



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

The Fourth Electricity Tariff Review 2010 (ETR4)

Consultation Paper

DISCLAIMER

This Consultation Paper has been prepared by ERO in order to obtain comments and views from stakeholders. It presents ERO's views and proposals on the licensees' applications and should not be considered to represent final decisions by ERO.

Prishtina, 26 February 2010

1 Introduction

The Energy Regulatory Office (ERO) is in the process of reviewing applications for Tariffs of the Kosovo Energy Corporation (KEK JSC) and Kosovo Transmission, System and Market Operator (KOSTT JSC) effective from 1 April 2010.

This Consultation Paper presents ERO's views on KEK and KOSTT proposals concerning allowed revenues to be recovered from regulated tariffs.

Any eventual comments from stakeholders should be addressed to ero.pricing-tariffs@ero-ks.org with the subject line "ETR4 Comments" or sent to the ERO address, marked for the attention of "Pricing and Tariffs Department". It is expected that ERO will take its final decision on 15 March 2010 after having considered all comments received by stakeholders.

2 Tariff Review Process

Tariff Review is an interactive process between the ERO, the Licensees (KEK and KOSTT) and stakeholders. ERO initially sends the principles and timetable of tariff review, to which the licensees respond by submitting a preliminary application. ERO's comments and remarks on preliminary applications are followed by the submission of the final application for which this Consultation Paper – representing ERO's views and proposals on Allowed Revenues and Tariffs for the coming year - is written. After receiving comments from the stakeholders on this Consultation Paper, ERO will take its decision on the new tariffs. During this process, ERO reviews all costs necessary for a normal functioning of the Licensees, according to its Rule of Pricing and Tariff Methodology.

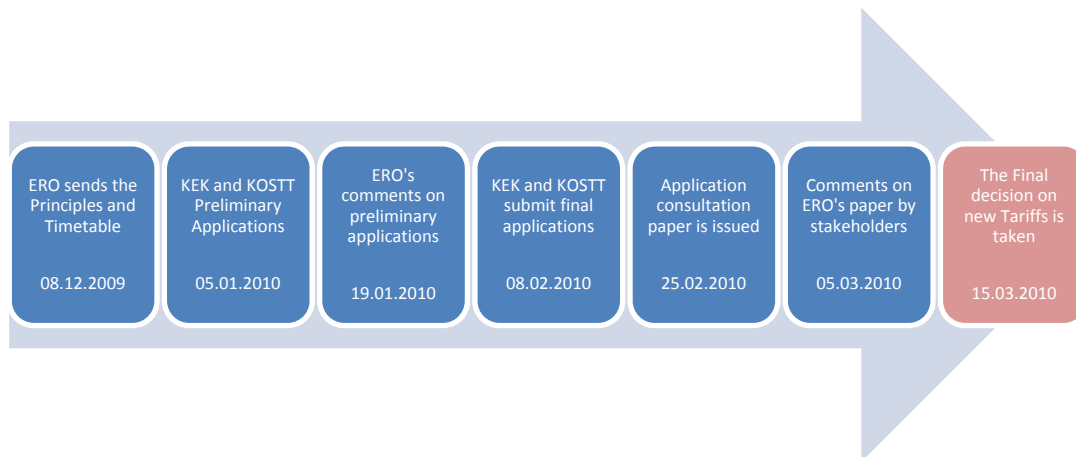


Figure 1: The process of the Fourth Electricity Tariff Review (ETR4)

3 The Final Application Review Approach

ERO's approach to reviewing the Licensees' applications for Allowed Revenues and Tariffs was divided into three phases:

- I. ERO reviewed the initial request of the licensees, as submitted in the application for tariffs
- II. ERO has made corrections on the licensees' applications and has updated the applications with new information;
- III. ERO has made its final proposals on the Allowed Revenues and Tariffs for 2010.

3.1 Evaluation of the request

During the first phase of the Review, ERO analyzed the values requested by KEK and KOSTT, focusing on the values of applications as submitted by the licensees. After analyzing the applications, ERO noted that the Requested Revenues for 2010 are €177.6 million, which represents an increase of 28% in Allowed Revenues compared to Allowed Revenues of €139.8 million for the last year.

According to the Energy Balance submitted by KEK, sales to regulated consumers are expected to grow by 9.2% compared to forecasted sales during the setting of tariffs for 2009, and by 7.0% compared to 2009 actual sales. The request of the licensees contained in their applications, after the adjustments is for €177.6 million, which results in the need to increase current tariffs by 13.6% according to the structure presented in Table 1.

If current transmission charges remain unchanged, then expected revenues for KOSTT would be €20.7 million, which represents an increase of €2.3 million compared to allowed revenues in 2009 as a result of the expected growth of energy demand. This means that KOSTT's requested revenues of €19.1 million (including the cost of loss purchase) for 2010 represent a reduction in the average transmission charge by 7.6%.

		Mining	Generation	Networks	Supply	Total KEK	KOSTT	TOTAL
Operating Expenses (exc. power purchase)	€000s	42,244	30,802	18,714	17,279	109,039	7,978	117,017
Depreciation	€000s	5,572	4,202	1,051	507	11,333	1,739	13,071
Return	€000s	18,838	8,787	4,238	308	32,171	1,588	33,759
Imports	€000s				75,540	75,540		75,540
Non-KEK Power Purchases	€000s				2,818	2,818		2,818
Ancillary Services	€000s					0	1,624	1,624
Allocated HQ Costs	€000s	5,046	2,399	1,768	1,751	10,964		10,964
TOTAL ALLOWED COSTS	€000s	71,700	46,190	25,771	98,203	241,864	12,929	254,793
Sales to Eligible Customers	€000s				-21,281	-21,281		-21,281
Exports	€000s				-4,430	-4,430		-4,430
Other Operating Income	€000s	-1,500				-1,500		-1,500
Subsidies	€000s				-50,000	-50,000		-50,000
Adjustments	€000s					0		0
TOTAL ALLOWED REVENUES	€000s	70,200	46,190	25,771	22,492	164,653	12,929	177,582
					2010 forecast average tariff	€/kWh		5.58
					Required average tariff	€/kWh		6.34
					REQUIRED AVERAGE TARIFF INCREASE			13.6%

Table 1 : Summary of Licensees' Applications for Allowed Revenues

3.2 ERO's Corrections and Adjustments

The applications as received contain a number of apparent calculation errors or incorrect data entries. ERO has corrected these. ERO has also adjusted the applications with more recent information on actual capital expenditures during 2009. Based on the Tariff Methodology, ERO has made adjustments to compensate for differences between actual and allowed capital expenditures and transmission losses in 2009. These corrections and adjustments are summarized below.

It should be noted that the application of these corrections and adjustments does not imply ERO's acceptance of the proposed costs included in licensees' applications. ERO's review of the reasonableness of these costs is contained in the following section of this paper.

3.2.1 Corrections

The corrections made by ERO are as follows:

- **Correction of errors** in the calculations and data entries contained in KEK's and KOSTT's applications. Corrections made resulted in an increase in KEK's Allowed Revenues by €291,000 and KOSTT's Allowed Revenues by €66,000.
- **Reduction of assumed capital expenditures by KEK in 2009 to match those actually made.** This reduces the starting value of the asset base used to calculate the depreciation allowance and return included in Allowed Revenues by €2.3 million.
- **Calculation of the supply margin and planned revenues from sales to eligible customers** by the Public Supplier, that differ from the values entered in the tariff application. The net impact is to reduce KEK's allowed revenues for 2010 by €1.1 million.
- **Deducting income earned by KEK Generation Division from its ancillary services contract** with KOSTT. This reduces KEK's allowed revenues for 2010 by €1.6 million.
- **Harmonization of the cost and volume of allowed transmission losses** included in KOSTT's allowed revenues to match the cost and volume of losses calculated from KEK's application.

3.2.2 Adjustments

ERO's approach is to adjust revenues for differences between actual and allowed costs in the preceding year, where these differences are outside the control of licensees. In the calculation of 2010 allowed revenues for licensees, ERO has made the following adjustments:

- Where **actual capital expenditures** are greater or lower than previously allowed by ERO in setting allowed revenues, then ERO recovers the resulting difference in depreciation allowances and allowed returns in the following year¹. This is to provide an incentive for

¹ For example, if actual capital expenditures were €1 million less than those included in allowed revenues then a licensee would have earned €20,000 in depreciation allowances and €65,500 in allowed returns for investments that it did not actually make (assumes 25-year asset life and 13.1% WACC with assets added mid-way through the year). ERO's adjustment reduces allowed revenues in the following year by the €85,500 in

licensees to meet or exceed capital expenditure targets included in allowed revenues given the need for large-scale investment in Kosovo. During 2009, KEK's aggregate capital expenditures were less than those included in 2009 allowed revenues, thus leading to a compensating reduction in 2010 allowed revenues of €2.2 million. KOSTT's capital expenditures in 2009 were higher than allowed, leading to an increase in 2010 allowed revenues of €455,000.

- **Actual transmission losses** for which KOSTT pays KEK Public Supplier may differ from allowed losses because of changes in total transmitted volumes, which are outside KOSTT's control, and because of changes in the level of losses (expressed as a loss factor or percentage) which KOSTT can largely control by investing in transmitting equipment about which investment has been allowed. During 2009, the actual costs of purchasing transmission losses were €2.3 million below those that would have applied given the allowed loss rate and actual transmission volumes in 2009. ERO considers that KOSTT can be considered a contributor for 50% of this saving and is allowed to retain that amount (i.e., a total of €1.15 million). KOSTT's actual costs for purchasing transmission losses in 2009 were around €1.1 million above the allowed level, which represents a share of total savings allocated to KOSTT. This will result in an increase of KOSTT's allowed revenues by €0.05 million.
- During 2009, ERO temporarily suspended the requirement on KEK Generation to pay **licence fees** to ERO. The level of license fees is outside the control of licensees and is passed-through to tariffs. ERO had adjusted KEK Generation's allowed revenues in 2010 downwards by the difference between allowed license fees in 2010 and those actually paid. This reduces KEK Generation's allowed revenues by €976,000.

3.2.3 Summary of ERO's Corrections and Adjustments

For the reasons mentioned above, the value of the Allowed Revenues and Tariffs request for 2010 is reduced by €7.3 million: from €177.5 million to €170.1 million. This would represent an average increase in tariffs of 8.8%. A summary of the allowed revenues and costs after ERO's adjustments and corrections is given in the table below:

'excess' depreciation allowances and allowed returns, adjusted for interest income on these revenues during the preceding year.

		Mining	Generation	Networks	Supply	Total KEK	KOSTT	TOTAL
Operating Expenses (exc. power purchase)	€000s	42,244	30,802	18,714	18,249	110,009	7,978	117,987
Depreciation	€000s	5,122	4,360	1,071	527	11,081	1,806	12,887
Return	€000s	17,115	8,925	4,293	264	30,596	1,587	32,183
Imports	€000s				75,540	75,540		75,540
Non-KEK Power Purchases	€000s				2,581	2,581		2,581
Ancillary Services	€000s					0	1,624	1,624
Allocated HQ Costs	€000s	5,066	2,409	1,775	1,758	11,008		11,008
TOTAL ALLOWED COSTS	€000s	69,547	46,496	25,853	98,918	240,814	12,995	253,809
Sales to Eligible Customers	€000s				-23,388	-23,388		-23,388
Exports	€000s				-4,430	-4,430		-4,430
Other Operating Income	€000s	-1,500	-1,624			-3,124		-3,124
Subsidies	€000s				-50,000	-50,000		-50,000
Adjustments	€000s	-1,224	-1,049	-893	-22	-3,187	504	-2,683
TOTAL ALLOWED REVENUES	€000s	66,823	43,823	24,960	21,079	156,685	13,500	170,185
					2010 forecast average tariff	€/kWh		5.58
					Required average tariff	€/kWh		6.08
					REQUIRED AVERAGE TARIFF INCREASE			8.8%

Table 2: Summary of Allowed Revenues after ERO's adjustments

3.3 ERO's Proposals

Following detailed review of each category of costs, ERO has determined that some of the requested costs are not reasonable or represent a disproportional difference with the allowed and actual level of costs of the same category in the previous year. ERO's interventions and proposals on allowed costs for 2010 are shown below.

3.3.1 Correction of the Regulated Asset Base (RAB) and the Regulated Base of the Assets funded commercially (RABf) for KEK and KOSTT

Based on previously established principles, it has been decided that:

- The value of assets included in the **regulated asset base (RAB)** for licensees is set at zero as at 1 January 2006, as set out in the Tariff Methodology, and is increased by actual capital expenditures (subject to adjustments) in later years. The RAB is used to determine the depreciation allowance included in the allowed revenues of licensees.
- Licensees earn a return equal to the allowed cost of capital on assets constructed using equity or debt financing. No return is earned on assets constructed using grant financing as licensees do not have any financing costs associated with these assets. For this purpose, a separate **regulated asset base excluding grant-funded assets (the RABf)** is calculation on which an allowed return is determined.

In the application received from KEK, the RAB and RABf were set equal despite a large part of KEK's assets being constructed using grant funding. This is clearly contrary to the second of the principles

outlined above. ERO has, therefore, recalculated the value of RAB and RABf as at 1 January 2010 for KEK applying the established principles above and using the information contained in the published audited accounts of KEK on additions and disposals of assets in each year. This calculation has been reviewed and agreed with KEK.

ERO has also conducted the same recalculation for KOSTT, although noting that KOSTT has, in its application, already distinguished between RAB and RABf values. ERO has not yet had the opportunity to discuss this recalculation with KOSTT but will do so before issuing its final decision.

This correction concluded that the RAB used so far has been underestimated, whereas RABf has been overestimated. We conclude from this that the depreciation value that is part of the KEK's and KOSTT's Allowed Revenues generally should be increased, whereas the value of Allowed Return that is calculated by RABf should be reduced. The differences between ERO's recalculated RAB and RABf values and those included in the applications are much smaller for KOSTT than for KEK and, consequently, so are the impacts on allowed revenues.

Net effect of this correction has been the reduction of allowed revenues for 2010 of €4.6 million for KEK and of €0.05 million in allowed revenues for KOSTT would also apply. However, ERO has not yet made this correction on KOSTT's allowed revenues as it has yet to adjust this calculation with KOSTT.

3.3.2 Distribution Losses

KEK's request for allowed technical losses for 2010 is 17.5% of energy entering the distribution system or 758.3 GWh. ERO notes that this rate of losses is less than that reported as actually occurring in 2009, (18.05%) but exceeds the 17.1% previously allowed by ERO for 2009. KEK has undertaken significant investment in its distribution network in recent years and ERO believes this should be reflected by a reduction of losses. Taking this into account, ERO proposes for 2010 as well a level of 17.1% of allowed technical losses, which represents a reduction of 27 GWh. ERO expects this to take the form of a reduction in required exchange imports and, therefore, not to impact on the costs of power purchases.

3.3.3 Import Costs

KEK's tariff application requests an amount of €61.1 million for import energy purchase. Volume of energy assumed in calculating this value is 859.9 GWh, which represents an average price of €71.1/MWh.

KEK's assumed costs use the actual prices in the first quarter of 2010 and projected prices for import energy purchase for the three remaining quarters. ERO has noted that the KEK's projected prices significantly exceed actual prices to date. Given this, ERO has prepared its own projections of import prices from April 2010 to the end of the year, using actual contract values during the first quarter of 2010 and assuming that these subsequently move in line with the price movements on the European

Energy Exchange². ERO has adjusted the resulting forecast of average import prices for 2010 upwards, to allow 'headroom' for unexpected increases in import prices during the year. It has been taken into account that in previous years, import prices have proven to be very volatile. ERO's proposed average cost for firm contract import costs for 2010 is €69.5/MWh.

This proposed change by ERO reduces KEK's requested allowed revenue in 2010 by €1.1 million.

KEK's application also makes provision for €14.4 million to cover the costs of emergency import contracts in cases of unplanned outages of Kosovo A or Kosovo B. KEK claims this will enable 24:0 service for all feeders classified in A and B.

Emergency imports are made under two types of contract—one for 72 hours of supply which is available once per month and one for 6 hours of supply which is available up to eight times per month. Based on previous years, ERO believes that KEK's assumed prices for purchasing power on 72 hour contracts were overestimated and notes that this price should be closer to the normal import contract price. ERO also notes that actual usage of 6-hour import contracts is generally lower than that assumed by KEK and has reduced the allowance for these contracts accordingly. ERO's proposals reduce the provision for emergency imports contained in allowed revenues by €4.2 million to a total of €10.2 million.

ERO emphasizes that allowing emergency energy imports makes sense only when the A, B and C categories are supplied equally. KEK's assumption for non-inclusion of C category to supply from emergency imports is discriminatory, because that can lead to further deterioration of supply for this category when the aim is to fulfil the criteria for A and B category. ERO, therefore, allows this amount of revenue for emergency energy purchase so that the three categories are supplied in a non-discriminatory way.

3.3.4 Weighted Average Cost of Capital (WACC)

ERO has recalculated the allowed weighted average cost of capital (WACC) to take account of the reduction in corporate income tax in Kosovo from 20% to 10%. The result is to reduce the allowed WACC from the current 13.8% to 13.1%. This results in a reduction of Allowed Revenues by €1.2 million for KEK and €0.06 million for KOSTT.

3.3.5 Asset Life for the Mining Division

KEK has requested a reduction in the life of mining assets from 35 years to 25 years. KEK's justification for this proposal is that the current mining investments are largely related to the extension of the life of the existing mines and will have little or no value following the closure of those mines. This is expected to happen in a time period much less than 35 years.

² The calculation uses movements in the prices of quarterly baseload and peak Phelix futures. These are expected to fall from current levels during the summer months of 2010 before increasing by 7-15% from current levels during the fourth quarter of 2010.

ERO accepts KEK's proposal on the reduction of asset lives. This results in an increase of KEK's Allowed Revenues of €1.69 million for 2010.

3.3.6 Bad Debts

In its tariff application, KEK have requested an allowance of €3.2 million for bad debts which it was not able to collect.

ERO continues to stand behind its previous proposal that bad debts should not be included in the allowed revenues of KEK as this would imply that the paying customers are covering the debts of non-paying customers.

ERO's proposal to reject the allowance of bad debts reduces allowed revenues requested by KEK by €3.2 million.

3.3.7 KOSTT's Capitalized Maintenance Expense

During 2010 KOSTT has actually spent only €0.9 million out of €3.9 million allowed for maintenance expenses. During consultations with ERO, KOSTT has explained that it is obliged to capitalize a large amount of maintenance expenditures under Kosovan Accounting Standards.

ERO's concern is that this can lead to double-counting of the same expenditures. These are included once in allowed revenues as operating expenses. Following capitalization, they are included again in the form of allowed depreciation and return on the assets already created.

To avoid double-counting ERO, therefore, proposes to remove capitalized maintenance from the RAB and RABf reducing the value of allowed return and depreciation that would have been earned if this value had been capitalized. In this calculation, ERO has assumed that the value of this capitalized maintenance is equal to the difference between allowed and actual amount of capital investment in 2009.

This change reduces KOSTT's requested allowed revenues in 2010 by €761,000.

3.3.8 Additional expenses for performance-related pay

KOSTT's tariff application includes a provision of €0.1 million for payments based on performance for 2010. ERO does not think it's reasonable for such costs to be recovered by regulated customers. For this reason, ERO proposes that the allowed revenues of KOSTT be reduced by this value requested in the application.

This proposal reduces KOSTT's Allowed Revenues by €0.1 million.

4. Subsidies

In its applications, KEK has presented subsidies amounting to €50 million financed from the Kosovo Budget. Under the Tariff Methodology, any subsidy must be deducted from allowed revenues recovered from regulated customers' tariffs. If these subsidies wouldn't have been allowed, the average tariff required to recover allowed revenues would have to be increased by 29% compared to current tariffs.

5. Summary of ERO's Proposals

Following above-mentioned proposals, the Allowed Revenues necessary for the normal functioning of the Kosovo Energy Corporation and the Kosovo System, Transmission and Market Operator are €156.2 million in total, which include also €18.1 million allowed for KOSTT. This level of revenues can be recovered with an average tariff of 5.58 cents/kWh, which is almost equal to the existing average tariff. ERO, therefore, proposes that no change in current tariffs for end-consumers is required and that they should be applied as such during this tariff review period.

The structure of Allowed Revenues according to ERO proposal is given in Table 3.

		Mining	Generation	Networks	Supply	Total KEK	KOSTT	TOTAL
Operating Expenses (exc. power purchase)	€0005	42,244	30,802	18,714	14,841	106,601	7,847	114,448
Depreciation	€0005	6,877	3,812	1,067	348	12,104	1,857	13,961
Return	€0005	16,292	4,696	3,078	76	24,143	934	25,077
Imports	€0005				69,990	69,990		69,990
Non-KEK Power Purchases	€0005				2,581	2,581		2,581
Ancillary Services	€0005					0	1,624	1,624
Allocated HQ Costs	€0005	5,138	2,443	1,801	1,783	11,164		11,164
TOTAL ALLOWED COSTS	€0005	70,551	41,753	24,660	89,619	226,584	12,262	238,846
Sales to Eligible Customers	€0005				-22,112	-22,112		-22,112
Exports	€0005				-4,430	-4,430		-4,430
Other Operating Income	€0005	-1,500	-1,624			-3,124		-3,124
Subsidies	€0005				-50,000	-50,000		-50,000
Adjustments	€0005	-1,224	-1,049	-893	-22	-3,187	235	-2,952
TOTAL ALLOWED REVENUES	€0005	67,827	39,080	23,768	13,056	143,731	12,497	156,229
					2010 forecast average tariff	€c/kWh		5.58
					Proposed Average Tariff	€c/kWh		5.58
					REQUIRED AVERAGE TARIFF INCREASE			-0.1%

Table 3: Summary of Allowed Revenues as proposed by ERO