5 KOSTT personnel expenses

The application submitted by KEK shows an increase in total staffing numbers to 7,899, which is 365 above those allowed in 2008 and 390 above actual 2008 staffing levels. ERO finds it difficult to understand why such a large increase is required.

Given this, ERO proposes to cap allowed staff numbers at the levels allowed in 2008. ERO will also investigate the reasonableness of current staffing levels further—in particular comparing them with staffing levels at regional comparators.

KEK's comments:

1. KEK assumes that this sub-section should be for KEK, not KOSTT
2. In its response to the ERO's letter in January 2009, KEK provided an explanation of the increase in the number of employees.
3. The staffing level determination is KEK management's responsibility and authority. KEK does not believe that it is within the ERO's authority to determine the *number* of KEK employees, however, the authority vested in ERO is to determine if the total amount of salary expenses requested by KEK in the tariffs is reasonable.

The resulting total reduction in allowed revenues is around €2.5 million.

KEK's comment: It is not clear how this amount was calculated and how is it divided between KEK and KOSTT. KEK respectfully requests the calculation of the numbers resulting in the above reduction.

4.6 KEK Headquarters materials and services expenses

In its application, KEK has requested €3.2 million in materials and services expenses in its Headquarters division. For comparison, allowed expenses in 2008 under this category were €0.6 million and actual expense around €1 million.

Such a large increase in requested expenses appears unreasonable. As with KOSTT's requested maintenance expenditures, ERO has, therefore, allowed a sum broadly equivalent to the average of actual expenditures in 2008 and those requested for 2009 of €2.1 million. This represents a reduction in allowed revenues of €1.1 million.

KEK's comment: KEK does not agree with this proposed arbitrary reduction. In its response to the ERO's letter in January 2009, KEK provided an explanation of the increase in the headquarters expense is due to a large improvement in its IT facilities (primarily networks) and capabilities (primarily skilled personnel to manage networks, data bases and software applications), which has resulted in better management of KEK, reduction in the use of outside services, and reduction of losses.

4.7 Bad debts and working capital

The application submitted by KEK includes a requested provision of €3.2 million for bad debts and €0.7 million for the costs of financing working capital through short-term loans. In accordance with its tariff methodology and preceding decisions, ERO proposes to disallow both these costs. It has been previously determined that the costs of collection losses, including bad debts, should not be recovered from those customers paying their bills. With respect to working capital costs, in its decisions on allowed revenues, ERO already provides for a supply margin which includes the recovery of these costs.

Together, these result in a reduction in allowed revenues of €3.9 million.

KEK's Comments:

- 1. KEK does not agree with the disallowance of bad debts. Even the best managed electric companies in the world have bad debts and the energy regulators allow a small portion (usually less than 2 %) of the amount of Allowed Revenues to reflect this. ERO's tariff methodology is out of line with internationally accepted practice on this issue.**
- 2. As far as Working Capital is concerned, KEK and ERO actually have no basic disagreement, except for the use of the term "working capital". KEK included a specific amount of €700,000 of short term interest in its application as a proxy for a working capital allowance. A review of the ERO model from the 2008 tariff process indicates that ERO provided an allowance for working capital by including €5 million in the Regulatory Asset Base of KEK Headquarters. Of course, the ERO method**

produces an amount of €690,000 (€5,000,000 x 13.8%) compared to KEK's request of €700,000.

3. KEK would like to point out that the ERO Tariff Methodology (Section 3.6) states that "The supply margin compensates the Public Supplier for the risks it assumes". It does not state that the supply margin is for working capital.

5. Summary of allowed revenues

Following these various adjustments, ERO's proposal is that allowed revenues will increase by 2.5% between 2008 and 2009, compared to the requested total increase of 18.3% submitted by KEK and KOSTT.

KEK's Comment: KEK would like to point out that increases in Allowed Revenues are not directly proportional to increases in tariffs, except in the case where the sales for each tariff category are exactly the same in each year.

Table 1: Allowed revenues summary

Regulated tariff revenues		2008	2009	2009	2009
		Allowed	Requested	Corrected	Proposed
KEK (excluding cross-charges / including HQ costs)					
Mining	€0005	46,324	59,397	53,506	50,309
Generation	€0005	37,692	41,953	43,404	42,226
Network	€0005	24,298	24,823	24,832	23,446
Supply	€0005	16,866	22,062	21,776	12,108
Sub-total	€0005	125,180	148,235	143,517	128,089
KOSTT (excluding cross-charges)	€0005	11,290	13,251	13,223	11,828
Total	€0005	136,469	161,486	156,740	139,917
Change from 2008 allowed revenues			18.3%	14.9%	2.5%

KEK's Comments:

1. KEK suggests that the comparison with 2008 allowed and requested 2009 may be somewhat misleading, particularly if the sales increase; as pointed out earlier, there is not a direct correlation in the percentage increases between Allowed Revenues and Prices. This would only occur if the sales to each customer categories are identical for both years.
2. The amount requested in the table for the Supply Division is not consistent with the amount that KEK submitted which was € 36,842 and included € 15,000 for KOSTT fee. Deducting the KOSTT fee (shown separately in the table above) results in the Supply Division request of € 21,842.

3. It is difficult to determine and evaluate how the ERO did all of the calculations contained in the table. Will the ERO please provide the details of the calculations for the "2009 Corrected" amounts column and the "2009 Proposed" amounts column? Also, since the "2009 Requested" column does not agree with the KEK submission, please provide the basis for the €161,486,000 in the table above.

6. Proposed tariff adjustments

The applications received do not propose any change in current tariff structures, although KEK has proposed an alternative means of determining cost-reflective tariffs for customer groups to that currently applied by ERO. It is ERO's intention to review this proposed methodology in more detail prior to the next tariff review.

KEK's Comments:

1. It is not clear what is meant by "an alternative means"; KEK submitted its Tariff Application based on its own model which is consistent with the ERO's tariff methodology and pricing rule. It appears that the ERO is mixing the distinct processes of (1) allocating costs to customer classes and (2) Tariff Design. "Tariff Structures" related to the way a customer tariff is designed using a mixture of customer charge, demand charge, and energy charges (including time of use and block structures).
2. KEK interprets this to mean that the ERO will not consider KEK's proposal to move towards a more cost-reflective tariffs until the next tariff filing in 2010. If so, KEK does not agree. The ERO has stated several times that its goal is to gradually move towards cost-reflective tariffs. There is no dispute that households' tariffs are recovering significantly less than the cost to serve them. The ERO apparently is not prepared to take the unpopular political stand to move toward cost reflective tariffs.
3. KEK would like to point out that the ERO stated its letter of 01 December, 2008 "Third Electricity Tariff Review 3 (ETR3) – Principles and Timetable" under the section titled "Application Principles" that "*There shall be a gradual movement in cost-reflective tariffs.*" KEK believes that its Tariff Application complies with this policy and is proposing tariffs to move towards more cost-reflective tariffs.

ERO proposes that, until it has investigated the proposed methodology for determining cost-reflective tariffs submitted by KEK, it would be appropriate to increase all tariffs by the same percentage amount. ERO will continue to review the different cost allocation methodologies and may make adjustments to this proposal, prior to its decision on final tariffs.

KEK's Comment: KEK would like to review this analysis by ERO, and provide comments, prior to the ERO's final decision. KEK respectfully request that the ERO's schedule for allowing KEK and others to review this analysis be provided as soon as possible so that comments can be provided in due time?

In determining what increase in tariffs is required to meet allowed revenue requirements, it is also necessary for ERO to determine what change it expects in sales volumes. ERO considers there is a high level of uncertainty over sales volumes in the current year given the impacts of the economic crisis and a large increase in sales volumes is unlikely. While estimated energy balances have been received from KEK and KOSTT, ERO has concerns that these may be unrealistic.

KEK's Comments:

- 1. It is KEK's understanding that, in addition to KEK and KOSTT, the Energy Balance has also been endorsed by the Ministry of Energy. There is always uncertainty with forecasted sales volumes, however, for tariff-making purposes; the forecasted sales volume should be used. Otherwise, many of the other cost elements for KEK and KOSTT would need to be modified to reflect this change prior to determining the tariff prices.**
- 2. There are also economic forces driving the Kosovo economy and energy consumption upwards. Now that Kosovo is independent funds are being invested in Kosovo in businesses and buildings. Also, KEK and the Government of Kosovo are committed to providing all the energy to the citizens of Kosovo who pay for it. KEK mining and generation capability is increasing each month, and investments are already being made to further increase energy supply to the people of Kosovo.**

Based on the overall review of the application and considering the adjustments and corrections made, ERO proposes to set the increase in tariffs equal to the percentage increase in allowed revenues as proposed by ERO (ie, 2.5% for all tariffs).

KEK's Comment: KEK does not believe that this conclusion is correct. As pointed out in Item 5, above, the tariffs (prices) do not change in a direct relationship as Allowed Revenues unless the sales for each tariff category are exactly the same in both years (2008 and 2009).

ERO will continue to assess the assumed energy balance, as amended for changes such as the planned reduction in output by Feronikeli, and may make adjustments to this proposed approach prior to determining the final tariff for 2009. During 2010, ERO may review and adjust allowed revenues to allow for over or under-recovery of allowed revenues that may result from this as a result of differences between allowed and actual volumes sold.

KEK's comments:

- 1. Please see comments above on possible adjustments in the Energy Balance.**
- 2. Concerning the statement that the ERO proposes for reviewing and allowing adjustments in the revenues during 2010. KEK assumes that the ERO means that it will occur during the 2010 annual tariff filing, is that correct? If not, please explain.**