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ENERGY REGULATORY OFFICE  
REGULATORNI URED ZA ENERGIJU

## Consultation Paper - KOSTT

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 ERO.

**Prishtina, 22 February 2011**

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## SUMMARY

### SUMMARY

- Allowed revenues required by the KOSTT's application under ETR5 in 2011 are €17.4 million. Following review of the application, ERO's assessment is that allowed revenues sufficient for KOSTT for 2011 are €14.1 million.
- ERO proposes that allowed costs for purchasing transmission losses are set at €3.9 million, which corresponds with allowed losses of 2.3% or the level achieved in 2010. Allowed losses in 2010 under ETR4 were 3.1%, while the level requested by KOSTT for 2011 was 2.7%.
- ERO proposes that allowed costs for KOSTT, other than transmission losses, are set at €10.2 million, compared to €12.3 million requested by KOSTT.
- Comments on these proposals are invited from stakeholders before 4th March 2011.

### 1 Introduction

The Energy Regulatory Office (ERO) is currently conducting its fifth review of transmission charges of the Transmission, System and Market Operator (KOSTT) to take effect from 1<sup>st</sup> 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 KOSTT on 28<sup>th</sup> 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 Transmission Use of System (TUOS), Market Operator (MO) and System Operator (SO) charges applied by KOSTT to take effect from 1<sup>st</sup> April 2011.

Comments on these proposals and the applications are invited from stakeholders. Comments on these proposals will be accepted until 4<sup>th</sup> March 2011 and should be sent either by email to [ero.pricing-tariffs@ero-ks.org](mailto: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 Prishtinë, Kosova**, marked for the attention of “Pricing and Tariffs Department”.

In reviewing the KOSTT’s application, ERO has followed the same 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 emphasized that at this stage, ERO has taken no decisions on the tariffs that will be approved. The proposals of ERO in this paper are preliminary and are provided for the purpose of receiving comments from stakeholders.**

### 2 Transmission losses

In their application KOSTT has proposed that transmission losses are set at 2.7% of transmitted volumes. KOSTT’s proposal is developed on the basis that allowed losses for 2010 were 3.1% while according to KOSTT, the allowance in losses should include half of the reduction in losses relative to the previous year.

ERO notes that KOSTT appears to have misunderstood ERO’s incentive mechanism as applied to transmission losses. ERO’s proposed adjustments for the difference between allowed and actual transmission losses are described later in this paper.

ERO proposes to set allowed transmission losses for 2011 as a proportion of volumes entering the transmission system at the actual level achieved in 2010 of 2.3%. The resulting allowed losses

## Allowed revenues

proposed under ETR5 would be 130.5 GWh<sup>1</sup>. This difference is valued at the average wholesale purchase price expected for 2011 of €29.9/MWh, and represents a reduction in KOSTT's allowed revenues of €1.3 million.

This discussion is described in the Figure 1.

**Figure 1: Transmission losses**

		ETR4 Approved	Actual	KOSTT Application	ERO Proposals
Volumes entering transmission	GWh	5,316.6	5,813.7	5,614.8	5,675.2
Allowed losses		3.1%	2.3%	2.7%	2.3%
	<b>GWh</b>	<b>166.0</b>	<b>131.0</b>	<b>151.6</b>	<b>130.5</b>

## 3 Allowed revenues

### 3.1 Approach

The allowed revenues for KOSTT are determined using a 'building-block' approach. Allowed costs are determined as the sum of operating expenditures, depreciation of post-2006 assets and an allowed return on grant financed post-2006 assets.

Allowed revenues to be recovered from regulated retail tariffs are then determined as allowed costs less unregulated income. In the case of KOSTT, this unregulated income is assumed to be zero. While KOSTT should be compensated for international transit flows across its network, it is not currently a member of ENTSO-E and, consequently, these compensation payments are not made to it.

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.

In this section, each of the components of allowed revenues has been reviewed and analyzed in details.

### 3.2 Operating expenditures

Excluding the costs of transmission losses (discussed above), KOSTT's proposed operating expenditures represent a reduction of 5% compared with those allowed under ETR4, but an increase of 35.8 % compared with actual reported expenditures for 2010. A comparison of operating

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<sup>1</sup> KOSTT in its application has requested losses of 151.6 GWh, while ERO has taken the value of 172.3 GWh, based on the Energy Balance.

## Allowed revenues

expenditures as allowed under ETR4, actually made in 2010 and proposed for 2011 is provided below.

**Figure 2: KOSTT operating expenditures**

OPERATING EXPENDITURES					
		ETR4	2010 Actual	Application	ERO Proposed
Maintenance	€000s	3.914	1.113	2.361	1.113
Materials/ services	€000s	52	37	52	52
Personnel costs	€000s	2.495	2.489	2.878	2.240
Security	€000s	205	205	230	230
Other overheads	€000s	1.181	1.190	1.888	1.631
Purchase of losses	€000s	5.582	3.150	5.184	3.903
Purchase of ancillary services	€000s	1.624	1.600	1.600	1.600
<b>Total operating expenses</b>	<b>€000s</b>	<b>15.053</b>	<b>9.784</b>	<b>14.193</b>	<b>10.769</b>
Total excluding losses	€000s	9.471	6.634	9.009	6.866

### 3.2.1 Maintenance

In 2010, allowed revenues for KOSTT included provision for maintenance costs worth €3.9 million. In actuality, KOSTT reports only €1.1 million of maintenance expenditures with the remainder being capitalized.

ERO does not dispute that capitalization of maintenance expenditure is appropriate when it leads to an extension of the life or increase in capacity of the asset concerned. However, capitalizing these costs should not lead to double benefits from these costs for KOSTT – first including them as an operating expense and then as revenues from capital expenditures. KOSTT has repeated this practice despite ERO's remarks in the previous Consultation Paper stating that maintenance expenditure costs should be allocated properly.

ERO is, therefore, proposing to avoid double-counting by reducing allowed operating expenditures on maintenance to their actual level in 2010 of €1.1 million. The difference between this and KOSTT's proposed amount will be included in RAB as capital expenditures.

### 3.2.2 Personnel costs

In the tariff application of 2011 KOSTT has submitted the request for personnel costs in the amount of €2.9 million. This represents an increase of 15%, compared to that allowed under ETR4.

KOSTT justifies its request for an increase in staff numbers of 25 persons and an increase in average personnel costs equal to the annual change in the Kosovo Consumer Price Index (CPI). ERO has compared personnel costs allowed for KOSTT with the costs of other personnel of a comparable profile employed in the energy sector and the result is that the average cost of KOSTT's personnel is significantly higher than average cost of personnel in the Kosova energy sector. Taking this into

## Allowed revenues

account, ERO has included the personnel cost of €2.2 million in the allowed revenues of KOSTT, which represents a reduction of 10% on the actual ones in 2010.

### **3.2.3 Other overheads**

KOSTT's proposed allowance for other overheads represents an increase of €0.7 million or 60% on that allowed under ETR4. KOSTT, in its application, has explained that the largest part of this increase, €0.45 million, is due to an increase in insurance costs resulting from the addition of assets to the network (insured in compliance with Article 24 of the TSO license). The remainder of the increase has not been explained in the application. ERO proposes to permit an increase equal to the insurance cost increase, but to disallow other increases in this category.

### **3.2.4 Ancillary services**

KOSTT has proposed an allowance of €1.6 million for the purchase of ancillary services under contract from the TSO for Albania, KESH, and from KEK's generation business. This is similar to the allowance proposed in the previous year.

ERO notes that KOSTT in actuality made no cash payments for ancillary services in 2010. In addition, KOSTT has clarified that it does not expect to be able to procure ancillary services from KESH during 2011 as the interconnector with Albania is not yet able to operate.

Given this, ERO remains unconvinced that KOSTT will incur expenses for the purchase of ancillary services during 2011. For the present, ERO has included the cost of ancillary services in KOSTT's allowed revenues. However, ERO notes that KOSTT should provide further justification of this cost ahead of ERO's final determination on allowed revenues and transmission charges for 2011. If this further justification is not forthcoming, ERO reserves the right to exclude this cost item from KOSTT's allowed revenues.

## **3.3 Capital expenditures, depreciation and allowed return**

ERO has decided to allow the projected capital expenditures contained in KOSTT's tariff application. In 2010, capital expenditures by KOSTT included in allowed revenues totaled €23.5 million. Of this sum, KOSTT actually expended only € 5.6 million or 24%. For 2011, KOSTT proposes capital expenditures of € 24.9 million of which grants are expected to cover €20 million, €0.5 million will be loans, and €4.3 million will be financed from KOSTT.

ERO proposes an increase in capital expenditures by €1.2 million from the level projected by KOSTT, which represents the transfer of the capitalized share from maintenance to capital expenditures.

## Allowed revenues

### 3.4 Adjustments

#### 3.4.1 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 the case of KOSTT, this adjustment represents a deduction of €0.59 million in allowed revenues. ERO adjustments are summarized in the following figure.

**Figure 3: Adjustments for unexpended capital expenditures**

<b>KOSTT Adjustments</b>			
<b>Capital expenditures</b>			
	Allowed (donor-financed)	€000s	14.959,0
	Actual (donor-financed)	€000s	1.497,0
	Allowed (other financing)	€000s	8.557,0
	Actual (other financing)	€000s	4.138,0
<b>Depreciation</b>			
	Asset life	years	35,0
	Allowed	€000s	335,9
	Actual	€000s	80,5
	Adjustment	€000s	-255,4
<b>Return</b>			
	WACC		13,1%
	Allowed	€000s	560,5
	Actual	€000s	271,0
	Adjustment	€000s	-289,4
	<b>Total</b>	<b>€000s</b>	<b>-545</b>
<i>Interest rate</i>			<i>8,15%</i>
<b>Total after interest rate adjustment</b>		€000s	<b>-589,3</b>

#### 3.4.2 Losses allowance

ERO allows KOSTT to retain that part of the difference between actual and allowed costs of transmission losses in preceding years that it considers is under KOSTT's control. Changes resulting from factors outside KOSTT's control are adjusted for in the allowed revenues in the following year's tariff review.

## Allowed revenues

This calculation includes the difference between allowed and actual levels of losses, that are attributable to differences in the level of losses, but not the difference in losses that is attributable to the changes in energy flows in the transmission network. In 2010, total transmission losses were 131 GWh compared to an allowed level of 166 GWh. If the allowed losses as a percentage of volumes were unchanged, the total losses would have been 182 GWh. Therefore, ERO's estimate is that the change in losses as a result of the difference between actual and expected volumes is equal to 16 GWh. This difference, valued at the cost of transmission losses in 2010, comes to €0.5 million, which is added to KOSTT's allowed revenues compensating it for the impacts of changing volumes on the electricity flows. The difference between actual and allowed costs of losses is retained by KOSTT as a compensation for the reduction in losses in the transmission network and provides an incentive to achieve reductions in losses in future years.

### 3.5 Summary of allowed revenues

KOSTT's proposed allowed revenues to be recovered from regulated charges in 2011 total €17.4 million, as calculated by ERO using its Revenue and Tariffs Model (RTM) which has been made available to KOSTT. This represents a decrease of 3.5% on allowed revenues under ETR4. ERO's own proposal for allowed revenues is €14.1 million, which would represent a decrease of 22% on KOSTT's allowed revenues under ETR4.

KOSTT's proposed allowed revenues and ERO's own proposals are shown below.

**Figure 4: Allowed revenues**

	ALLOWED REVENUES			
		ETR4 Approved	KOSTT Application	ERO Proposals
Operating Expenses	€000s	7.847	7.409	5.266
Depreciation	€000s	1.857	2.039	2.056
Return	€000s	934	1.209	1.290
Purchase of Losses	€000s	5.582	5.184	3.903
Ancillary Services	€000s	1.624	1.600	1.600
<b>TOTAL ALLOWED COSTS</b>	<b>€000s</b>	<b>17.844</b>	<b>17.441</b>	<b>14.115</b>
Adjustments	€000s	235	-25	-25
<b>TOTAL ALLOWED REVENUES</b>	<b>€000s</b>	<b>18.080</b>	<b>17.416</b>	<b>14.090</b>

The difference between allowed revenues in KOSTT's application and those proposed by ERO is €3.3 million. A reconciliation of KOSTT's application to ERO's proposed allowed revenues is shown below.

**Figure 5: Reconciliation of allowed revenues**

RECONCILIATION OF ALLOWED REVENUES	€000s
<b>KOSTT Application</b>	<b>17.416</b>
Reduction in losses	-1.281
Personnel Cost Deduction	-639
Maintenance set at 2010 actual	-1.248
Transfer of maintenance to capex	98
Other overheads set at 2010 approved plus insurance	-257
<b>ERO Proposed</b>	<b>14.090</b>

## 4 Other matters

### 4.1 Capping of KEK payments

During 2010, a dispute has arisen between KEK and KOSTT over the payments of KEK to KOSTT. KEK has argued that, invoices for November and December should not be paid to KOSTT because it had already paid by October 2010 the full allowed revenues for KOSTT under ETR4. KOSTT’s position has been that these invoices are properly calculated and should be paid in full.

As there is no official request to resolve this dispute, ERO will not provide its position on this dispute in this Consultation Paper. However, ERO wishes to avoid similar disputes arising in future.

KOSTT has proposed, in its application, that this situation can be avoided by improving the accuracy of forecasting actual volumes transmitted and peak demand. ERO agrees that accurate forecasting is to be encouraged. However, ERO also recognizes that inevitably, totally reducing deviations is almost impossible.

ERO, therefore, proposes to establish allowed revenues for KOSTT under ETR5 on a revenue-cap basis. ERO would set total allowed revenues, excluding losses which are volume-dependent, and KOSTT’s charges and tariffs. If actual volumes and demand deviate from projected levels, then the difference will be carried forward as an adjustment in the following year. Therefore, KEK can expect to pay and KOSTT can expect to receive only the allowed revenues.

### 4.2 Valuation of pre-2006 assets

KOSTT has previously submitted an application for the revaluation of their pre-2006 assets included in the RAB at their depreciated historic cost (as shown in KOSTT’s audited financial accounts).

ERO 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:

## ERO proposals on Allowed Revenues

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.

However, ERO has previously stated in its Principles and Timetable letter sent to licensees on 30<sup>th</sup> December 2010 that this tariff review will be conducted under the existing Tariff Methodology, which values pre-2006 assets at zero.

## 5 ERO proposals on Allowed Revenues

ERO’s own proposal for allowed revenues is €14.1 million, which would represent a decrease of 22% on KOSTT’s allowed revenues in 2010. This will also be reflected in the tariffs and charges to be set for KOSTT.