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ENERGY REGULATORY OFFICE
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Consultation Paper

The Seventh Electricity Tariff Review

ETR7 (2013-2017)

Initial Review of KOSTT's Cost Submissions

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.

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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. Those maximum allowable revenues must, by law, be adequate to cover the reasonable operating and capital costs of performing the licensed activities. In order to determine adequacy of revenues, ERO must therefore carefully assess the licensees' forecast costs and satisfy itself that their proposals are reasonable and appropriate. It should be noted that, by law, the licensees are obliged to provide all the data that ERO requires for this analysis. In June ERO therefore consulted on its proposed reporting formats, which were designed to be used as the basis for data collection for the review. Following that consultation, the licensees were given some eight weeks to complete the reporting formats. The licensees were asked to present their submissions to ERO and the public on 3rd September. Neither company provided complete returns. Since that date, ERO has had several working level meetings with both licensees in order to clarify the data submitted. ERO has reviewed the KOSTT's data submissions with the support of an international engineering firm. More detailed information about ERO's findings are given in Appendix A at the end of this document.

2 General Comments

The data requests that form the basis of this MYT review contain a large amount of detail about past and proposed future expenditure. ERO understands that company inexperience of the requirements may have contributed to difficulty in delivering complete and justified data. However, despite active interchanges between ERO and the company during the analysis period, significant questions remain unanswered. These principally relate to:

- A lack of justification for proposed costs;
- Possible inconsistencies with other sources of information, particularly with the Network Development Plan; and
- Provision of supporting information and narratives to back up cost forecasts

There is a risk that, without proper supporting evidence, ERO will conclude that some cost elements are unjustified and exclude them from the MYT calculations. It is important that the company recognise this danger and use its best efforts to clarify and justify all information requested by ERO or its consultants.

3 Assessment KOSTT'S TO CAPEX Submission

The principal findings from the initial review carried out by ERO into KOSTT's TO capital expenditure forecast are as follows.

3.1 Transmission Operation CAPEX

KOSTT's proposals for transmission operation capex can be summarised as:

- An initial submission totalling €118.5 million of which €36.4 million is funded by grants
- Of this, €84 million (71% of total Capex) appeared to be justified by the Transmission Network Development Plan (NDP)
- KOSTT later resubmitted its forecast at €123.1 million with grants of €37.9 million.
- Only €77.3 million of this is included in the Transmission Network Development Plan and of this €21 million is grant funded
- Only €56 million may presently be considered as KOSTT net expenditure.

There have been significant changes in KOSTT's capex forecasts during the consultation period. There continue to be unexplained differences between KOSTT's capex forecast and its Transmission Network Development Plan (NDP). These differences need to be explained and justified by KOSTT.

3.2 LRE and NLRE modelling

The KOSTT CAPEX proposals are significantly below the level indicated by load-related (LRE) and non load-related (NLRE) modelling processes. It appears that KOSTT's 5 year forecast does not address network replacement requirements.

3.3 Transmission Operation Opex

There has been a significant delay in getting information from KOSTT regarding the justification for its proposed opex for transmission operations, seriously affecting ERO's ability to analyse the data submitted. Initial indications are that 2012 costs are high compared with historic levels, and without explanation or justification for these high costs, it may be difficult for ERO to make the allowance requested.

4 Assessment of KOSTT'S SO Submission

4.1 System Operation Capex

KOSTT has included approximately €10 million of capex in its forecast for expenditure from 2013-17. It has not provided evidence of the nature of or justification for such expenditure. Unless it is able to provide such information, it may not be appropriate for ERO to include an allowance for this capex in the MYT.

4.2 System Operation Opex

KOSTT SO opex consists principally of salary costs. The KOSTT submission shows salary costs rising at about 5% per annum over the forecast period. KOSTT says that this corresponds to an increase in staffing levels for additional metering maintenance and operation of new SCADA / telecoms equipment. Such increases in staff are normally accompanied by reductions in staffing requirements elsewhere, particularly in substation manning requirements which normally fall when SCADA is introduced. KOSTT should provide further justification to support any increase in salary costs above 2012 levels.

5 Assessment KOSTT'S MO Submission

5.1 Market Operation Capex

KOSTT have not submitted any proposals for capex for their market operations for the MYT period.

5.2 Market Operation Opex

KOSTT MO costs are principally staff costs. KOSTT projects these to increase by 2.5% per annum over the forecast period. KOSTT has provided no justification for the proposed increase and without this it may be appropriate to assume that 2012 salary levels will continue to apply during the forecast period.

6 Next Steps

KOSTT is now invited to comment on ERO's initial assessments of its data submission and, wherever possible, to provide substantiation and justification in support of that submission. Where no such justification is received, ERO will need to take its own view on appropriate levels for certain costs. If the company fails to provide this justification, costs that may be entirely appropriate may be excluded from consideration to the detriment of its financial position.

KOSTT's response is sought no later than close of business on 9th November 2012.

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Following receipt of KOSTT's responses to this paper, ERO will prepare its Provisional Evaluation of the MARs for the separate licensed businesses, which it aims to send to the company by the end of December 2012. At that time it will make available to KOSTT the revenue model that has been developed to support the calculation of MARs in line with the Pricing Rules.

Appendix

KOSTT TSO Capex Submission

1 Introduction

This Appendix outlines ERO's assessment of the submission made by KOSTT in the multiyear tariff questionnaire on 31 August 2012, subsequent clarification meetings and additional documentation provided by KOSTT.

2 Methodology

In assessing the capital expenditure ERO:

- Reviewed the submission against the Network Development Plan (NDP) provided by KOSTT for the period to assess whether the submission was accurately derived from the licensee's investment planning process and targeted at the areas identified by the licensee as priority areas. ERO identified those projects that were in the NDP and in the capex submission and those that were in either the capex submission or in the NDP, but not both.
- Reviewed the forecast expenditure against historic expenditure. KOSTT did not provide historic capital expenditure as requested by ERO. However, ERO derived a figure from the asset age information.
- Reviewed the unit costs used by KOSTT in the development of the capital expenditure forecast.
- Used the findings of the above analysis to determine whether any adjustment to the forecast capital expenditure was required.

3 Data Submitted

The KOSTT capital expenditure submission included a Capex forecast by project as requested. They also provided a detailed asset age profile, expected asset lives and unit costs.

The NDP and the Capex submission do not align and there is no justification provided for a number of projects in the Capex submission. This is a surprising outcome, as it would be expected that KOSTT's

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capex submission would closely follow the current NDP, which identifies and justifies transmission development projects.

KOSTT did not provide an historic expenditure profile. However ERO have used the asset age profile and unit cost information to model historic capital expenditure at current prices.

4 KOSTT 2013-2017 CAPEX submission

4.1 Capex Projects

KOSTT's initial submission for CAPEX totalled €118.5 million with grants of €36.4 million. The projects in the first submission included new 400 kV transmission line interconnection with Albania, new 110 kV transmission lines, reinforcement and rehabilitation of 110 kV transmission lines as well as new and upgraded 220/110 kV, 110/35 kV and 110/10 (20) kV substations.

When the capex projects were compared with the Transmission Network Development Plan (NDP) 2012-2021 it was found that only €84 million (71% of total Capex) had a justification in the NDP.

KOSTT were asked to explain the discrepancy and resubmitted the capital expenditure submission. The Capex re-submission for totals €123.1 million of which €37.9 million is grant funded. It still demonstrates a significant mis-match with the developments described in the NDP.

Using the re-submission as the basis for assessing capex, Table 1 shows the projects that have a justification within the NDP or a separate justification provided by KOSTT. The total capex for these projects is €77.3 million (63% of the total capex submission). Furthermore, €21 million of this total capex is funded by grants. The remaining projects in the re-submitted forecast have no separate justification in the NDP. The capex associated with these projects corresponds to €45.8 million (€123.1 million less €77.3 million). Unless KOSTT can substantiate these projects, they may not be considered in the overall capex allowance in the MYT.

ERO has requested further justification or an explanation as to why the projects in the TNDP have not been included in the capex submission but to date these have not been provided.

4.2 Unit Costs

Unit costs were provided in the re-submission.

ERO has reviewed the unit costs provided by KOSTT. The unit costs are generally lower than would be expected, particularly in the case of switchgear where costs are 20-25% lower than in comparable markets.

5 Findings

Only €77.3 million of capital expenditure in the forecast is included in the Transmission Network Development plan and has therefore been demonstrated to be justified by system development needs.

Of this €21 million is grant funded leaving only €56 million of net KOSTT expenditure that can presently be considered in the MYT costs.

KOSTT should clarify why there are discrepancies between the projects included in the submission and those in the NDP, and in particular explain why new projects have been proposed and how these can be justified, and why other projects included in the NDP are omitted from the MYT submission.

An initial assessment of the unit costs provided by KOSTT indicates that some are generally reasonable by international standards. However some of the unit costs appear very low, particularly for switchgear.

It is for further consideration whether unit cost adjustments are appropriate in the light of further information or justification which KOSTT may provide in the response to this consultation. KOSTT should also provide more detailed unit costs (with ratings) used in the development of their project costs. In the absence of such further information, ERO may assume lower unit costs than KOSTT may otherwise be able to justify.