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

Responses Paper (KEK)

Sixth Electricity Tariff Review

ETR6 (2012-2013)

Maximum Allowed Revenues Calculation

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.

20 June 2012

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1 Introduction

The Energy Regulatory Office (ERO) is currently in the process of conducting its Sixth Electricity Tariff Review (ETR6).

This Responses Paper sets out ERO's responses to the comments received on its Consultation Paper, issued with respect to the applications submitted to ERO by the Kosovo Energy Corporation j.s.c. (KEK) for approval of its proposed:

- Maximum Allowed Revenues (MAR) to be recovered by its Generation and Distribution System Operator (DSO) icensed businesses; and
- Regulated retail tariffs[1] to be applied by its Public Electricity Supply (PES) licensed business, which recover the costs of this business attributable to regulated customers.

The applications received have been published on ERO's website along with the Consultation Paper, the comments received on that paper and this Responses Paper.

The purpose of this Responses Paper is to advise stakeholders of ERO's views on the comments received and ERO's resulting draft proposals on maximum allowed revenues and regulated tariffs. These draft proposals will be considered by the Board of ERO at a public meeting ahead of a decision being issued.

The decision issued by ERO will establish MAR for KEK's Generation and DSO businesses and regulated retail tariffs to be applied by KEK's PES business. The charges applied by KEK's Generation and DSO businesses will be determined by the relevant licensees, subject to the requirement that these conform to charging methodologies approved by ERO.

2 Structure of this paper

Detailed comments were received on ERO's review and initial proposals from KEK. Comments were also provided by OJQ Konsumatori (Consumer NGO), SHUKOS (Association of Water Supply and Sewerage of Kosovo) and the Association of Kosovo Millers[2]. Given this, for ease of reference, this paper is organised according to the headings in KEK's comments with the comments from OJQ

[1] Regulated retail tariffs are those applied to non-eligible customers and to eligible customers served by the PES where ERO has determined that effective competition in supply does not currently exist. At present, all customers in Kosovo are served by the PES under regulated retail tariffs.

[2] The comments from all three organisations were received after the deadline for submission. However, given the lack of comments from other consumers, ERO has decided to accept these comments as representative of the concerns of consumers.

Konsumatori and SHUKOS discussed following these. **The use of these headings for the convenience of readers does not imply any agreement by ERO with the views expressed.** For each heading, the arguments presented by KEK are summaried followed by ERO's responses on these. Readers are referred to the comments provided by KEK for fuller information[3]. The final sections of the paper provide ERO's comments on other matters not included in KEK's responses and ERO's draft proposals.

3 Providing transparency

3.1 Bundling of costs

KEK have commented that ERO, in the Consultation Paper, has focused solely on total (or 'bundled') costs and the resulting required change in average retail tariffs and has not provided any proposals with regard to the individual MAR for the generation and DSO businesses. KEK also comments that the lack of a separate MAR for the DSO does not support the development of retail competition which requires separate distribution charges to be applied to those customers who seek an unregulated supply.

ERO notes that in previous years, ERO has approved separate distribution charges but that KEK has failed to apply these, given that there are no unregulated customers connected at distribution network voltages at present. ERO, therefore, considers it somewhat unreasonable for KEK to now claim that it is willing to apply separate distribution charges. ERO also notes that KEK has failed in the past to propose separate regulated generation charges, let alone apply these.

Despite this, ERO does agree that separate MARs will need to be approved for KEK's generation and DSO businesses. It will then be KEK's responsibility to develop these charges in line with methodologies approved by ERO.

3.2 Movement toward cost-reflective tariffs

KEK comments that ERO is failing to adjust tariffs towards cost-reflective levels. ERO notes that it clearly stated in its Consultation Paper that it is conducting an analysis of the costs of service to different customer classes that will be used as the basis for establishing cost-reflective tariffs. This study will identify the size of eventual cross-subsidies which ERO can use to move towards calculating cost reflective tariffs, in line with the provisions of the Law on Energy Regulator.

[3] "Response to ERO Consultation Paper", KEK, 12 March 2012. Available from ERO's website at www.ero-ks.org under the Pricing and Tariffs menu.

3.3 Energy balance clarification

KEK comments that unbilled supplies provided to North Kosovo should not be considered as distribution losses as they are outside its control. KEK also comments that, following the privatisation of KEDS, the costs of these losses will fall on KEK and should be recovered by it.

ERO agrees that the costs of these supplies are outside the control of KEK and are an obligation imposed on it which should be fully compensated. ERO also agrees that these costs should be separately identified in the calculation of allowed revenues and has done so in this Responses Paper. However, this does not change the calculation of those allowed revenues in the current tariff review.

ERO notes that the KEDS privatisation has not yet concluded. However, ERO does note that, in the absence of a Government subsidy, the costs of these unbilled supplies will ultimately have to be recovered from electricity customers in Kosovo irrespective of which licensee is nominally responsible for paying for them.

A summary of the energy balances as provided by KEK in its application and as used by ERO in developing its proposals is presented below, with unbilled supplies separated.

Table 1: Summary energy balances compared with unbilled supplies separated

GWh	**KEK Application**	**ERO Proposals**
Supply		
1. KEK net generation [a]	4,868	4,868
2. Purchases from other Kosovo generators	134	134
3. Imports	825	797
4. Total supply	**5,826**	**5,798**
Demand		
5. Exports	170	184
6. Unbilled supplies	204	204
7. Transmission losses [b]	132	132
8. Distribution losses	1,520	1,399
9. KEK own use [c]	145	131
10. Final sales	3,656	3,748
11. Total demand	**5,826**	**5,798**
12. Transmission losses [d]	2.3%	2.3%
13. Distribution losses(without unbilled supplies) [e]	32.8%	30.4%

Notes

a KEK net generation represents total KEK-owned generation less power used in auxiliary consumption. KEK presents these separately in its application while ERO combines them in its own calculations.

b ERO Proposals include the impacts of the transfer of 110 kV assets from KEK DSO to KOSTT, which results in the associated losses being reallocated to KOSTT as transmission losses (see Section 5.2).

c KEK own use represents power consumed by KEK in mines and other internal consumption. It excludes auxiliary consumption by KEK-owned generators.

d Calculated as percentage of energy entering the transmission network. [(8 / 4) excluding distribution-connected generation of 51.5 GWh]

e Calculated as percentage of energy entering the distribution network. [8 / (8 + 10) excluding sales to transmission-connected customers of 744.5 GWh]

3.4 Allowed revenue clarification

ERO comment that they are unable to identify from the Consultation Paper what MAR is being proposed or how the initial proposal for a 7.6 % increase in the average regulated retail tariff was calculated. ERO notes that, following the issuing of the Consultation Paper, KEK was provided with an electronic copy of the spreadsheets used for ERO's calculations to enable it to review these. It appears that KEK has failed to do so. A summary of the calculations by ERO is provided at the conclusion of this paper.

4 KEK comments on ERO's position

4.1 Points of general agreement

ERO does not consider that responses are needed to KEK's statements in this section.

4.2 Adjustments disputed by KEK

4.2.1 Lack of clarity in determining capital-related costs

KEK comments that the Consultation Paper does not describe how the Regulatory Asset Base (RAB), Regulatory Asset Base used to determine the allowed return (RABf) and depreciation allowances were determined. KEK also disputes ERO's removal of an allowed return on pre-2006 assets.

ERO notes that, as the Consultation Paper clearly states in Sections 5.1 and 5.2, the values of RAB, RABf and corresponding depreciation allowances were established according to the consultation papers issued by ERO in 2011 on these matters and the subsequent ERO Board decisions. KEK was provided ample opportunity to comment at that time, including being provided with ERO's calculations in the form of spreadsheets.

As regards the return on pre-2006 assets, ERO has consistently stated that it does not allow a return on these assets as KEK has no financing costs associated with them. Therefore, any allowed return would reflect additional income to KEK with no corresponding costs, thereby simply representing a tax on electricity customers, which is not acceptable by the Regulator. KEK, in its comments, states that "KEK paid for those assets" (p7). To the best of ERO's knowledge, these assets comprise a mixture of pre-1999 assets for which KEK has made no payment to their previous owner nor assumed any debt associated with the construction of these assets and assets constructed between 1999 and 2006 which were almost entirely funded by grants from international donors. ERO invites KEK to provide evidence of the payments it has made for these assets and the associated financing costs assumed by KEK.

ERO proposes to make no change to the RAB, RABf and depreciation allowance established in the Consultation Paper, with the exception of agreements related to the asset transfer.

4.2.2 Incorrect calculation of unspent operating and maintenance costs for 2011

KEK comments that ERO has inappropriately calculated the adjustment applied for differences between allowed and actual operating and maintenance (O&M) costs for KEK's mining, generation and DSO business in 2011. KEK states that the difference is lower than that calculated by ERO as ERO's calculation used incomplete data on actual costs and did not include all O&M costs incurred by KEK. Using its unaudited accounts for 2011[4], KEK calculates that the difference between allowed and actual O&M costs is €4 million, rather than the €8.8 million applied by ERO.

ERO notes that the reconciliation was applied for differences in actual and allowed maintenance expenditure, not to all O&M costs. The reason for this was that ERO is concerned that underspend against expected maintenance expenditure implies a reducing quality of service and KEK should not be rewarded for this. As KEK argued that some maintenance expenditures were included in materials and services costs, ERO applied this reconciliation by comparing the sum of allowed maintenance, materials and services costs with those reported by KEK for 2011. ERO did not seek to reconcile other costs such as staffing or utility costs.

ERO has recalculated the reconciliation adjustment as below, using the unaduted accounting data provided by KEK. Write-downs of inventories have been included as maintenance and materials costs.

Table 2: Adjusted O&M reconciliation calculation

€ millions	**Consultation Paper [a]**	**Responses Paper [b]**	**Difference**
Cost categories included	Maintenance Materials and supplies	Maintenance Materials and supplies Write-down of inventories	
Actual	27.7	27.5	-0.2
Allowed	36.6	36.6	0.0
Reconciliation	-8.9	-9.1	-0.2

Notes

[4] KEK has requested that these unaudited accounts be kept confidential. This Responses Paper, therefore, does not include a breakdown of the costs provided.

a Calculated using costs provided by KEK in its application

b Calculated using costs provided by KEK in the form of its unaudited 2011 accounts

Given that the unaudited accounts provide virtually identical cost data to that used by ERO in its calculations in the Consultation Paper, ERO proposes to make no change to the reconciliation adjustment for maintenance and materials costs.

4.2.3 Improper reduction of KEK 2012 allowed revenues for 2010 transmission fees

KEK is currently in dispute with the Transmission System Operator (KOSTT) over the payment of transmission fees for 2010. This dispute has been referred to ERO who, at a Board meeting held on 29 December 2011, issued its decision[5] that an outstanding amount of €3.88 million was owed from KEK to KOSTT and that this amount should be deducted from the allowed revenues recovered by the PES through regulated retail tariffs for 2012-13 (ie, those established under ETR6). In its comments, KEK sets out its points of disagreement with ERO's decision and states that it is appealing this decision to the Supreme Court.

This Responses Paper is not the place to enter into a discussion of ERO's decision, the reasons for which are fully explained in the published decision. Instead, the relevant matter for this Responses Paper is whether the appeal to the Supreme Court means that the decision, as issued by ERO, should be suspended until a decision on the case is issued by the court.

ERO's understanding is that an appeal to the relevant court against a decision of the Board of ERO does not invalidate that decision or require its suspension. The decision remains in effect as issued unless and until the court rules it to be invalid or to require amendment at which time the court may also require damages to be paid to parties adversely affected by the decison. Given this, ERO will continue, under the current review, to apply the decision as issued by the Board of ERO.

ERO proposes to continue to implement Decision V_400_2012 under ETR6.

5 Other matters

5.1 Generation division capital expenditures

In its Consultation Paper, ERO drew attention to its concern that KEK's proposed capital expenditures in its generation business were extremely high provided to actual levels achieved in previous years and that KEK apparently planned to fund these expenditures from cashflows without any external financing. ERO requested that KEK provide further information on the composition of these expenditures and the planned financing arrangements. KEK has not provided the requested information.

[5] Decision V_400_2012. Available from ERO's website at www.ero-ks.org under the Acts / Decisions 2012 sub-menu.

ERO stated in the Consultation Paper that, in the absence of such information, ERO will reduce proposed the generation capital expenditures to bring these to what may be considered more realistic levels. ERO considers that actual capital expenditure levels in 2011 best reflect KEK's ability to implement capital investments under ETR6. ERO has therefore adjusted its allowed capital expenditures for KEK Generation Division from €60.7 million, as requested by KEK, to €21 million which is the actual level of capex in ETR5.

This adjustment has reduced KEK Generation MAR by €3.3 million.

5.2 Transfer of 110kV assets

In its Consultation Paper, ERO proposed to allocate the costs associated with 110kV assets which are to be transferred from KEK to KOSTT[6] to KEK, in the absence of a clear date for this transfer. Subsequently, on 12 March 2012, ERO has received a request from KEK for approval for the transfer of these assets with immediate effect following the signing of a transfer agreement between KEK and KOSTT on 29 February 2012. The final agreed values of the assets to be transferred were provided to ERO on 28 May 2012.

Given this, ERO proposes to adjust the allowed revenues of the DSO business of KEK to take account of this asset transfer. The proposed adjustments use information provided by KEK and are as follows:

- The impaired gross value of assets to be transferred is €14.837 million, the accumulated depreciation on these assets is €3.752 million and the net value of deferred grants (on which no return is to be earned) associated and transferred with these assets is €5.092 million. The net RAB of the DSO has been reduced accordingly by €5.993 million.
- The gross value of post-2006 assets to be transferred is €9.637 million, the accumulated depreciation on these assets is €2.421 million and the net value of associated deferred grants is €3.855 million. The RABf of the DSO, used to calculate the allowed return, has been reduced accordingly by €3.355 million.
- Along with the assets, 130 staff will be transferred from KEK to KOSTT. The annual salary cost for these staff is € 875,734. The allowed revenues of the DSO have been reduced accordingly.
- The annual maintenance costs associated with the transferred assets are estimated at €250,000. The allowed revenues of the DSO have been reduced accordingly.

Additionally, the losses allowance for KEK DSO have been reduced by the losses associated with these 110 kV assets, responsibility for which will now transfer from KEK to KOSTT.

[6] In accordance with Government Decision 10/29 dated 3rd August 2011.

As a consequence of this transfer, ERO proposes to reduce the net RAB for the DSO by €6.0 million and the net RABf by €3.4 million. Allowed personnel costs for the DSO will be reduced by €0.87 million.

5.3 Increase in lignite royalties

On 25 May 2012, the Assembly approved an increase in the royalty on lignite to 3.0 €/t.

According to the Law on Mines and Minerals, new lignite royalties take effect from the 1st day of the next calendar year if the decision is taken in the first half of the current calendar year. This implies that the increase will take effect from 1 January 2013. As the royalty increase will only take effect from January 2013, it will only apply for the last three months of the period covered by the tariffs to be approved under ETR6 (from 1 January 2013 to 31 March 2013). Therefore, the total increase in allowed revenues over the tariff period of KEK's mining and generation division resulting from the increase in the lignite royalty is €5.4 million. This has been included in allowed revenues for 2012.

6 Other comments

6.1 OJQ Konsumatori

OJQ Konsumatori has submitted comments arguing that any increase in retail electricity tariffs is unjustified. They argue that:

- KEK has significant potential to reduce costs by improving its technical and commercial performance. It should do so, rather than seeking to pass the costs of poor performance on to customers in the form of tariff increases.
- Paying customers should not be expected to also cover the costs of imports to cover demand from non-paying customers.
- Customers in the rest of Kosovo should not be expected to pay for the costs of supplying electricity to north Kosovo.
- The Government of Kosovo has an obligation to protect electricity customers from the impacts of high import prices.
- Electricity customers should not be required to pay higher tariffs in order to increase the attractiveness of KEK for privatisation.
- KEK has failed to match its proposed tariff increases with guarantees on the reliability and quality of supply, as required under its contracts with customers.
- The "ABC" scheme should be ended as being unfair to paying customers located in feeders with lower classifications.

Other comments

- The block tariff provides opportunities for manipulation by KEK meter readers and should be ended.

ERO's responses to each of these comments are provided below:

- ERO's proposals take account of its assessment of KEK's ability to improve its performance. ERO expects significant efficiency improvements by KEK and has removed those costs it considers unjustified.
- In the absence of a commitment by government to fund any shortfall, ERO needs to approve tariffs at a level that allows KEK to recover efficient and justified costs taking into account ERO's views on the level of collections that KEK can be expected to achieve if it pursues bad debts aggressively. ERO cannot set an approved tariff that does not allow KEK to recover justified costs.
- The decision to provide unbilled supplies is one for Government. ERO's responsibility is to ensure that, in the absence of any Government subsidy funding this obligation, KEK is able to recover the resulting costs which are outside KEK's control.
- ERO's assessment of the costs of imports is based on observed market prices in the region. Decisions on the extent to which subsidies should be provided to help fund these costs are a matter for Government and not for ERO.
- ERO's decisions on tariffs are based on its assessment of the justified and efficient costs of KEK rather than trying to achieve a particular privatisation value. However, ERO does recognise that privatisation is a government policy objective and that its decisions should not block the implementation of this objective.
- The approved tariffs should allow KEK to recover the costs of providing a reliable electricity supply that meets the quality of service standards set by ERO.
- The use of the "ABC" mechanism has helped improve collection rates. ERO is aware of the concerns over its potentially unfair nature and keeps the continued use of the mechanism under review.
- The block tariff is intended to help ensure the affordability of electricity supplies for poorer households. The continued need for the block tariff is under review by ERO. Where there is evidence of abuses of the tariff, these should initially be reported to KEK and subsequently to ERO if the complaint is not satisfactorily resolved.

6.2 SHUKOS

SHUKOS have submitted comments raising their concern over the impacts of tariff increases on the costs of water supply in Kosovo and proposing that these might be mitigated by defining water treatment and supply facilities as a specific class of strategic customer, with lower tariffs reflecting the baseload nature of their demand.

ERO notes that SHUKOS provided similar comments under ETR4 (for tariffs from 2010-11). ERO stated at that time that SHUKOS should submit proposals on amendments to customer categories and tariff structures to KEK, who is then responsible for preparing a proposal to submit to ERO for approval. If SHUKOS has made such a proposal to KEK and is dissatisfied with the response received, it may appeal to ERO under the dispute resolution mechanisms in force.

6.3 Association of Kosovo Millers

The Association raises the following concerns:

- Out of 98 mills in Kosovo, only 58 are operating. The Association attributes this to high electricity tariffs and estimates that half of the remaining mills will close if electricity tariffs increase further, leading to growing dependence on imported flour and bread.
- This pressure comes on top of other disadvantages for millers in Kosovo compared to those elsewhere in the region. These include higher VAT rates and no access to state reserves of wheat.

The Association proposes that:

- Greater emphasis should be placed on the need for KEK to reduce its costs through efficiency improvements.
- A separate and lower tariff for millers should be determined, following the example of Macedonia.

ERO notes that the taxation of food products and the desirability or otherwise of reducing food imports are matters of government policy and not for ERO. The responsibility of ERO is to approve electricity tariffs where there is no effective competition and these tariffs should recover the efficient and justified costs of electricity supply and be cost-reflective. With respect to the proposals by the Association, ERO refers to its responses to OQJ Konsumatori and SHUKOS as provided above.

7 Proposed allowed revenues and required average tariff increase

KEK's assessment is that the adjustments implied by their comments (a reduction in the amount reconcilied between actual and allowed O&M costs in 2011 and the removal of the reduction in revenues required under ERO Decision V_400_2012) would increase allowed revenues recovered by the PES by €8.6 million compared to ERO's initial proposals.

ERO's assessment of the responses provided by KEK is that these do not justify any modification to the initial proposals for allowed revenues for KEK's licensed businesses as set out in ERO's

Consultation Paper. Adjustments are required to the allowed revenues for individual licensees to take account of the transfer of 110kV assets from KEK to KOSTT. It is also necessary to update the calculation of allowed revenues to take account of ERO's draft proposals on the MAR to be recovered by KOSTT (see the separate Responses Paper issued on the comments received on ERO's consultation on KOSTT's application). Lastly, it is necessary to increase allowed revenues for KEK's mining and generation business by €5.4 million to allow recovery of the costs of the increased lignite royalty applicable from January 2013.

ERO, proposes an increase in the average tariff for regulated costumers by 8.9 % after allowing for expected increases in sales at regulated retail tariffs.

A summary of the initial applications received from KEK and KOSTT, the initial proposals contained in ERO's Consultation Paper, KEK's proposals as presented in its comments and ERO's draft proposals determined in accordance with this Responses Paper is provided below.

Although the tariffs approved under ETR6 are only expected to take effect from 1 June 2012, the calculation of ERO's draft proposals shown above is made on an annualised (12-month) basis for comparability with the applications and initial proposals. ***A reconciliation adjustment will be applied in 2013 (the first year of the Multi-Year Tariff to be set under ETR7) for the shortfall in revenues allowed under ETR6 and actually recovered due to the two-month delay in implementing the ETR6 tariffs.***

Table 3: Summary of applications and proposals on allowed revenues

€ millions unless noted	**2011 Allowed**	**Application**	**ERO Initial Proposals**	**KEK Comments**	**ERO Proposals**
KEK Generation					
O&M costs excluding depreciation (a)		39.0	30.3	30.3	30.3
Depreciation		18.7	20.2	20.2	18.9
Allowed return		18.8	12.0	12.0	10.2
Costs of lignite supply		74.2	65.1	65.1	70.4
KOSTT fees		3.3	2.7	2.7	2.7
Unregulated revenues		-0.3	-0.3	-0.3	-0.3
Other adjustments		-0.7	-3.5	0.0	-3.5
Generation MAR	**120.8**	**152.9**	**126.4**	**130.0**	**128.7**
Other power supply costs					
Non-KEK power purchase costs		4.5	4.5	4.5	4.5
Imports		57.7	60.1	60.1	59.8
Exports		-5.1	-8.3	-8.3	-8.3
Total power supply costs	**170.4**	**210.0**	**182.7**	**186.3**	**184.8**

Proposed allowed revenues and required average tariff increase

€ millions unless noted	2011 Allowed	Application	ERO Initial Proposals	KEK Comments	ERO Proposals
KOSTT TSO + MO					
O&M costs excluding depreciation		9.5	5.3	5.3	6.4 (b)
Depreciation		5.3	4.3	4.3	4.7 (b)
Allowed return		1.9	2.2	2.2	2.6 (b)
Purchase of transmission losses		4.1	3.9	3.9	4.4 (b)
Unregulated revenues		0.0	0.0	0.0	0.0
Other adjustments		-0.3	-0.7	-0.7	-0.7
KOSTT MAR	**12.8**	**20.5**	**14.9**	**14.9**	**17.3**
KEK DSO					
O&M costs excluding depreciation (a)		16.5	16.5	16.5	15.3 (b)
Depreciation		5.6	6.1	6.1	5.6 (b)
Allowed return		7.8	7.8	7.8	7.4 (b)
Purchase of distribution losses		61.9	46.5	46.5	46.4 (b)
Unregulated revenues		-2.8	-2.8	-2.8	-2.8
Other adjustments		-0.4	-3.3	-1.7	-3.3
KEK DSO MAR	**70.7**	**88.6**	**70.8**	**72.3**	**68.7**
KEK PES					
Power purchases		210.0	182.7	186.3	184.8
KOSTT and DSO fees		105.7	83.0	84.5	83.3
O&M costs excluding depreciation (a)		13.6	14.4	14.4	13.6
Depreciation		1.0	1.1	1.1	1.1
Retail margin		10.5	5.5	5.5	5.5
Bad debts allowance		12.0	10.7	10.7	10.8
Sale of energy for losses		-66.0	-50.4	-50.4	-50.8
Other unregulated revenues (c)		-16.5	0.0	0.0	0.0
Import susidies		-13.5	-13.0	-13.0	-13.0
Decision V_400_2012 implementation		0.0	-4.2 (d)	0.0	-4.2 (d)
Other adjustments		-11.7	-15.5	-15.5	-15.5
KEK PES MAR	**180.3**	**245.1**	**213.9**	**223.2**	**215.6**

Notes

a Costs of corporate services provided by KEK's Head Office are allocated across KEK's licensed businesses.

b This change results from the incorporation of the transfer of 110kV assets from KEK to KOSTT and the transfer of associated staff and losses.

c Unregulated revenues include sales of own use energy from KEK PES to KEK Generation and KEK Mining in anticipation of the privatisation of KEK PES. These internal transfers are excluded in ERO's proposals.

d The adjustment includes an interest charge calculated at 7% per annum.

e Actual average tariff as provided by KEK.

f This does not match the increase calculated by KEK in its comments, as that used an incorrect value for ERO's initial proposals. The adjustments applied to the allowed revenues calculation are those proposed by KEK in its comments.

The largest contributions to the increase in the allowed revenues of the PES are the expected increase in the costs of imports as demand and import prices rise, the reduction in import subsidies paid to the PES from the Kosovo Budget, the increase in lignite royalty from January 2013 and the increase in the MAR resulting from the inclusion of pre-2006 assets in the RAB for depreciation purposes[7]. Import volumes, prices and subsidies and lignite royalties and the legally-obliged inclusion of pre-2006 assets in the RAB and the 1011% increase on lignite royalties are entirely or largely outside the control of licensees or of ERO. A breakdown of the difference between the proposed allowed revenues for the PES in 2012 and those allowed for 2011 is provided below.

Table 4: Breakdown of changes in PES maximum allowed revenues

€ millions	**2011 Allowed**	**ERO Draft Proposals**	**Change from 2011 Allowed**
KEK PES MAR	**180.3**	**215.6**	
Increase in lignite royalties (from 1 Jan 2013)		5.4	3.0%
Change in KEK Generation MAR (exc. royalties)		7.9	4.4%
Changes in other power purchase costs		6.4	3.5%
Change in KOSTT MAR		4.5	2.5%
Change in KEK DSO MAR		-2.0	-1.1%
Change in bad debt allowance		5.8	3.2%
Reduction in import subsidies		14.4	8.0%
Decision V_400_2012 implementation		-4.2	-2.3%
Other changes in KEK PES MAR		-2.9	-1.6%

[7] Previously these assets were excluded from the RAB on the basis that they had been acquired 'for free'. The 2010 Law on the Energy Regulatory requires that they are now included in the RAB.

8 Proposed new tariffs

KEK agrees with ERO that there is insufficient time under the existing review to consider changes to the structure of regulated retail tariffs. KEK argues that there is sufficient evidence that household tariffs are below the costs of supply that it is appropriate to increase household tariffs more than those of other customer types in order to begin the process of moving all tariffs towards cost-reflective levels. KEK notes that there, following this review, there are only two further years in which household tariffs can be increased to cost-reflective levels to meet the legal requirement of achieving this by 31 December 2014. The longer this is delayed, the higher the increase needed in future reviews to achieve this requirement. KEK, in its comments, therefore proposes that tariffs for non-household customers are uniformly increased by 5% and tariffs for households are then increased by the amount necessary to recover the allowed revenues of the PES in full. KEK's calculations are that this would require an increase of 19% in tariffs for households with time-of-use (TOU) metering and of 14% for other household customers.

ERO agrees that moving towards cost-reflective tariffs is a legal obligation and that this implies a greater increase in tariffs for household customers than for other customers. However, ERO also remains concerned that the cost-reflective level of household tariffs remains to be identified.

Given this uncertainty, ERO proposes to increase all regulated tariffs by the same percentage, implying a common 8.9 % increase.