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ENERGY REGULATORY OFFICE
REGULATORNI URED ZA ENERGIJU

Revaluation of the Regulatory Asset Base – Consultation Paper

1 August 2011

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

The new Law on the Energy Regulator requires in Article 43.3.6 that tariffs issued or approved by ERO allow for, among others, the recovery of:

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.

The Regulatory Asset Base (RAB) plays a key part in the calculation of allowed revenues to be recovered from regulated tariffs and charges. For regulatory purposes, ERO presently values all pre-2006 assets included in the RAB at zero (the reasons for this are set out below). The new law does not permit this approach to continue and, instead, it will be necessary to revalue the RAB to conform to its requirements. The principles for revaluation will need to be established ahead of the next review of allowed revenues and regulated tariffs, which is expected to take place by March 2012.

This Consultation Paper has been issued to set ERO’s position on the treatment of the assets and the value of RAB. Comments are invited from stakeholders until 15th August 2011. Comments should be sent either by email to ero.pricing-tariffs@ero-ks.org, with the subject line “RAB Revaluation Comments”, or in writing to the address indicated on the cover, marked for the attention of “Pricing and Tariffs Department”.

2 Valuing regulated assets

There are multiple approaches to asset valuation for regulated utilities. At its simplest, these approaches can be divided into the categories of financial and operational capacity valuations.

2.1 Financial valuations

A financial valuation approach focuses on returning the costs of the asset to investors. Under this concept, the most appropriate valuations are:

- For assets where the ownership remains unchanged, the actual historic cost of these assets which represents the payment made for them.
- For assets where the ownership has changed, the sales price (ie, for companies that have been privatised the value of the transaction) which represents what the new owner has paid for them.

It is also possible to impute the value of the assets to their owner (ie, their market value) by discounting the stream of future cashflows derived from the asset.

2.2 Operational capacity valuations

An operational capacity valuation approach, in contrast, focuses on reflecting the current cost of the assets. Typically this is done by valuing them at their replacement cost. Most accurately, the optimized replacement cost should be used with redundant assets being removed from the asset base. As frequent revaluations at replacement cost are generally not practical, it is common to instead index asset values to some measure of the change in costs.

Revaluations at replacement cost can result in higher or lower asset values than under historic costs. Where technological progress is rapid and assets are short-lived then it is entirely possible that a new asset is able to deliver the same performance as an existing asset at lower cost.

3 Regulatory valuation of assets in Kosovo

A summary of the asset valuation methodologies as currently applied by ERO and those contained in the draft Tariff Rules which are under development to implement the requirements of the amended laws is shown below. A brief description of the reasons for the different approaches follows.

Figure 1: RAB valuation methodologies applied in Kosovo

	Date of asset		
	Pre-2006	2006-11	2012 onwards
Current approach	Zero	Actual historic cost	Approved cost, indexed to CPI
Draft Tariff Rules	<i>under consultation</i>	<i>under consultation</i>	

3.1 Current approach

Pre-2006 assets are currently valued at zero for regulatory purposes on the basis that licensees (KEK and KOSTT) have incurred no costs with respect to the purchase of these assets. Therefore, it was considered that allowing licensees to earn depreciation and a return on these assets would imply a large windfall gain to them and a large step increase in tariffs. Licensees are able to recover the costs of maintenance of these assets as an operating expense. The costs of replacement investments, as and when incurred, are added to the RAB.

ERO initially intended to apply multi-year price controls. Under these, post-2006 assets would be valued at their actual cost on their entry into the RAB and would subsequently be indexed to inflation. This would broadly preserve the real financial value of these assets. To avoid double-

Valuation of assets in licensee financial accounts

counting, licensees would earn a return on these assets calculated using a real cost of capital (as they would already be compensated for the impacts of inflation through the indexation of the RAB). The use of actual costs was adopted in order to create incentives for licensees to deliver on proposed investment programmes.

Subsequently, when ERO adopted the temporary use of annual price control in response to concerns over data availability and reliability, it was decided to switch to the use of historic cost valuations of assets included in the RAB for simplicity. The calculation of the allowed return was consequently adjusted to use a nominal cost of capital.

3.2 Draft Tariff Rules

Under the draft Tariff Rules, multi-year price controls will be applied. As with ERO's existing methodology for multi-year controls the RAB will be indexed to inflation and an allowed return will be calculated using a real cost of capital.

Unlike the existing methodology, assets would be added to RAB at the investment cost approved by ERO at periodic reviews rather than at actual cost. This is intended to provide incentives for licensees to make investments efficiently, by allowing them to keep the difference between actual and approved costs.

4 Valuation of assets in licensee financial accounts

The accounting principles applied by KEK (the holder of the DSO and Public Electricity Supplier, PES, as well as owner and operator of Kosovo A and B generators and the accompanying mining activities) are as follows:

- Fixed assets as at 1 January 2005 are stated at deemed cost less depreciation and impairment.
- The deemed cost is the value of these assets as assessed by an independent valuer during 2005. A previous revaluation of assets was undertaken during 2002.
- Impairment applies where the recoverable value of the asset is less than its carrying value (revalued or actual cost). The recoverable value is the greater of the net sales price of the asset (essentially its scrap value) and its value in use. The value in use is determined by the cashflows generated by the asset.
- Fixed assets purchased after 1 January 2005 are stated at actual (historic) cost less depreciation and impairment.

Proposed approach

Assets transferred to KOSTT on its establishment in 2006 were included in KOSTT’s statutory accounts at their transfer value. This was the deemed cost less depreciation and impairment. Subsequently, new assets have been added at their actual costs, as for KEK.

A summary of the approach to asset valuation in the statutory financial accounts of the licensees is shown below.

Figure 2: Asset valuation in licensee financial accounts

	Date of asset		
	Pre-2006	2006-11	2012 onwards
Financial accounts	Impaired replacement cost	Actual historic cost	Actual historic cost

5 Proposed approach

The approach to valuation of assets will be largely determined by practical constraints.

5.1 Valuation of pre-2006 assets

In setting the initial value of pre-2006 assets, the only practicable approach appears to be the use of their value as stated in the statutory accounts of licensees as at 1 January 2006. This represents the replacement cost of these assets as determined in 2005.

Alternative financial cost valuations are considered to be unrealistic:

- Historic cost asset values are unavailable, following the revaluations of assets in both 2002 and 2005. It would not be practical to seek to reconstruct these. In addition, as discussed above, there are no actual financial costs associated with these assets and, therefore, no link between the historic costs of these assets as recorded in statutory financial accounts and their actual costs of purchase to licensees.
- A valuation on the basis of cashflows from current tariffs would also not be practical. These tariffs have been set on the basis that pre-2006 assets are valued at zero for regulatory purposes. Imputing a value for these assets based on the expected future cashflows generated from them would, therefore, logically lead to their being valued at zero.

It is also unrealistic to commission a new study on revaluing the assets at their replacement cost, given the time and expense involved.

5.2 Asset lives

It is also necessary to determine the appropriate asset lives to apply for pre-2006 assets. Consistency suggests that these should be the same as the assets lives approved by ERO for application to similar new assets. Pre-2006 assets are already partially depreciated. As at 1 January 2006, the accumulated depreciation of these assets represents 21% of their gross value (before impairment), implying this part of their lives has already expired.

It is, therefore, appropriate to depreciate pre-2006 assets over their remaining life. To illustrate how this works, assume a standard asset life of 30 years. As of 1 January 2006, the remaining life of pre-2006 assets is 79% (the proportion of the gross value that is undepreciated). This is equivalent to 24 years (rounding to the nearest year). The annual depreciation allowance would, therefore, in this case be $1/30^{\text{th}}$ of the gross book value applied for a 24-year period (which should bring the net value to zero).

5.3 Updating to 2012 values

Once a value for pre-2006 asset is established, it will be necessary to update this to an opening RAB in 2012, for use in the calculation of new price controls. Consistency of approach would suggest that this should be done in the same manner as is proposed in the draft Tariff Rules for updating of the RAB between price controls—ie, indexing this to consumer price inflation.

6 Tariff impacts

The RAB used to calculate depreciation has been estimated for KEK as a whole in 2011 by applying the following assumptions:

- The RAB as at 1 January 2006 is equal to the revalued cost of assets, including impairment, less assets transferred to KOSTT.
- From 2006 to 2009, assets are added to the RAB at the actual value reported in KEK's statutory accounts. Disposals are similarly taken from the statutory accounts.
- Grant-funded additions (identified as donations in the statutory accounts) are added to the RAB.
- For 2010 and 2011, assumed additions to the RAB are equal to those reported by KEK for the tariff year 2010-11 and approved by ERO for the tariff year 2011-12 respectively under the Fifth Electricity Tariff Review (ETR5).
- The RAB is indexed to the December value of Kosovo CPI. For 2011, this value is assumed to equal that in December 2010.

Tariff impacts

- Depreciation is calculated on a straight-line basis using an assumed average asset life of 30 years (the average asset life applied by ERO across KEK's divisions weighted by their share of the total RAB).

A similar approach is applied to determine the 2011 RAB for KOSTT, using as a starting value at 1 January 2006 the value of the assets transferred from KEK to KOSTT in July 2006. In its financial accounts, KOSTT uses as the opening value of its asset base the net book value of transferred assets (ie, after depreciation and impairment). This is obviously inconsistent with the approach applied for KEK and, therefore, we have recalculated the starting gross value of KOSTT's RAB as the gross value of assets transferred from KEK to KOTT. This represents the maximum possible value for the opening RAB and it may be appropriate to lower this to match the opening asset value recorded in KOSTT's own accounts.

For KOSTT, an average asset life of 35 years is applied as with ERO's current regulatory assumption. Actual additions as recorded in the financial accounts are available for KOSTT for 2010 and are used in the calculation.

For both KEK and KOSTT, the starting RABf, used to calculate the allowed return, has been set as zero as at 1 January 2006. In subsequent years, it has been increased in line with non-grant funded additions. This starting value reflects the understanding that pre-2006 assets are either grant-funded and, in instances, licensees have no associated financing costs. For the avoidance of doubt, the assets are included at a positive value in the RAB used for depreciation purposes.

Under these assumptions, the net carrying value of KEK's RAB as at 31 December 2011 would be €500 million (on an impaired basis) compared to the €363 million calculated by ERO under ETR5 using the current methodology. For KOSTT, the net carrying value of the RAB would be €123 million compared to €80 million under the current methodology.

The resulting depreciation charges, based on ERO's proposal, are shown below. These are compared to the depreciation and allowed return calculated by ERO as part of the approval of tariffs under ETR5. The calculation of the allowed return presented uses a real cost of capital while the allowed return under ETR5 is calculated using a nominal cost of capital. The resulting increase over ETR5 allowed revenues is also shown.

Table 1: Tariff impacts of RAB revaluation (2011)

€000s unless stated	Proposed		ETR5	
	KEK	KOSTT	KEK	KOSTT
Depreciation	30 769	3 963	15 392	2 059
Basis of calculation	Impaired RAB		n/a	

Allowed return	24 129	1 468	33 544	1 302
Basis of calculation	RABf set at zero as at 1 Jan 2006		n/a	
Total capital costs	54 897	5 432	48 937	3 361
	60 329		52 297	
Increase on ETR5 allowed revenues				
	4%		n/a	