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

The Sixth Electricity Tariff Review (ETR6) (2012-2013)

KEK Consultation Paper

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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Adresa: Rr. Hamdi Mramori Nr. 1, 10000 Prishtinë, Kosovë
Tel: 038 247 615 lok. 101, Fax: 038 247 620, E-mail: info@ero-ks.org, web: www.ero-ks.org

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1 Introduction

The Energy Regulatory Office (ERO) is currently in the process of conducting its Sixth Electricity Tariff Review (ETR6). The tariff review process entails the establishing of the Maximum Allowed Revenues (MAR) that the licensee under review is allowed to recover for the regulated services it provides. The MAR established under this review is expected to be effective from April 1st, 2012.

This Consultation Paper sets out ERO's views on KEK's application for the Maximum Allowed Revenues for the Generation, Distribution and Supply components of the Kosovo Energy Corporation j.s.c. (KEK), which were submitted to ERO. The applications have been published on ERO's website along with this Consultation Paper.

KEK submitted both ERO's application templates and its own separate calculations on behalf of its application in ETR6. In this paper, ERO makes reference to KEK's figures reported in the templates.

ERO invites stakeholders to provide comments on its views given in this Consultation Paper. Comments on these proposals will be accepted until 12th March 2012 and should be sent either by email to ero.pricing-tariffs@ero-ks.org, with the subject line "ETR6 Comments", or by mail to the address of ERO: Rr. Hamdi Mramori nr.1, 10000 Prishtinë, Kosovë, marked for the attention of "Pricing and Tariffs Department".

At this stage, ERO has taken no decisions on the MAR which will be effective from April 1st. These are preliminary proposals. ERO invites all stakeholders to provide comments on ERO's views presented in this Paper.

2 Legal changes

2.1 Legislative changes

In October 2010 the Parliament of Kosovo enacted the Law on Energy Regulator No. 03/L-185. Various changes to ERO's previous tariff methodology have been required to conform to the new law. Most significantly, these are::

1. ERO recognizes a positive value[1] of pre-2006 assets in the Regulatory Asset Base[2] for the purposes of calculating depreciation charges, in line with the requirements of the new Law that depreciation be earned on all assets irrespective of funding arrangements.
2. Any cross-subsidies between different customer categories are to be eliminated by 31st December 2014[3].

[1] Under the previous Methodology, these assets had a value of zero.

[2] According to the Pricing Rules, the Regulatory Asset Base represents the sum of used and useful assets of the regulated entity.

3. ERO allows the regulated entity to recover a reasonable amount of bad debt[4], as required under the new Law.

Through an interactive consultation process, ERO amended its tariff methodology to reflect the changes in the law. In September 2011, ERO Board approved the following new methodologies governing the regulation of the electricity sector:

1. Rule on Generation Pricing;
2. Rule on Transmission System and Market Operator Pricing;
3. Rule on Distribution System Operator Pricing;
4. Rule on Public Electricity Supplier Pricing.

In reviewing KEK's applications, ERO has followed the newly adopted methodologies, with the exceptions stipulated in Section 2.2 of this Paper.

2.2 Tariff structure and cost allocation

Licensees are responsible for submitting charging methodologies for approval by ERO. These methodologies are used to convert the allowed revenues recovered from regulated sales in each year into actual tariffs and charges.

ERO considers that adequate time is required to consult on these methodologies, given that they can have substantial impacts on individual customer classes. ERO has prepared draft statements of charging principles to guide the preparation of the methodologies[5] and is also conducting a study of the costs of supply to different customer groups which will guide ERO in determining whether tariffs are cost-reflective as required by the law. ERO intends to publish these principles and cost analysis following the completion of ETR6 and, subsequently, to invite licensees to submit their proposed charging methodologies for review and consultation.

ERO does note that KEK has included a proposed cost allocation methodology in its application under ETR6. This is not a charging methodology as it does not describe how costs allocated to individual customer classes would be converted into actual tariffs. ERO is considering the cost allocation proposed by KEK as part of its analysis of the costs of service and will respond on it as part of its consultation paper on this matter.

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[3] Article 40.2 of the Law on Energy Regulator

[4] Until ETR5, ERO did not allow companies to recover any costs of bad debt.

[5] It is the responsibility of licensees to develop the charging methodologies. These statements assist licensees in doing so by setting out ERO's views on the principles to be followed in the methodologies and against which ERO will make its assessment of whether to approve the proposed methodologies.

For the current ETR6, ERO proposes to keep the tariff structure unchanged and to adjust all tariffs by the same average percentage amount.

2.3 Timing of price controls

The Pricing Rules issued by ERO provide for an initial one-year transition period for all licensees before moving to multi-year price controls with the exception of the regulated generation business of KEK, for which an immediate move to a multi-year control was planned. Given the short period available for ETR6, ERO considers it unrealistic to establish a multi-year control and, therefore, will apply a one-year transitional control for regulated generation as well.

3 Structure of this paper

This Consultation Paper is organized as follows:

- Section 4 reviews KEK's projections of electricity demand, losses, supplies and energy imported.
- Section 5 reviews KEK's proposals on the MAR of the Generation component.
- Section 6 reviews KEK's proposals on the MAR of the Distribution System Operator component.
- Section 7 reviews KEK's proposals on the MAR of the Public Electricity Supplier component.
- Section 8 sets out a summary of ERO's proposals on regulated tariffs to apply from 1st April 2011.

4 The Energy Balance

The Energy Balance used for the purpose of calculating the Allowed Revenues is built using a bottom-up approach. First, the value of final energy sales to distribution customers is taken from the Energy Balance that is approved by the MED[6], adjusted for the increase in sales associated with the decrease of technical and commercial losses. The value of ERO's allowed distribution losses and distribution-embedded generation is then added to that figure to end up with the figure for energy entering distribution. The sum of this value, transmission losses and transmission consumption is then compared to the sum of total transmission-connected domestic generation and exports. The difference is recovered by imports.

[6] Ministry of Economic Development

4.1 Final sales

The Final sales value was established by ERO based on the level of final sales foreseen by the latest version of the Energy Balance and ERO's assumptions of conversion of reduced commercial losses to sales. ERO assumed that a 1 GWh reduction in losses leads to an increased sales of 0.9 GWh with the remaining 0.1 GWh offsetting imports or, in certain months, exports.

4.2 Losses

In KEK's tariff application it is evident that KEK responded positively to ERO's insistence that KEK reduce distribution losses as KEK have reduced distribution losses (technical and commercial) by 3.15 percentage points to a level of 38.08% (points).

The Board of ERO approved the loss reduction targets for the transitional period and the upcoming 5 year tariff review. The loss reduction targets are presented in the following table. The starting actual value of losses is 38.08%.[7]

Year	Target	Losses
1	3.0%	35.08%
2	3.0%	32.08%
3	3.0%	29.08%
4	2.5%	26.58%
5	2.5%	24.08%
6	2.5%	21.58%

Table 1: The indicative loss reduction targets approved by the Board of ERO[8]

ERO's total allowed value of distribution level of losses is therefore 35.08%. This level of losses is allowed by ERO under the assumption that the losses allocated to 110kV/x transformers will continue to remain under KEK operation until the next tariff review.

The level of implied import levels is therefore 800.8 GWh.

A summary of the Energy Balance is given in the following table:

[7] This value includes unbilled supplies of 4.5% (percentage points)

[8] Decision V_393_2011 of the Board of ERO dated 29 december 2011

		-- 2012 -- Application	-- 2012 -- ERO Proposed
Generation			
KEK Generation			
Kosovo A	GWh	1,552.3	1,475.3
Kosovo B	GWh	3,470.2	3,392.5
Other domestic generation			
HPP Ujmani	GWh	82	82
Distribution-connected generation	GWh	52	52
Imports and exports			
Imports	GWh	824.7	800.8
Exports	GWh	-169.8	-183.7
Transmission losses			
Transmission losses	%	2.23%	2.07%
	GWh	132.2	119.0
Transmission-connected demand			
Sales to transmission-connected customers			
220kV (Feronikeli)	GWh	657.0	657.0
110kV (including Trepca)	GWh	87.6	87.5
KEK Consumption	GWh	299.4	131.4
Distribution losses and unbilled energy			
Distribution losses and unbilled energy	%	37.19%	35.04%
	GWh	1,723.8	1,619.9
Distribution-connected demand			
Sales to distribution-connected customers	GWh	2,910.9	3,003.6
Balance	GWh	0.0	0.0

Table 2: The Energy Balance used for calculating Allowed Revenues

5 Adjustments

This section of the Consultation Paper sets out ERO's adjustments made on KEK's application. ERO makes no judgment as to the reasonableness of KEK's application in this section. The purpose of the adjustments is to set out changes in KEK's applications that arise due to the application not being in line with the Rules. The adjustment section, in this case, includes any updates of the values of KEK's application since the original submission.

5.1 RAB_f adjustment

ERO notes that KEK set the initial value of RABf (the asset value used for calculating the allowed return rathe than depreciation) at a higher number than that used by ERO. KEK has obtained this value by subtracting the value of grants from the gross book value of assets. ERO notes that this is incorrect because ERO allows depreciation but does not allow return on pre-2006 assets because there as no financing costs associated with these assets. This view has been clarified by ERO in its RAB consultation paper published by ERO on August 1st 2011. The opening RAB_f in 2006 should therefore be set at a value of zero.[9]

5.2 Depreciation adjustment

Between 2006 and 2011, KEK updated RAB and RAB_f using depreciation from the audited financial accounts. These use shorter asset lives than ERO applies with the result that assumed depreciation in 2006-11 is higher than that actually allowed by ERO at the time. As a result, the NBV of RAB in 2011 as calculated by KEK is lower than that calculated by ERO using the economic asset lives applied at tariff reviews. Going forward, this implies that the remaining RAB to be depreciated as calculated by KEK is less than that assumed by ERO. Therefore, future depreciation charges are lower than they would be using ERO's calculation of the RAB in 2011. This could imply that KEK will not recover the full value of RAB as KEK's calculation implicitly assumes it earned higher depreciation charges between 2006 and 2011 than ERO actually allowed. KEK also do not index RAB and RAB_f to inflation, therefore their calculated RAB in 2011 is lower than that calculated by ERO. This implies that KEK is earning depreciation charges and an allowed return lower than it should do under ERO's proposed approach.

Therefore, ERO will use ERO's calculation of KEK's RAB (updated for KEK's information on grants) for the purpose of calculating the MAR of KEK.

5.3 Import adjustment

The original KEK application forecasted that the weighted average price of purchasing imports in 2012 would be €70/MWh. On 8 February KEK 2012 provided ERO with information on import contracts for 2012 which showed that the actual price of imports is €75/MWh rather than the previously forecasted €70/MWh.

ERO has amended KEK's application and passed through this cost to MAR. As per the Pricing Rule, any difference between actual and allowed costs is trued-up in the forthcoming tariff review.

This amendment has increased KEK's allowed revenues by €4.5 million.

[9] KOSTT followed an approach with is consistent with that of ERO.

5.4 Adjustments due to the transfer of 110kV transformers

On August 3rd 2011, the Government of Kosovo decided to transfer all 220/35/10(20) kV and 110 kV/x transformers to KOSTT. The Decision states that all assets and employees currently working on these assets are transferred from KEK to KOSTT.

Both KEK and KOSTT have included the value of these assets and their estimates of the associated operating and maintenance costs in their tariff application.

In a meeting held at ERO premises on 23 January 2012, KOSTT have claimed that the working group for the implementation of the government decision for the transfer of assets has almost completed all tasks and agreements related to the transfer of these assets. According to KOSTT, the implementation is subject to finalization and these assets should be transferred to KOSTT starting from January 31st 2012. KEK, on the other hand, claim[10] that to date no workers and no transformers have been transferred from KEK to KOSTT and that they have no information as to the value of the operating and maintenance costs which are associated with the assets to be transferred. KEK adds that they do not believe this can be done quickly.

ERO notes that the costs associated with these assets should be allocated either to KOSTT or to KEK but not to both. Taking into consideration the uncertainty over whether the transfer has actually occurred as well as the associated changes in operating and maintenance costs, ERO proposes to allocate these costs to KEK only for the present.

5.5 Internal electricity costs

KEK have requested an allowance for internal electricity costs for KEK businesses because, according to them, businesses that consume electricity out of the distribution network, such as Mining for example, will be billed by the PES with regulated tariffs. KEK have subsequently subtracted this allowance from the Allowed Revenues of the PES to avoid double counting.

ERO notes that KEK and KEDS are not yet separate companies and, as there is no sales agreement between them and no approved tariff, the previous approach should continue to be applied. ERO has therefore removed the request for allowed revenues for KEK businesses and has made the proper adjustments in the Supply Revenues so that no double counting occurs.

This adjustment has not affected the total allowed revenues of KEK.

[10] Meeting held at KEK premises on January 26th 2012

5.6 Generation Division capital expenditures

In the Generation tariff application, KEK foresees that the capital expenditures in the generation division in 2012 are 117% larger than those in 2011. KEK further claim that they are going to finance these investments using internal cash generation.

While ERO has not made any adjustments to the value of expected Capex in the generation division in the current proposal, ERO kindly asks KEK to provide evidence of the funding of these investments (€60.7 million). Unless strong justification is provided, ERO will apply a proper adjustment to the MAR of KEK in its final decision, to bring hese proposed capital expenditures to what ERO considers a more realistic level given the apparent absence of committed funding.

5.7 Third-party revenues for the DSO

ERO notes that KEK have included an amount of €2.8 million as third party revenues to the DSO in the application.

KEK has made no adjustment to this value but notes that it is important that KEK provides a breakdown of these revenues and set out the amounts received from such revenues during the previous tariff reviews.

6 Reconciliation

This section of the Consultation Paper sets out changes in allowed revenues that arise due to differences between values allowed under the previous tariff review and actual values reported by KEK under the current tariff review.

6.1 Operational and Maintenance costs

ERO noted a difference between the actual reported values of Maintenance expense in 2010 and those that figured in the financial statements. KEK clarified that the difference arises from the allocation as some of the expenses which have been allocated to maintenance costs in ERO's sheets, to Materials and Services in the financial statements. In addition, ERO notes that there are differences between Opex allowed last year and actual reported Opex under ETR6. Due to different accounting practice, a line-per-line comparison of costs cannot be made. Nevertheless, ERO considers it is appropriate to reconcile the sum of maintenance costs and materials and services between allowed and actual values.

This reconciliation reduced KEK's allowed revenues by €8.8 million.

6.2 Costs related to KOSTT dispute

On 29th December 2011, ERO's Board decided to approve KOSTT's payment dispute. In this dispute, KOSTT provided evidence that KEK was refusing to pay the difference between Allowed Revenues estimated for KOSTT by ERO and actual allowed revenues. ERO's Board noted that KEK should make the payment to KOSTT but, as those revenues exceed the revenues forecasted by ERO and are solely related to increased energy flows, decided that those revenues should be refunded back to customers. For practical purposes, taking into account the circumstances of the current tariff review, ERO Board proposed that those revenues be deducted directly from KEK rather than from KOSTT.

This adjustment reduced KEK's allowed revenues by €3.8 million.[11]

6.3 Costs related to imports

Under ETR5, ERO had allowed KEK to pass through import costs of €50.1 million. In order to meet its demand needs KEK actually spent a value of €54.6 million. ERO will therefore reconcile KEK for the difference of 4.5 million.

This adjustment increased KEK's allowed revenues by €4.5 million.

6.4 Costs related to exports

Under ETR5, ERO had allowed KEK to pass through import costs of €4.4 million. During 2011 KEK exported a total value of €12.5 million mostly due to the increased price of exports compared to that forecasted. ERO will therefore reconcile for the difference between actual and allowed export revenues.

This adjustment reduced KEK's allowed revenues by €8.1 million.

6.5 Costs related to capital expenditure

This subsection reconciles differences in allowed return and depreciation that arise from the capital expenditure allowed by ERO in the previous tariff review and the capital expenditure that was actually implemented by KEK. This reconciliation is summarized in the following table:

[11] For more details about the dispute please refer to the Decision published on ERO's website

Korporata Energjetike e Kosoves - Azhustimet		Minierat	Gjenerimi	Distribucioni	Furnizimi
Shpenzimet Kapitale					
Lejuara (Donacionet)	€000	0.0	0.0	0.0	0.0
Aktuale (Donacionet)	€000	0.0	0.0	0.0	0.0
Lejuara (Financim tjeter)	€000	62,600.0	28,000.0	17,900.0	484.0
Aktuale (Financim tjeter)	€000	87,179.0	21,000.0	13,800.0	840.0
Zhvlerësimi					
Jetëgjatësia	vite	35.0	16.0	30.0	5.0
Lejuar	€000	894.3	400.0	255.7	6.9
Aktuale	€000	1,245.4	300.0	197.1	12.0
Azhustimi	€000	351.1	-100.0	-58.6	5.1
Kthimi					
MPKK		13.1%	13.1%	13.1%	13.1%
Lejuar	€000	4,100.3	1,834.0	1,172.5	31.7
Aktuale	€000	5,710.2	1,375.5	903.9	55.0
Azhustimi	€000	1,609.9	-458.5	-268.6	23.3
Gjithsej	€000	1,961.1	-558.5	-327.1	28.4
Norma e Interesit		*7.00%*	*7.00%*	*7.00%*	*7.00%*
Gjithsej pas Normës së Interesit	€000s	2,098.3	-597.6	-350.0	30.4

Table 3: Adjsutments due to differences between allowed and actual capex

Under the new tariff methodology, assets are added to the Regulatory Asset Base only when they are fully functional and ready to operate. ERO therefore asks KEK to provide evidence that all assets reported as actual and those which are included as capex under ETR6 are fully operational . If no such convincing evidence is provided, ERO will adjust the RAB used for the calculation of Allowed Revenues accordingly.

7 ERO's Proposals

This section of the Consultation Paper sets out changes in the MAR that arise due to ERO's judgment on the reasonableness of KEK's requested inputs in their tariff application.

7.1 The Retail Margin

KEK have requested a retail margin allowance of 5% of the Power Purchase costs which implies an allowance of €10.3 million to be passed through to Allowed Revenues.

ERO intends to stand by its original proposal that the retail margin should be 3% of the Power Purchase costs. As there is no separate revenue item for an allowed return on the assets of the PES, ERO will annually confirm that the approved Retail Margin would offer a reasonable return on investments made by the PES. To do so, ERO will calculate an implied WACC by dividing the revenues from the Retail Margin in each year by the RAB for the PES in that year. The resulting implied return will be compared to the WACC approved for other regulated licensees. Where the implied return is less than that the approved WACC for other licensees, the Retail Margin will be adjusted upwards accordingly.

For example, under ETR5, the total allowed net wholesale power purchase costs before import subsidies were approximately €168 million. Applying a retail margin of 3% to this would imply income from the margin for the PES of around €5 million. The average PES RAB for 2011 was approximately €6 million. The implied rate of return would, therefore, be 80% or well in excess of the WACC permitted for other regulated licensees of 13.1%. In this case, therefore, there would be no need to adjust the margin.

This ERO proposal reduced KEK's allowed revenues by €4.3 million.

7.2 The Weighted Average Cost of Capital (WACC)

ERO notes that KEK used actual gearing levels in their WACC calculations. ERO notes that it is important to consider what can be considered an optimal gearing level for the utilities – one that assures a lower overall cost of capital and, at the same time, does not encourage excessive gearing which could endanger the financial viability of the licensees. ERO therefore suggests that a gearing between 0.4 and 0.7 is appropriate and has followed this principle in the calculation of WACC for the licencees. Where actual gearing is less than 0.4 then the lower boundary of 0.4 has been used to calculate WACC and, where the actual gearing is higher than 0.7, then 0.7 has been used for calculating WACC. Any actual gearing values that lied between 0.4 and 0.7 were used as such in the calculation of the WACC.

Component	----- KEK -----				----- ERO Proposal -----				Calculation
	Mining	Generation	DSO	PES	Mining	Generation	DSO	PES	
Risk-free rate									
Nominal	10.0%	10.0%	10.0%	10.0%					a
Eurozone HCIP (Nov 2011)	3.0%	3.0%	3.0%	3.0%	See ERO Consultation on WACC				b
Real	7.0%	7.0%	7.0%	7.0%					c=a-b
For calculation	7.0%	7.0%	7.0%	7.0%	6.0%	6.0%	6.0%	6.0%	d
Gearing	0.87	0.21	0.00	0.00	0.70	0.40	0.40	0.40	e
Cost of debt									
Debt risk premium							2.5%	2.5%	f
Small company premium							0.6%	0.6%	g
Cost of debt	3.7%	3.5%			3.7%	3.5%	9.1%	9.1%	h=d+f+g
Cost of equity									
Equity risk premium	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	i
Equity beta	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	j
Post-tax cost of equity	13.0%	13.0%	13.0%	13.0%	12.0%	12.0%	12.0%	12.0%	k=d+i*j
Corporate tax rate	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	l
Pre-tax cost of equity	14.4%	14.4%	14.4%	14.4%	13.3%	13.3%	13.3%	13.3%	m=k/(1-l)
WACC									
Real pre-tax WACC	5.2%	12.2%	14.4%	14.4%	6.6%	9.4%	11.6%	11.6%	n=e*h+(1-e)*m
Eurozone HCIP (Sep 2011)	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	o
Implied nominal pre-tax WACC	8.2%	15.2%	17.4%	17.4%	9.6%	12.4%	14.6%	14.6%	p=n+0

Table 3: Weighted Average Cost of Capital calculations for KEK

ERO's Proposals

7.2.1 *The WACC of the Distribution System Operator*

On December 29th 2011, the Board of ERO, having undergone a public consultation on the appropriate level of WACC for the regulated commercial-owned utilities, approved an indicative value of WACC to be used for the purpose of calculating the Maximum Allowed Revenues. This indicative WACC calculation was set at 14.5% (pre-tax, nominal, with an assumed inflation of 3%), as shown in Table 3.

Meanwhile, on 24th January 2012, the Board of ERO received a letter from the advisors of the Government of Kosovo on the KEDS transaction. In this letter, which is published in ERO's website along this Consultation Paper, the Transaction Advisors (TA) argue that, based on the feedback received from investors, the level of WACC set by ERO is not sufficient to guarantee investment in the DSO business. Among other things, the Transaction Advisors suggested that the WACC is set at a minimum of 16.5%.

ERO considers that the indicative WACC previously set by ERO entails considerations of the risk perceived by private investors for investment in Kosovo. The calculation of these values includes country-specific risk parameters which add up to a WACC which provides a reasonable return for potential private investors in Kosovo. Nonetheless ERO is willing to respond positively to the TA's request and proposes a WACC of 15% (nominal pre-tax) be used for the calculation of MAR. ERO believes this is a step forward towards investor feedback which takes into consideration appropriate indicative WACC previously established by ERO.

This proposal has increased KEK's Allowed Revenues by €0.2 million.

7.3 The Export price

KEK foresee that the average price of exports for 2012 will be €30/MWh and therefore reduce the value of the allowed revenues by only €5.0 million. KEK's average price of exports in 2011 was €45/MWh.

ERO notes that the increase in the price of imports implies that the market price of electricity is expected to go up in 2012 compared to 2011. ERO therefore considers that an appropriate export price for the inclusion in Allowed Revenues should be at least equal to the average of 2011, ceteris paribus.

ERO has therefore amended KEK's request of the average export price to €45/MWh. ERO notes that, as for imports, any differences between allowed and actual values will be trued-up in the subsequent tariff review.

7.4 Allowed Operating and Maintenance Costs

KEK requested a lower value of Operational and Maintenance (O&M) costs under ETR6 than ERO allowed under ETR5. ERO welcomes this and encourages KEK to further continue to improve O&M

efficiency. ERO has therefore not yet made any adjustments to KEK's requests on the level of O&M costs. Nevertheless, ERO asks KEK to provide justification for each sub-category of the O&M costs **for** each KEK division. In the absence of convincing arguments for the allowance of these costs, ERO will make proper adjustments to the allowed O&M costs of KEK.

8 Summary

ERO notes that - subject to the adjustments, reconciliations and proposals made by ERO - tariffs may have to be increased by 7.6% in order to enable KEK to collect enough revenues to recover the reasonable costs proposed by ERO under the current review. Due to the fact that some of the issues raised by ERO under this Consultation Paper are still under review, ERO emphasizes that the proposed value of 7.6% may change in the final decision on tariffs.