ZYRA E RREGULLATORIT PËR ENERGJI
ENERGY REGULATORY OFFICE
REGULATORNI URED ZA ENERGIJU

Consultation Paper

The Fifth Electricity Tariff Review
ETR5 (2011-2012)

DISCLAIMER

This Consultation Paper has been prepared by ERO for the purpose of receiving eventual comments from stakeholders. It does not represent a decision by the ERO.

Prishtinë, 22 February 2011

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1 SUMMARY

- Allowed revenues required by the KEK's application in 2011 are €201 million. Following review of the application and necessary adjustments, ERO's assessment is that allowed revenues needed for KEK as a Public Supplier are €184.6 million.
- KEK's application would represent an increase of 3.5% on the average regulated retail tariff in 2010, to €c5.78/kWh.
- ERO's assessment of allowed revenues would represent a decrease of the average regulated retail tariff by 8.2%, to €c5.13/kWh.
- Changes in the primary legislation require adjustments in the secondary legislation as well, i.e. Tariff Methodology, which is expected to result in an increase in energy tariffs.
- **Given this, ERO proposes to approve regulated retail tariffs for 2011 at the same levels as in 2010 (ie, no change).**
- The difference between revenues earned under the approved tariffs and assessed revenue requirements will be credited to a notional **Tariff Balancing Account**. This balance will be used to reduce tariff increases required in subsequent years.
- Comments on these proposals are invited from stakeholders before 4th March 2011.
- **Note: ERO's proposal is based on the assumption that the level of subsidy for import by the KCB for the year 2011 will be €33.05 million, as provided in the Draft Budget of Kosova. This proposal will change if the value of the subsidy for import is changed in the approved Budget.**

2 Introduction

The Energy Regulatory Office (ERO) is currently conducting its fifth review of retail electricity tariffs to be charged by KEK JSC[1] and transmission charges applied by KOSTT JSC from 1st April 2011. The review covers both the level of allowed revenues to be recovered by KEK and KOSTT ("the licensees") in 2011-12 from regulated tariffs and charges and the structure of those tariffs and charges.

ERO received the tariff application from KEK and on 28th January 2011. The application has been published on ERO's website alongside this Consultation Paper. This paper sets out ERO's views on this application and proposals on the new retail tariffs for regulated customers and Distribution Use of System (DUOS) charges to take effect from 1st April 2011.

ERO invites stakeholders to provide comments on its views given in this Consultation Paper. Comments on these proposals will be accepted until 4th March 2011 and should be sent either by email to ero.pricing-tariffs@ero-ks.org, with the subject line "ETR5 Comments", or in written form to the address of ERO: Str. Hamdi Mramori nr.1, 10000 Prishtina, Kosova, marked for the attention of "Pricing and Tariffs Department".

A separate Consultation Paper reviews the application received from KOSTT covering regulated Transmission Use of System (TUOS) charges, Market Operator (MO) charges and System Operator (SO) charges. This Consultation Paper and the application received from KOSTT are also available on ERO's website.

In reviewing the applications, ERO has followed the same tariff methodology as applied in previous years. The recently enacted Law on the Energy Regulator No. 03/L-185 will require changes to this methodology. These changes are to be implemented within nine months of the new law's enactment. In the interim period, ERO will continue to apply its previous methodology.

It should be emphasised that at this stage, ERO has taken no decisions on the tariffs which will be approved. The proposals of ERO in this paper are preliminary and are provided as a basis for comments from stakeholders.

3 Structure of this paper

This Consultation Paper is organized as follows:

- Section 4 reviews KEK's projections of electricity demand, including losses, supplies, and import.

[1] For conciseness, in the remainder of this Paper, references to KEK JSC omit the JSC, and similarly for KOSTT.

- Section 5 reviews KEK's proposals on the allowed revenues to be recovered from regulated retail tariffs.
- Section 6 reviews KEK's proposed DUOS charging structure.
- Section 7 considers other matters arising from the application.
- Section 8 sets out ERO's proposals on regulated tariffs to apply from 1st April 2011.

4 Electricity demand and supply

KEK's projections for demand and supply use those in the Electricity Balance 2011, issued by KOSTT in November 2010[2].

KEK has respected the request of ERO which encouraged licensees to use this published balance as the basis for their projections for demand and supply. Nevertheless, ERO believe it appropriate to make two modifications to the projections provided by KEK. In both cases, these relate to the assumptions on losses in the distribution network.

- ERO has adjusted allowed technical losses downwards from the 17.6% contained in KEK's application to 17.1% to match the level allowed in previous tariff reviews and that achieved by KEK in 2010[3]. ERO notes that KEK has made significant investments in its distribution network in recent years, funded in large part from customer tariffs, and this should have resulted in a reduction in technical losses. The difference between ERO's allowed losses and those proposed by KEK is treated as a reduction in imports or, in months where there are no imports, as a reduction in generation by KEK-owned power plants.
- ERO has also adjusted allowed commercial losses downwards from the 22.4% (comprising both commercial losses and unbilled supplies) contained in KEK's application to 20.0% as approved in previous years. This difference is assumed to be converted into increased sales representing the conversion of theft into paid sales. ERO notes that, excluding unbilled supplies, KEK is projecting a reduction in commercial losses to 18.0% in this year.

ERO has also adjusted allowed transmission losses recovered by KOSTT from the 3.0% contained in the 2011 Electricity Balance to 2.3%. The reasons for this proposed adjustment are set out in the separate consultation paper on KOSTT's tariff application. This adjustment is expected to reduce

[2] ERO has noticed a minor discrepancy in projected regulated sales between the KOSTT-issued 2011 Electricity Balance and KEK's tariff application. This is of 4.2 GWh representing only 0.1% of sales and is considered to be immaterial.

[3] Calculated on the same basis as applied by ERO in the electricity balance used to determine allowed revenues, KEK's technical losses on the distribution network in 2010 were 17.1%.

import requirements or, in months where there are no imports, generation from KEK-owned power plants and will, therefore, impact on total supplies required by KEK.

The electricity balance adjusted by ERO is shown below, alongside that contained in KEK's application. The impacts of ERO's proposed adjustments are to increase projected retail sales to distribution-connected customers from 2,713 GWh to 2,828 GWh, to reduce projected import requirements from 891 GWh to 840 GWh and to reduce projected requirements for supply from KEK-owned power plants from 4,768 GWh to 4,753 GWh.

Figure 1: Energy balance

ELECTRICITY BALANCE

		KEK Application	ERO Proposals
Generation			
Kosovo A	GWh	1,384.8	1,370.3
Kosovo B	GWh	3,382.9	3,382.9
HPP Ujmani	GWh	82.0	82.0
Total generation	**GWh**	**4,849.7**	**4,835.2**
Trade			
Imports	GWh	891.2	840.0
Exports	GWh	-194.2	-193.0
Total supply at transmission	**GWh**	**5,546.7**	**5,482.2**
Transmission			
Transmission losses	GWh	172.3	130.5
		3.0%	2.3%
Total transmission-connected sales	GWh	767.8	772.6
KEK internal consumption	GWh	126.4	126.4
Distribution			
Energy available from transmission	GWh	4,480.2	4,452.7
Distribution-connected generation	GWh	42.9	42.9
Total energy supplied to distribution	**GWh**	**4,523.1**	**4,495.6**
Technical losses	GWh	796.7	768.7
		17.6%	17.1%
Commercial losses	GWh	1,013.2	899.1
		22.4%	20.0%
Total distribution-connected sales	**GWh**	**2,713.2**	**2,827.7**
Sales			
Total transmission-connected sales	GWh	767.8	772.6
Total distribution-connected sales	GWh	2,713.2	2,827.7
Total sales	**GWh**	**3,481.0**	**3,600.3**

Note: The small differences between KEK's application and ERO proposals for exports and sales to transmission-connected customers are due to the use by ERO of the values contained in the 2011 Electricity Balance rather than those in KEK's application.

5 Allowed revenues

5.1 Approach

ERO separately determines allowed revenues for each licensed activity of KEK (generation, distribution and public supply). In addition, ERO also estimates allowed revenues for KEK's mining activities (which are used to determine the costs of lignite supply to KEK's licensed generation activity) and KEK's common headquarters division (the costs of which are then allocated between KEK's other activities in proportion to their share of total staff numbers).

The allowed revenues for each activity are determined using a 'building-block' approach. Allowed costs are determined as the sum of operating expenditures (including the costs of power purchases from non-KEK generation and imports and KOSTT fees), depreciation of post-2006 assets and an allowed return on non-grant financed post-2006 assets. Pre-2006 assets are valued at zero for regulatory purposes, while no return is earned on assets that are grant-financed (and for which, therefore, KEK has incurred no financing costs).

Allowed revenues to be recovered from regulated retail tariffs are then determined as allowed costs less unregulated income (which includes sales to third parties, unregulated customers and imports). Finally, adjustments are applied for differences between actual and allowed capital expenditures in the preceding year as well as for differences between actual and allowed cost and revenue items outside the control of licensees (which include import costs, subsidies, license fees, royalties).

In this section, each of these components of final allowed revenues is reviewed in turn.

5.2 Import Costs

In the application for ETR5, KEK has requested an average price of purchasing imports of 59.66 €/MWh. KEK have based their assumption on actual and offered contract prices for 2011. ERO considers this price to be reflective of current import conditions, and has therefore accepted KEK's request in the calculation of allowed revenues.

In 2010, under ETR4, KEK also proposed an emergency imports allowance. This is not included in this year's application. The treatment under this review of the allowance for ETR4 is discussed further below.

ERO notes that Article 38 of the recently enacted Law on Electricity No. 03/L-201 requires that a state-owned enterprise other than KOSTT will, in future, be responsible for imports to meet demand from non-eligible customers when otherwise such customers would be disconnected. This will be considered a public service obligation, the costs of which, subject to a review of reasonableness, will be compensated from regulated tariffs in accordance with Article 16.4 of the Law on Energy No. 03/L-184. ERO will be issuing proposals on the future regulatory treatment of imports under the new laws in the near-future.

5.3 Other operating expenditures

5.3.1 Bad debts

KEK has included in its tariff application an allowance of €5 million for bad debts. In previous tariff reviews, ERO has not permitted bad debts to be included in allowed revenues. However, in the last review (ETR4 conducted in 2010), ERO stated in its document Review of Comments, ERO stated that: "*ERO will review its approach on bad debts in the future, in accordance with common international practices on such debt*" (Section 3.4).

KEK's current accounting treatment of bad debts is to record these as an impairment of receivables carried on its balance sheet. The change in the total impairment value is then included as an operating expense in the annual income statement.

Under the Law on Corporate Tax, bad debts are may be treated as expenses if they fulfil the following criteria:

> 1.1. The amount that corresponds to the bad debt has been previously recorded as income.
>
> 1.2. The bad debts have been written off from the accounts used of taxpayers as irrecoverable.
>
> 1.3 Adequate proof exists of unsuccessful efforts that were made to collect the debt.
>
> 2. Bad debts that were deducted as expenses and later on were collected are included as an income in the year in which they were collected.

KEK has stated that its treatment of bad debts complies with these requirements and also the requirement under International Financial Reporting Standard (IFRS) that accounts receivable are stated at their recoverable value (ie, excluding unrecoverable bad debts).

In 2008, KEK recorded bad debt expenses of €31.5 million and in 2009 of €25.6 million. The proposed bad debts allowance contained in KEK's tariff application for the year 2011 is €5 million. This amount which represents approximately 2.5% of total expected income from electricity sales in 2011 is comparable to values allowed internationally and as such is acceptable to ERO.

Given this, ERO has included KEK's request for the inclusion of bad debts in allowed revenues of ETR5. However, ERO does not intend to permit KEK to recover from regulated revenues bad debts in excess of what a well-managed electricity utility operating in similar circumstances might expect to achieve.

5.3.2 *Supply margin*

In its tariff application, KEK has assumed a supply margin of €2.4 million, which equates to 1.3% of estimated costs of power purchases to meet demand in Kosova served at regulated tariffs. ERO has adjusted the allowed margin upwards to 3% in line with ERO's previous decisions.

5.3.3 *KOSTT fees*

KEK, in its application, has estimated net fees payable to KOSTT (after deducting payments for transmission losses[4]) as €12.2 million. ERO has adjusted this value to reflect its own proposals on KOSTT's revenues of €10.2 million. This represents a reduction of €2 million.

5.4 Capital expenditures, regulated asset base, depreciation and allowed return

ERO has accepted the projected capital expenditures contained in KEK's tariff application. ERO notes that KEK has consistently failed to achieve projected levels of capital expenditure in previous years. If this is also the case for 2011, revenues in subsequent years will be adjusted for the resulting over-recovery of depreciation allowances and allowed returns as has been the practice at previous tariff reviews. ERO has satisfied itself that funding is available for the largest component of capital expenditures, relating to investments in KEK's mining operations, which means shortfalls of actual against projected expenditure should be less likely to occur.

5.5 Unregulated income

5.5.1 *Import subsidies*

At the time of the preparation of this Consultation Paper, a government has yet to be established following the December 2010 elections. Consequently, the Kosova Consolidated Budget (KCB) for 2011 has yet to be approved.

In developing its proposals on allowed revenues, ERO has assumed that the sum of €33.05 million allocated for import energy purchases in the draft KCB will remain unchanged. If the KCB is approved prior to ERO's issuing its final decision with respect to allowed tariffs for 2011, then the allowed revenues and tariffs will be adjusted according to the final sum allocated for import subsidies. If the KCB is not approved prior to ERO's final decision, then any difference between imports assumed by ERO and those provided by the KCB will be recovered in the following year.

[4] Part of the fees paid by KEK to KOSTT represents the costs to KOSTT of purchasing energy to cover transmission losses. KEK sells this energy to KOSTT. For the purposes of determining allowed revenues, the allowances for KOSTT to purchase transmission losses and the expected revenues to KEK from the sale of this energy are equal and as such cancel out.

5.5.2 Revenues from unregulated sales to eligible customers

Currently, KEK supplies Feronikeli NewCo at unregulated tariffs under a commercial contract. ERO deducts the expected revenues from these unregulated sales from the revenues to be recovered from sales at regulated tariffs. These revenues are calculated assuming that Feronikeli is supplied at the same average wholesale cost as other customers and allowing for associated transmission charges.

The current contract will expire in April 2011. At this stage, it is not clear whether Feronikeli will subsequently continue to be supplied by KEK at an unregulated tariff, will be supplied by KEK at a regulated tariff or will be supplied by another licensee at an unregulated tariff. This should not be considered to represent a decision by ERO on whether regulated tariffs will or will not apply to Feronikeli in future. This will depend on the decision of Feronikeli to request for supply at regulated tariffs and on the decision of ERO determining whether effective competition exists in supply or not (see the discussion below).

If a decision on whether Feronikeli is to be supplied at a regulated or unregulated tariff is taken prior to ERO’s final decision on allowed tariffs for 2011, then the tariffs will be adjusted accordingly.

5.6 Adjustments

5.6.1 Capital expenditure adjustments

As in previous years, ERO adjusts allowed revenues downwards to recover ‘excess’ revenues earned in the preceding year from allowed capital expenditures that were not actually undertaken. These excess revenues comprise depreciation allowances and allowed returns associated with the difference between actual and allowed capital expenditures. An interest rate of 8.15% is applied to this difference, which is derived from the short-term commercial lending rate and represents the additional interest income or payments associated with these excess revenues.

In its ETR4 allowed revenues, ERO had allowed KEK to recover depreciation costs and allowed return for capital expenditures foreseen to be implemented during the ETR4 time span. With this regard, ERO had allowed KEK to recover €3.4 million in depreciation allowances and €8.9 million in allowed returns on a total of €135.8 million investments.

In its ETR5 tariff application, KEK reports actual capital expenditures in 2010 to have been a total of €85.5 million. ERO has therefore reconciliated for the depreciation and allowed return allowances corresponding to the difference between actual and the allowed capital expenditures. As a result, ERO will deduct a total of €4.8 million. ERO’s adjustments are summarized in the following table.

Figure 2: Adjustments for unrealised capital expenditures

			Mining	Generation	Network	Supply	HQ	Total KEK
Capital expenditures								
	Allowed (donor-financed)	€000s	0	0	0	0	0	0
	Actual (donor-financed)	€000s	0	0	0	0	0	0
	Allowed (other financing)	€000s	73,500	30,000	26,400	465	5,400	135,765
	Actual (other financing)	€000s	56,000	18,600	6,515	446	3,951	85,512
Depreciation								
	Asset life	years	25	16	30	5	5	n/a
	Allowed	€000s	1,470	938	440	47	540	3,434
	Actual	€000s	1,120	581	109	45	395	2,250
	Adjustment	€000s	-350	-356	-331	-2	-145	-1,184
Return								
	WACC		13.10%	13.10%	13.10%	13.10%	13.10%	n/a
	Allowed	€000s	4,814	1,965	1,729	30	354	8,893
	Actual	€000s	3,668	1,218	427	29	259	5,601
	Adjustment	€000s	-1,146	-747	-1,302	-1	-95	-3,292
Total adjustment								
Total before interest income/costs		€000s	-1,496	-1,103	-1,634	-3	-240	-4,476
Short-term interest rate			8.15%	8.15%	8.15%	8.15%	8.15%	n/a
Total after interest income/costs		€000s	**-1,618**	**-1,193**	**-1,767**	**-3**	**-259**	**-4,841**

5.6.2 Emergency imports allowance

In ETR4, ERO had allowed KEK to recover €10.2 million for emergency imports. This allowance was given under the condition that KEK supplies 24:0 to all categories[5].

In fact KEK has provided evidence in its ETR5 submission that it has not been able to meet the 24:0 condition. Average daily load shedding in 2010 for customers on category A feeders was 11 minutes, for category B feeders was 59 minutes and for category C feeders was 2 hours and 40 minutes.

Given KEK's failure to deliver on its commitments as regards quality of supply, ERO therefore proposes to deduct the €10.2 million allowance from KEK's revenues in ETR5, with interest income added to this as for other year-on-year adjustments.

5.6.3 Subsidies reconciliation

In ETR4 ERO had assumed that the level of subsidies given to KEK from the 2010 KCB budget would be €40 million[6]. KEK's submissions and the Ministry of Economy and Finance prove to have in fact

[5] KEK's application stated that the inclusion of this allowance would allow it to deliver 24:0 supply for customers on feeders in A and B categories. ERO, in its decision, noted its concern that this would provide incentives for KEK to excessively reduce supply for customers on category C feeders, in order to reach the 24:0 condition for supply for A and B category feeders. Given this, in its document "Response to comments" under ETR4, ERO stated that: "*ERO, therefore, allows this amount of revenue for emergency energy purchase so that the three categories are supplied in a non-discriminatory way*".

[6] €10.0 million more were carried over from the 2009 subsidies

only paid KEK €29.4 million. ERO therefore has included in its proposal a compensation for KEK for the difference of €10.6 million plus interest costs associated with them.

5.6.4 Regularisation of supplies north of the River Ibër

In ETR4, ERO allowed KEK additional one-time operating expenses of €3 million to cover the costs of regularising supplies north of the River Ibër (eg, purchasing new meters). Given the fact that KEK has not succeeded in regularising supplies north of River Ibër, ERO will deduct the unused expenses of €3 million plus the applicable rate of interest.

5.7 Summary of proposed allowed revenues

KEK's proposed allowed revenues to be recovered from regulated tariffs in 2011 total €201.3 million, as calculated by ERO using its Revenue and Tariffs Model (RTM) which has been made available to KEK. This would represent an increase of 28.7% on ERO's approved allowed revenues under ETR4 for 2010 of €156.5 million. KEK is also projecting an increase in sales at regulated tariffs of 24.3%, from 2,800 GWh to 3,481 GWh. The increase in sales results from the expected conversion of Feronikeli to a customer supplied at regulated tariffs. Annual sales to Feronikeli are projected at 678 GWh.

KEK's application would, therefore, represent an increase in average regulated retail tariffs of 3.5% from the average allowed for 2010 of €c5.59/kWh to €c5.78/kWh.

A breakdown of KEK's application is shown below.

Figure 3: Allowed revenues - KEK application

		--------------------		KEK	--------------------		KOSTT	TOTAL
		Mining	Generation	Networks	Supply	Total KEK		
Operating Expenses	€000s	42,244	30,802	16,714	15,734	**105,494**	9,009	**114,503**
Depreciation	€000s	8,899	4,912	1,143	439	**15,392**	439	**15,831**
Return	€000s	22,152	6,663	3,308	1,421	**33,544**	1,209	**34,754**
Imports	€000s				53,166	**53,166**		**53,166**
Non-KEK Power Purchases	€000s				3,971	**3,971**		**3,971**
Ancillary Services	€000s					**0**	1,600	**1,600**
Allocated HQ Costs	€000s	5,470	2,708	1,827	2,055	**12,061**		**12,061**
TOTAL ALLOWED COSTS	**€000s**	**78,765**	**45,085**	**22,992**	**76,786**	**223,628**	**12,257**	**235,886**
Sales to Eligible Customers	€000s				0	**0**		**0**
Exports	€000s				-4,467	**-4,467**		**-4,467**
Other Operating Income	€000s	-1,500	-1,600			**-3,100**		**-3,100**
Subsidies	€000s				-33,050	**-33,050**		**-33,050**
Adjustments	€000s	-1,859	-2,075	-1,806	11,826	**6,085**	-25	**6,061**
TOTAL ALLOWED REVENUES	€000s	**75,406**	**41,410**	**21,185**	**51,096**	**189,097**	**12,232**	**201,330**
						Total Public Supplier sales	GWh	3,481
						REQUIRED AVERAGE TARIFF	**€c/kWh**	**5.78**

Following the proposed adjustments to the electricity balance and allowed revenues described above, ERO's calculates KEK's allowed revenues requirements for 2011 as €185.5 million, an increase of 18% on allowed revenues under ETR4. Sales made at regulated tariffs are calculated as 3,600 GWh, an increase of 28.6% on those estimated under ETR4. ERO's proposals would, therefore, represent a reduction in average regulated retail tariffs of 8.0% to €c5.13/kWh.

ERO's proposals are shown in Table 4.

Figure 4: Allowed revenues - ERO proposals

		--------------------		KEK	--------------------		KOSTT	TOTAL
		Mining	Generation	Networks	Supply	Total KEK		
Operating Expenses	€000s	42,244	30,802	16,714	18,435	**108,194**	6,866	**115,060**
Depreciation	€000s	8,899	4,912	1,143	439	**15,392**	456	**15,849**
Return	€000s	22,152	6,663	3,308	1,421	**33,544**	1,290	**34,834**
Imports	€000s				50,114	**50,114**		**50,114**
Non-KEK Power Purchases	€000s				3,971	**3,971**		**3,971**
Ancillary Services	€000s					**0**	1,600	**1,600**
Allocated HQ Costs	€000s	5,470	2,708	1,827	2,055	**12,061**		**12,061**
TOTAL ALLOWED COSTS	**€000s**	**78,765**	**45,085**	**22,992**	**76,434**	**223,276**	**10,212**	**233,489**
Sales to Eligible Customers	€000s				0	**0**		**0**
Exports	€000s				-4,467	**-4,467**		**-4,467**
Other Operating Income	€000s	-1,500	-1,600			**-3,100**		**-3,100**
Subsidies	€000s				-33,050	**-33,050**		**-33,050**
Adjustments	€000s	-1,859	-2,075	-1,806	-2,479	**-8,220**	-25	**-8,245**
TOTAL ALLOWED REVENUES	**€000s**	**75,406**	**41,410**	**21,185**	**36,438**	**174,440**	**10,187**	**184,627**
						Total Public Supplier sales	GWh	3,600
						REQUIRED AVERAGE TARIFF	**€c/kWh**	**5.13**

The required average retail tariffs under KEK's application and ERO's proposals are shown in Table 5.

Figure 5: Average retail tariffs

AVERAGE RETAIL TARIFFS

		Approved 2010	Application 2011	Change	ERO Proposed 2011	Change
Chargeable volumes	GWh	2,800	3,481	24.3%	3,600	28.6%
Allowed revenues	€000s	156,465	201,330	28.7%	184,627	18.0%
REQUIRED AVERAGE TARIFF	**€c/kWh**	**5.59**	**5.78**	**3.5%**	**5.13**	**-8.2%**

The difference between allowed revenues in KEK's application and those proposed by ERO is €16.7 million. The largest components of this difference are the clawback of the emergency imports allowance, given KEK's failure to meet quality of supply targets, the clawback of unused expenses allowed for regularization of supplies north of the River Ibër and the reductions in allowed losses. A reconciliation of KEK's application to ERO's proposed allowed revenues is shown in Table 6.

Figure 6: Reconciliation of KEK application and ERO proposed allowed revenues

RECONCILIATION OF ALLOWED REVENUES

	€000s
KEK Application	**201,330**
Reduction in losses / imports	-3,052
Increase in supply margin	2,700
Clawback of emergency import allowance	-11,061
Clawback of regularisation costs	-3,245
Change in KOSTT allowed revenues	-2,045
ERO Proposed	**184,627**

6 Proposed DUOS charges

In its application, KEK has set out a proposed methodology for establishing DUOS charges once the allowed revenues for KEK's Distribution System Operator (DSO) activities have been assessed. The methodology allocates network costs and the costs of losses between voltage levels based on their share in peak demand, energy flows and sales depending on the cost being allocated. The resulting DUOS charges are the sum of these cost components and are expressed as flat-rate energy charges (in €c/kWh).

KEK's methodology of setting DUOS charges is not aligned with ERO's own methodology which requires that demand and energy charges are separated and that network costs are allocated based on relative long-run marginal costs (LRMC) at each voltage level. However, under the new Law on the Energy Regulator, responsibility for proposing distribution charging structures (subject to ERO approval) will pass to the licensees. Given this, and the minimal likelihood of retail competition for distribution-connected customers developing in the tariff year under review, ERO considers that it would be excessive to require the application of the proposed methodology for this tariff review. This should not be considered, however, to represent approval by ERO of the proposed charging methodology. ERO's view on KEK's proposal will be dependent on ERO's review of the charging methodology as submitted by KEK in compliance with the Law on the Energy Regulator.

7 Other matters

7.1 *220 kV Tariff*

KEK's application states that KEK will refuse to supply Ferronikeli at an unregulated contract after its current contract expires and, therefore, that Feronikeli is treated as a customer supplied at regulated tariffs in the tariff application. ERO believes that this may represent a misunderstanding by KEK of the legal requirements. Article 18.6.2 of the Law on Electricity states that:

18.6 The public supplier shall:

> 6.1 supply electricity to any non-eligible customers which request it to do so;
>
> 6.2 supply electricity to eligible customers where requested to do so, provided that such supply shall only be at a regulated tariff where such a regulated tariff has been established by the Energy Regulatory Office for such eligible customers, and subject to such other conditions as the Energy Regulatory Office may determine;

KEK as the Public Supplier cannot, therefore, refuse a request by Feronikeli to receive supply. However, it is free to establish the tariffs and charges applicable to such supplies unless ERO determines that a regulated tariff is to apply. Under Article 41.1 of the Law on the Energy Regulator, a regulated tariff can only apply to eligible customers where ERO determines that effective competition in electricity supply does not exist. ERO is in the process of drafting the criteria to evaluate whether or not effective competition exists in the market and will be issuing these for public consultation.

Without prejudging the conclusions of ERO following review of the effectiveness of competition in supply and, therefore, whether Feronikeli will be supplied at a regulated tariff, for the purposes of this tariff review, ERO has followed the approach of KEK in assuming that Feronikeli is a regulated customer.

7.2 *Valuation of pre-2006 assets*

KEK's tariff application includes an estimate of the impacts on allowed revenues and tariffs if pre-2006 assets were included in the RAB at their depreciated historic cost (as shown in KEK's audited financial accounts). KEK notes that the new Law on the Energy Regulator includes, in Article 43, a provision that:

> 3. In approving or fixing tariffs, the Energy Regulatory Office shall ensure that licensees are permitted to recover all reasonable costs, including:
>
> ......
>
>> 3.6. the normal costs of depreciation in respect of the Regulatory Asset Base, where "Regulatory Asset Base" means those assets used and useful in the delivery of services by the regulated entity, except fully depreciated assets.

ERO has previously stated in its Principles and Timetable letter sent to licensees on 30th December 2010 that this tariff review will be conducted under the existing Tariff Methodology, which values pre-2006 assets at zero in the RAB. This has been acknowledged by KEK, who state in their application that:

> It is KEK's understanding that secondary legislation, such as the Tariff Methodology, will be revised during 2011 to eliminate conflicts with the new primary legislation. For that reason, KEK is providing the following information on the Allowed Revenue for 2011 if the depreciation and return on pre 2006 assets was included.

ERO confirms that, in its proposals set out in this paper, it has continued to value pre-2006 assets at zero. ERO will be consulting in the near future on amendments to its Tariff Methodology to comply with the requirements of the new Law on the Energy Regulator in the near future.

7.3 Lignite royalty

KEK's tariff application also includes an assessment of the tariff adjustments required to recover the costs of the increase in lignite royalty determined by the Independent Commission on Mines and Minerals (ICMM) at its meeting on 27th August 2010 and communicated to KEK in writing on 23rd September 2010.

Subsequent to the submission of KEK's application, ICMM has withdrawn this decision. In its proposals, therefore, ERO has assumed that current lignite royalty rates remain unchanged.

8 ERO proposals on regulated tariffs

8.1.1 Allowed revenues

ERO's assessment is that the appropriate level of allowed revenues for KEK Public Supply to be recovered under tariffs becoming effective from 1 April 2011 is €184.6 million, representing an increase of 18.0% on the allowed revenues established under ETR4. ERO's projection of total sales made at regulated tariffs for the same period is 3,600 GWh, an increase of 28.6% on those expected under ETR4. This would imply a reduction in the average regulated retail tariff from €c5.59/kWh to €c5.13/kWh.

In addition to any changes that may be made to this assessment following the review of stakeholder comments, ERO would also wish to note that its assessments are based in two important assumptions:

- ERO's assessment assumes that Feronikeli will be supplied at a cost-reflective regulated tariff following the expiry in April 2011 of its current unregulated supply contract with KEK. It is possible that Feronikeli may choose not to be supplied by KEK in future or that it is supplied at an unregulated tariff if ERO considers effective competition in supply exists.

- Allowed subsidy for import energy purchase in the approved KCB for 2011 will be the same value as that in the October 2010 draft of the KCB, of €33.05 million.

A change in these assumptions will necessitate adjustments to ERO's assessed allowed revenues and, consequentially, to allowed regulated tariffs.

8.1.2 Proposed tariff adjustment

Although ERO's assessment would imply a reduction in regulated tariffs would be possible in this year, ERO considers that this should not be the case. ERO considers it likely that regulated tariffs may rise significantly in 2012 as a result of:

- An increasing share of imports in total power supplies, until new domestic generating capacity can be commissioned.
- Revisions to the Tariff Methodology necessitated by the new Law on the Energy Regulator including, in particular, the requirement to include a depreciation allowance of some form on pre-2006 assets.
- Ongoing reductions in import subsidies from the KCB which are expected to fall by €10 million annually and to approach zero by 2014.

Given this potential for large tariff increases in future years, **ERO proposes that regulated retail tariffs remain unchanged for 2011**.

8.1.3 Tariff Balancing Account (TBA)

ERO will treat the difference between its assessment of KEK's allowed revenues requirement and the revenues that it expects to be recovered under the approved tariffs as a balancing item, that can be used to moderate tariff increases in subsequent years.

This difference will be allocated to a Tariff Balancing Account (TBA). The balance of this TBA will be adjusted for interest in the same way as other adjustments applied so far. In the subsequent tariff year, the TBA will be available and, as determined by ERO, will be used to offset any increase in tariffs. Any unused part of the TBA or any addition or to the TBA as a result of ERO's decisions will be carried forward to future years.

ERO estimates that the difference between its assessment of revenue requirements and revenues expected to be recovered at current regulated tariffs is €16.5 million. This amount would be credited to the TBA. In the following year, if the allowed revenues requirement were to increase from the consequences shown in Section 7.1.2, then ERO will deduct the TBA balance from this amount of Allowed Revenues. The effect would be to reduce the excessive in the future.

Figure 7: Calculation of the TBA

	Average Tariffs €c/kWh	Projected Sales GWh	Allowed Revenues €000
Allowed Revenues collected from current level of tariffs	5.59	3,600.3	201,163.7
Allowed Revenues collected from calculated tariffs	5.13	3,600.3	184,627.0
Difference	**€000s**		**16,537**

ERO will issue further details on its proposals as to the determination and application of the TBA ahead of its decision on tariffs for the coming tariff year.

8.1.4 Tariff structure

Following detailed review of the applications ERO does not propose to make any change to the existing regulated retail tariffs; the existing tariff structure will therefore remain unchanged and will be applicable to the next tariff review.