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

Seventh (Multi-Year) Electricity Tariff Review (ETR7)

First Consultation Paper

DISCLAIMER

This Consultation Paper has been prepared by ERO in order to obtain comments and views from stakeholders. It is not a decision document and should not be considered to represent a decision by ERO.

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1 Introduction

In a letter dated 8 June 2012 ERO announced the commencement of Electricity Tariff Review 7 (ETR7) which, for the first time, will enable the setting of licensee maximum allowable revenues over multi year periods. This first consultation document sets out ERO's initial position on the process and its timing. It also provides licensees with an opportunity to consider ERO's proposed reporting formats, which will be used as the basis for data collection for the review.

1.1 Objectives of the Multi-Year Tariff (MYT) Review

In its 2011 consultations on revisions to secondary legislation, ERO accordingly proposed shifting to multi-year, rather than single-year control periods. ERO believes that this change will bring the Kosovo power sector closer into line with best international practice and that licensees will benefit from having more certainty over their future revenue streams. In an asset-intensive industry such as electricity investment plans need to be closely aligned to revenues and ERO believes the multi-year approach will allow closer examination of the linkage between investment and quality of service.

1.2 Outline of the MYT Process

ERO has decided to launch the MYT process in May 2012, some nine months prior to the date when the resulting tariffs should be introduced. The timetable indicated in ERO's letter of 8 June 2012 also provides for three rounds of public consultation, as well as extensive opportunities for clarification meetings with licensees. This will improve the overall transparency of the process, and should provide for revenues to be set on a firm basis. That process is as follows:

- Initiation of consultation on multi-year reporting formats – 11 June 2012
- Closing date for consultation – 29 June 2012
- Reporting formats issued to licensees – 9 July 2012
- Deadline for return of formats supported by written submissions – 31 August 2012
- Public Hearing at which licensees present their submissions to ERO and public – 3 September 2012
- Provisional evaluation published for consultation – 19 October 2012
- Closing date for consultation – 9 November 2012
- Final Evaluation published for consultation – 28 December 2012
- Closing date for consultation – 18 January 2013
- Public Hearing – 11 February 2013
- Final Decision on Maximum Allowable Revenues – 28 February 2013
- Licensees propose their resulting tariffs and charges for approval – 15 March 2013
- Approval of tariffs and charges – 29 March 2013

Over previous tariff reviews, ERO has gradually been introducing more specific reporting formats. These are now extended, and more detail is required. In particular, previous years have required only actual data for the year past, and estimated outturn data for the current year. In this multi-year process ERO is seeking historic data for 5 historic years, an estimation of the outturn position for the current year and five forecast years. The data reporting formats are discussed in more detail later in this document.

Once completed returns are received from licensees, the data will be used in a revenue model that is being modified and refined for the purposes of the current review, and updated to the new pricing rules.

1.3 Background to the Industry Structure

In 2006, the transmission activities of the power sector were separated out from KEK and incorporated into a State-owned transmission system and market operator, KOSTT. At the time of the current review, the sector is going through a further unbundling of KEK, with the distribution and supply activities being offered for sale to international investors. That sale transaction is ongoing. The Government's Kosovo e Re project aims to place Kosovo B station into the hands of a private investor, who will also be charged with the construction of a new coal-fired 2 x 300MW power plant. ERO believes that potential purchasers will welcome the multi-year approach, which reduces uncertainty about future revenues, and provides more information on forecast future costs than is presently in the public domain. This consultation paper discusses the implications of these reforms on the review.

1.4 Purpose of this Consultation

The Kosovo Energy Strategy is driving the current reforms of the sector. While these should deliver benefits to customers in terms of better quality of supply and improved customer service, those improvements have a cost, for which licensees must be compensated through the tariffs. The multi year review will allow a more intensive examination of those costs, and ERO believes that a more extensive consultative process is necessary to improve understanding of the relationship between cost of service, and quality of service. It is important that customers understand why they are being asked to pay for their electricity supply, and that they understand what their payments are being used for.

This consultation paper sets out in Appendix I ERO's initial proposals on the reporting templates that it intends that licensees should complete. The reporting formats will be revised following input from the licensees. A key objective is to invite views on the form and scope of data requests to licensees.

Additionally, we seek the views on the timetable for the review set down in ERO's letter of 8 June 2012.

Finally, we seek views on the ERO's proposed assumptions set out in this paper.

The proposals given in this paper are indicative in nature only and should not be considered to represent a decision by ERO in any form.

Comments should be sent by **29 June 2012** to:

Pricing and Tariffs Department

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2 Key Issues for the MYT Review

This section sets out some of the issues which ERO will need to address during the course of the review and raises questions on appropriate treatment.

2.1 Assessment of licensees' costs

ERO has a statutory duty to ensure that licensees remain financially viable and can earn a reasonable return on their investments. ERO cannot simply accept what licensees ask for in terms of tariffs, but must make a detailed examination of costs to ensure that customers are paying no more than they need to, and that their payments are delivering the maximum benefits in terms of improved availability and quality of supply.

The pattern, level and nature of forecast costs cannot be interpreted correctly unless they are understood by reference to historic costs. ERO will therefore be asking licensees to set down their actual historic operating and capital expenditures (opex and capex). Licensees should have this data readily available, although some adjustments may be required to ensure that historic and forecast costs are on the same basis.

The forecasting of costs will require licensees to make certain assumptions. ERO will be asking licensees to give careful thought to these assumptions when completing the returns, and to state clearly the assumptions made. All licensees, and ERO, will then need to agree common assumptions going forward to ensure consistency across the board.

Currently the two operators in the sector, KEK and KOSTT, hold multiple licences. There will be elements of cost-sharing between different licensed activities. ERO will review the basis of allocation to ensure that these are reasonable, that there is no double counting, and that there is no mis-allocation that could give rise to competition concerns in the future. ERO does not intend to micro-manage the licensee's business activities, but it is important that ERO is satisfied that costs borne by the businesses are giving value for money to customers.

One of the key benefits of the multi-year control is that it allows sufficient time for operators to react to incentive to improve performance and productivity. The new pricing rules introduce such incentives. In the case of KEDS, some of the factors have already been determined for 2012 and for the five years of the new control in a Decision by the ERO Board dated 6th February 2012. ERO will need to set parameters for KOSTT and for the other KEK licensees as part of this review.

2.2 Potential Sale of Licensed Businesses

The potential change in ownership during the control period (or even during the review itself) should in itself change little. It is the cost structure of carrying out licensed activities that is being examined, and for which remuneration is to be determined, and those licensed activities will not change. ERO understands that one of the key drivers of the Government's Energy Strategy for the KEDS transaction is to give added impetus to the drive to improved performance, both in terms of a reduction in losses, and in overall efficiency gains.

Until the KEDS business formally changes ownership, KEK J.S.C. will continue to have the legal obligation to carry out the licensed activities. KEK must therefore provide in its data evidence of a strong business plan for the investment, operating and maintenance costs of running the distribution and supply businesses over the five years of the new control. In the event that the business is successfully sold to a new owner, it is reasonable to suppose that the new owner may wish to modify the business's investment plans. ERO may consider the evaluation of this potential modified investment plan if it is likely to provide at least as great a benefit to customers as the original one. The benefits to customers should outweigh the corresponding additional costs of this potential investment plan.

An underlying assumption for KEK in completing its return is therefore that it will continue to be the operator of the KEDS business throughout the five years of the control period, as it is the only source of forecast costs available at present.

For the generation transaction, this situation is less clear-cut. ERO believes that licensees should assume that the transaction goes ahead and should use their best technical judgement in forecasting the most likely timing of commissioning. This should lead licensees to derive other costs – those of imported energy, and other costs that may be necessary to reduce the power shortfall in the intervening years.

ERO seeks the views of stakeholders on these assumptions.

2.3 LOMAG

LOMAG, the "Land of Mines and Generation" refers to an area just to the west of the city of Prishtina where Kosovo A and B thermal power stations and the open cast lignite mines are located, hence its name. Energy delivered from the transmission network to LOMAG is consumed by KEK (for self consumption, i.e. consumptions by mines, generation and substations) and by tariff customers (industrial, commercial and residential).

The treatment of LOMAG has implications for the level of losses reported by KEK and may also have implications for the future competitive market. Also, in its ETR6 application KEK proposed that the PES business should make an internal charge to the KEK Generation business. Such internal charges will have no impact on customer prices, but will facilitate the future unbundling of the licensed distribution and supply activities.

ERO invites comments on an appropriate treatment for LOMAG going forward.

2.4 System Condition and Performance Improvement

In this and future reviews, ERO wishes to focus on the drivers of sector condition and performance improvement. By better understanding the drivers of business cost, ERO believes that the sector can better manage those costs. For example, on the network side, cost drivers will include interruptions (number and duration), poor voltage levels and network overloading. All licensees will be asked to identify the drivers of their costs in the reporting formats, and link investment programmes to expected improvements in performance.

2.5 Losses

The TSO and DSO licensees may propose investments designed specifically to address technical losses, but they are more likely to be combined with other investments, particularly measures to alleviate overloading or excessive voltage drops. The licensees will need to demonstrate the benefits to customers arising from investments in terms of better meeting of operating and security standards and reduced technical losses.

The Distribution System Operator will be asked to give thought to low-cost measures that could reduce its commercial losses over the period. The Losses Study Report produced in 2011 by AEAI identified a number of possible measures.

2.6 Incentive Mechanisms in the Revenue Controls

ERO’s revised Pricing Rules contain implicit incentives built into the algebraic formulae. In particular, the setting ex ante of maximum allowable revenues provides a strong incentive to reduce losses over the period.

More explicit incentives, linking revenue to performance, are used by many regulators to reward licensees for improved system outputs in the form of greater availability, reliability or quality of supply for example. ERO approved new standards of performance for licensees with effect from 1st January 2011. In setting those standards, ERO said that it would in the future introduce fines for failure by licensees to meet performance standards. To date ERO has been closely monitoring the companies’ performance against those standards.

ERO seeks the views of stakeholders on whether it is now timely and appropriate to introduce financial penalties for failures to meet regulatory standards of performance.

2.7 Settlement Costs

KOSTT is currently revising the market arrangements and has submitted to ERO a proposed Detailed Market Design which is currently under review and consideration. The design raises important questions for the sector, for instance in terms of certain costs of market settlement. In order to invoice each other, parties need to know exactly how much energy was provided and taken under their bilateral commercial arrangements. The role of the settlements function to provide this volumetric data. However, the majority of Kosovo customers do not have meters which will allow their consumption to be recorded at specific intervals. The solution may be to undertake profiling of customer consumption, or to initiate a programme of meter replacement, switching consumption meters for interval meters. Neither solution is ideal. The costs of meter administration, and where those costs should be borne, must also be considered.

ERO requests views on the most appropriate assumptions to be made for the purposes of the new controls.

2.8 Market Competition

Article 19 of the Law on Electricity introduces the right of household customers to seek an alternative supplier from 1st January 2015. According to specific criteria set by it following consultation in March 2012 ERO has confirmed that, in the absence of any independent supplier licensed to serve retail customers, there is currently no effective retail competition in Kosovo. The PES business will, however, need to make an assumption about the extent to this situation may change, and the extent to which that might affect their retail costs.

ERO seeks the views of licensees on what working assumptions should be made regarding future competition for the purposes of the MYT review*.*

2.9 Harmonisation of Revenue Control and Accounting Years

Currently both companies have statutory accounting years which run from January to December. The regulatory accounting year has historically been different, running April to March. ERO considers that it is timely to confirm whether a continuation of the existing policy remains appropriate, or whether harmonisation of the statutory and regulatory financial years would be pragmatic.

ERO seeks the view of stakeholders on these assumptions.

2.10 Other Factors

There may be other factors which must be addressed during this MYT review. These may include forecasts of renewable generation available to the system, and its price; environmental considerations; subsidies for a vulnerable customers; public service obligations; alignment with international transmission requirements under ENTSO-E and costs of compliance with the *acquis communautaire* (3rd Package).

ERO welcomes the views of licensees and other interested parties on other factors which need to be considered, and assumptions which should be made as part of this exercise.

3 Form and Structure of the Revenue Controls

This section outlines the proposed form and structure of the new revenue controls.

3.1 Duration of the Controls

In line with the new pricing rules promulgated in 2011, ERO will set revenue controls in 2013 as follows:

- 5 years for the TSO and DSO licensed activities;
- 4 years for the Generation/Mining licensed activities (delayed from 2012);
- 1 year for the Public Supplier licensed activities.

3.2 Nature of the Controls

The new control will be a multi-year revenue control. It will determine the maximum allowable revenue in euros that each separate licensee may earn over the control period to cover its operating and capital expenses. Licensees are free to run businesses within those overall revenue constraints, which encourages higher efficiency. At the end of the period, and as part of setting the next multi-year controls, ERO will seek to confirm that the business has met or surpassed its planned business targets. Where licensees have been able to secure the same or greater quality of service, for lower cost, customers will receive the benefit of this in the next control period, in the form of lower allowed revenues.

Once the maximum allowable revenues are determined it will be for the licensees, under the terms of primary legislation, to propose tariffs and prices for their services. These must be approved by ERO before they come into force in March 2013.

Although it is for the licensees to propose tariffs (including their structure), ERO believes it will be sensible to give guidance to licensees, and in particular the PES licensee, on the rate of introduction of more cost reflective pricing. ERO expects that it will seek an earlier indication of likely tariff structures and prices during the course of this year, in order that the formal proposal of tariffs by licensees, and approval of those tariffs, goes smoothly.

3.3 Incentive properties of MYTs

One of the key benefits of the multi year approach to revenue-setting, is that it enables stronger incentives to improve performance to be placed on operators. The new pricing rules incorporate a mechanism to drive up overall efficiency of the companies, as well as including specific factors to reduce losses. The efficiency factor in particular must be balanced against clear targets for the quality of service to avoid licensees reducing the quality of their service by, for example, deferring necessary maintenance.

The 6th February Decision of ERO has already set the efficiency and losses factors for KEDS. However, factors for KOSTT will need to be set during this review.

4 Assessment of Costs in Each Business

In this section, ERO describes in a little more detail the nature of the cost information sought from licensees as part of this review.

4.1 Nature of each licensees' costs

Both KOSTT and KEK have some costs such as corporate costs which are not specific to regulated businesses but are centralised. . It is important that these costs are allocated appropriately and clearly to the different licensed activities, particularly given the impending sale of KEDS. ERO will seek to understand the basis of any allocation made and to ensure that it is reasonable.

For the asset intensive businesses of mining, transmission and distribution ERO will undertake a detailed examination of historic and particularly forecast opex and capex.

4.2 Proposed approach to assessing costs

In common with general regulatory practice, ERO will expect licensees to answer questions as defined by ERO, rather than depending on licensees' own views on the information they consider necessary to support tariff applications. While KOSTT has generally complied with ERO's requests in previous years, KEK has not hitherto responded in line with ERO's requirements. It is essential that both licensees respond in a consistent and systematic manner, using the reporting formats, to ensure that ERO can carry out its statutory role effectively. While ERO will be responsive to licensee concerns about any particular data that may be difficult to forecast, it is satisfied that the information as currently requested is no more than should be available to any competent operator.

The structure of the templates are similar for each business type. Broadly they focus on

- Operating costs
- Capital costs

- Cost drivers

The forms are designed to capture data on a consistent basis for five historic and five forecast years.

ERO will expect that each company will submit a narrative commentary to explain and support the licensee's completed forms. This will in particular explain assumptions used. It will also describe the link between expected expenditures and improved quality of output in terms of both statutory requirements and quality of service enhancements.

4.3 Phase 1 - Data Collection

ERO has allowed two months for the companies to complete the reporting templates, recognising that the activity falls around the holiday season. ERO considers that with proper internal organisation, this period should be sufficient for the companies.

The completed templates, and the supporting narrative, should present the business case of the companies over the next five years. In return, they will be seeking adequate revenues to be allowed by ERO. ERO believes that it will be appropriate to ask each of the companies to give a presentation of their submissions to ERO and to other interested parties at a Public Hearing. This is scheduled for Monday 3rd September 2012.

Following that presentation, ERO will commence its analysis of the company submissions. ERO envisages that a number of meetings will be needed between itself and each company to clarify data and to agree assumptions and their impact. There may be some areas where the companies are unable to provide data, but it is hoped that this will be minimised through this present consultation exercise.

4.4 Phase 2 – Data analysis

ERO will commence the analysis of company submissions after the consultation session to review the level and the attribution of costs. Using international and regional experience ERO will carry out consistency and credibility checks – identification of missing items, double-counting etc.

Where possible, ERO will carry out benchmarking using international comparator companies, capex unit costs, and key performance indicators, for example costs/MWh, costs/customer, number of staff/MWh, number of staff/customer. This benchmarking will be used to guide and support ERO's eventual determination of maximum allowable revenues.

Close examination will be paid to the trend of recent historic costs and companies' forecast costs will be seen in this light. Companies should explain and justify any step changes between costs. It is particularly important that companies explain the impact of forecast costs on projected performance levels

ERO must seek to find a balance between customer prices and business viability. It will therefore examine the hypothetical profit and loss position of the different licensed activities. This is particularly important with a view to ensuring that the licensed activities are individually viable and that costs have been correctly and efficiently allocated across the sector.

Finally, ERO will evaluate the impact of licensee costs on their revenue requirements through use of a revenue control model which will be refined and modified to match the new pricing rules. In the interests of transparency, this model will be shared with the Companies to ensure that all parties are working on a comparable basis.

5 Setting of Revenues

5.1 The Revenue Control Model

The revenue control model will need to be modified to match the logic of the new pricing rules. It will take data from the companies' data returns and forecast annual maximum allowable revenues. The model will also contain assumptions on the Regulatory Asset Base (RAB), on cost of capital, on losses, and on other factors. In the case of the DSO and the PES licences, some of those factors have been predetermined by ERO Decision V_399_2012.

The pricing rules envisage a process of annual adjustments. This process is quite different from the previous annual tariff reviews. These are "automatic" adjustments to update forecasts of non-controllable external costs – the costs of imports, inflation etc. The model will enable ERO and the companies to assess the implications for prices and revenues over the relevant control year period – and help to determine possible future path of prices which avoids price shocks for customers, by smoothing allowed revenues throughout the MYT.

5.2 Treatment of losses

Target loss levels for technical and commercial losses have already been set for the DSO and PES but not for TSO. ERO intends to set appropriate targets for transmission losses taking into consideration the company's investment programme. In so doing, it will seek to leave a substantial incentive on KOSTT to beat the target. This will allow KOSTT to keep the benefit of any gains over and above the target for the period of the control. Those greater gains will then be returned to customers at the end of the period with a new target.

For both companies, ERO will wish to ensure that actual losses for 2012 (and in future years) are being reported on a comparable basis with historical losses. In the case of KEK, there has already been a detailed examination of the loss reporting methodology in the 2011 AEAI report referred to above.

The losses factors will be included in the revenue control model. Other Incentives may also be included in the revenue control model. These could include:

- System loading – removal of overloading on circuits [e.g. target reduction in number of feeders overloaded at end of period – this is already implied in KEK's distribution development plan so it would be sensible to set it as a target in the MYT.
- New connections – response times for connection requests, number of connections made
- Quality of supply
    - Number and duration of customer interruptions, taking account of targets set under Article 13 of the DSO license.
    - Number of circuits with unacceptable voltage levels – again, this is already recognised as a driver within KEK's distribution development plan.

6 Next Steps

Stakeholders are invited to give views on reporting templates, and in particular:

- Is the scope of information required reasonable?
- Is the coverage of data complete?
- Are the data requests consistent across the templates?
- Would modifications give a better match with existing company reporting procedures?
- Are there any suggestions for changes in reporting templates to facilitate reporting from existing accounting or management information systems?
- Are any of the data not presently available to the companies, and if so, how might such gaps be overcome?
- Is the timetable for feedback reasonable?

6.1 Finalisation of MYT review process

ERO will confirm the final MYT process steps and timetable in the light of feedback from this consultation. ERO will take account of stakeholder feedback and modify reporting templates as necessary. In line with the letter of June 8 2012, ERO expects to issue the final templates to licensees for completion on 9th July.

Appendix – Reporting Forms