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

Consultation Paper

The Seventh Electricity Tariff Review

ETR7 (2013-2017)

Provisional Evaluation – Distribution System Operator Detail

DISCLAIMER

This Consultation Paper has been prepared by ERO for the purpose of receiving eventual comments from stakeholders. It does not represent a decision by the ERO.

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1 Introduction

In a letter dated 8 June 2012 ERO announced the commencement of Electricity Tariff Review 7 (ETR7) which, for the first time, will enable the setting of licensee maximum allowable revenues over multi year periods. Those maximum allowable revenues must, by law, be adequate to cover the reasonable operating and capital costs of performing the licensed activities. In order to determine adequacy of revenues, ERO must therefore carefully assess the licensees' forecast costs and satisfy itself that their proposals are reasonable and appropriate. It should be noted that, by law, the licensees are obliged to provide all the data that ERO requires for this analysis. The Distribution System Operator (DSO) was asked to present its submission to ERO and the public on 3rd September. Since that date, ERO has worked closely with the company to clarify initial submissions. The DSO has shown considerable progression in submitting data since their initial submission.

In line with its published Pricing Rules, ERO must set out and consult upon its proposals on the Maximum Allowed Revenues to be recovered by the licensee during the regulatory period, and the justification for these. The Rules allow for the ERO to amend, remove or replace any part of the licensee's proposals where such action is justifiable.

This document forms part of that Provisional Evaluation and should be read in conjunction with the "Provisional Evaluation – Overview" published concurrently with this document and its annexes. It is structured as follows:

Section 2 - Provisional Evaluation of DSO's proposed Capital Expenditures

Section 3 – Provisional Evaluation of DSO's proposed Operating Expenditures

Section 4 – Provisional MARs 2013-2017

Section 5 – Other Regulatory Parameters

2 Provisional Evaluation of DSO's proposed Capital Expenditures

2.1 DSO's CAPEX Proposals

On 19 October 2012 ERO issued a consultation document (the "Initial Proposal of KEK's submissions") setting out ERO's understanding of, among others, the DSO's submission to date and asking for additional clarification and justification. ERO stated that without proper justification of the DSO's costs and explanations of inconsistencies, ERO would consider some cost elements as unjustified and exclude them from the MAR calculation.

The final MAR submission[1] of the DSO consists of a list of projects totalling €114.1m to be conducted during the Regulatory Period of five years. The DSO plans to eavenly spread-out this capex plan throughout each Relevant Year of the Regulatory Period, with investments ranging from €22m to €23m per year.

[1] The submission dated 23 November 2012

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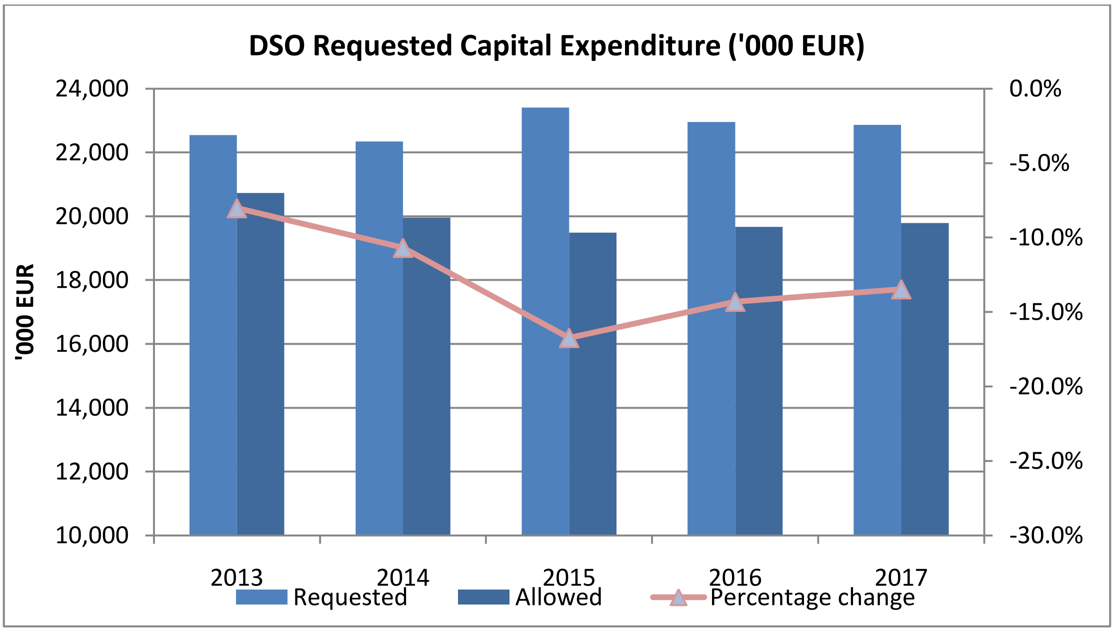
The technical evaluation of the DSO capex suggests that the DSO investment plan is in line with the Network Development Plan of the DSO and that the capital expenditures are based on the requirements of the network and the priorities of the DSO. Furthermore, Load-Related Expenditure and Non-Load Related Expenditure modelling suggests that the current capital expenditure levels are below levels that would be expected given the current asset age profile, even under the more optimistic assumptions on asset lives. As such the technical evaluation suggests that none of the projects requested by KEK are excluded from MAR.

DSO's capex submission underwent a further rigorous investigation to assess whether the unit costs of each of their proposed capital expenditure projects were in line with relevant international comparators. The technical evaluation data suggests that the DSO's unit costs are higher than would be expected particularly those of overhead lines (at all voltage levels) and 400 V cables.

ERO subsequently adjusted DSO's capex plan to reflect the unit costs adjustments. Total DSO capex proposed by ERO mounts up to €99.6m compared to DSO's €114.1m representing a 12.7% reduction for the same list of capital expenditure projects.



3 Provisional Evaluation of DSO's proposed Operating Expenditures

Since the initial tariff submission on August 31st, DSO presented their operating expenditures in a number of submissions after subsequent clarification meetings between KEK and ERO. It should be noted that KEK's submission for total opex reduced by €4.4m between the first and the final submissions. The different requests provided by DSO are summarized in the following table:

Submission Filename	HQ Total Opex 2013-2017 (From Worksheet HQ1 Opex (HQa)	DSO Total Opex 2013-2017 (From Worksheet DS3 Other (DSO))

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Formularet Raportues 2013-2017 (01-09-2012)	59.8	130.1
Formularet Raportues 2013-2017 (14-09-2012)	59.8	130.1
Finale Formularet Raportues (09-11-2012)	59.8	130.1
Finale Formularet Raportues (23-11-2012)	59.8	125.7

ERO allocated HQ costs to KEK divisions using KEK employee numbers as an allocation key and with the following proportions:

Submission Filename	DSO	PES	Generation	Mining
Finale Formularet Raportues (23-11-2012)	16%	16%	22%	45%

In assessing the reasonableness of DSO Opex, ERO is of the opinion that these should match allowed ETR6 levels, unless there is an obvious reason to change these.

3.1 Staffing levels

ERO has assessed DSO's staffing levels with a benchmarking analysis conducted by ERO's consulting engineers. ERO notes that sound reliable data is required to properly carry out a benchmarking exercise and that benchmarking DSO costs against international comaprators may not be practical, taking into consideration accounting treatment and lack of management accounts information by KEK.

Nonetheless ERO has analyzed a high-level benchmarking of staff levels per unit of network, given this is the main controllable cost driver in DSO Opex. ERO's benchmarking analysis has compared KEK DSO staff levels relative to the length of the network with Middle-Eastern distribution companies and presented this analysis in the following Figure:

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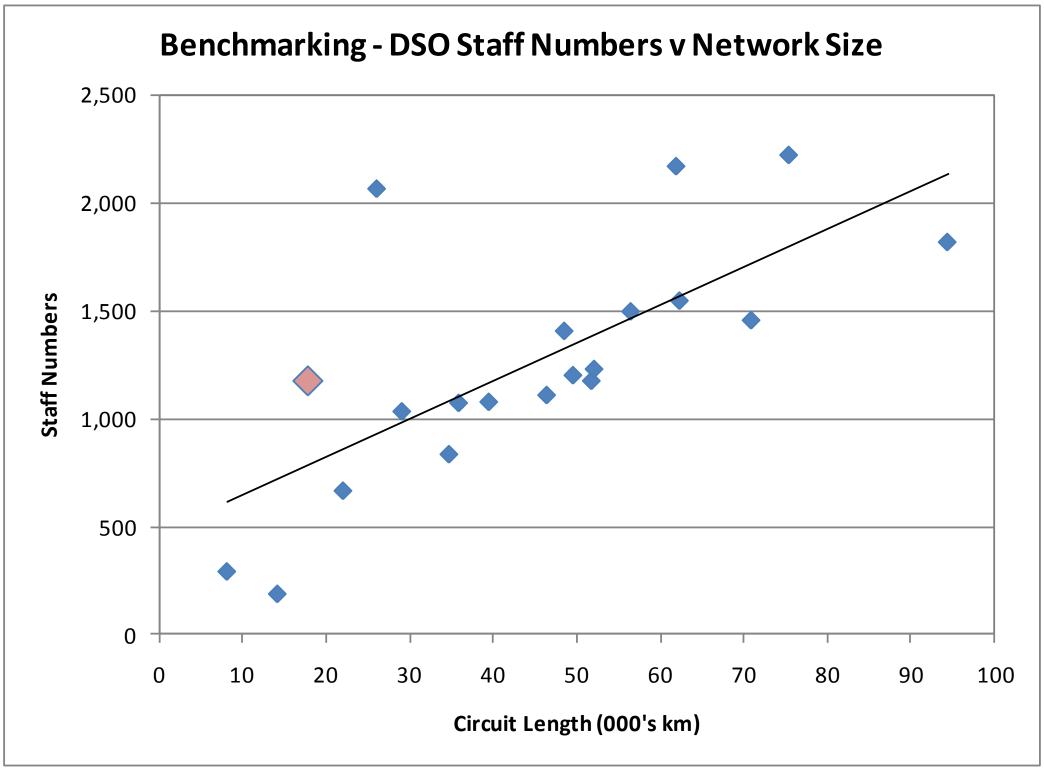

The benchmarking data taken into account suggest that DSO number of staff compared to the circuit length is higher than other international comparators. SKM have proposed holding the staff numbers at 2012 levels throughout the period and ERO considers this appropriate for the purposes of determining an appropriate allowance for salary costs.

3.2 Salary and related costs

The DSO have forecasted a yearly increase in average salaries of 5% in real terms. There is no corresponding staff numbers as the DSO proposes to freeze staff numbers throughout the Regulatory Period. The DSO suggests this is being done to increase the costs per employee above the Harmonized Index of Commodity Prices (HICP) for the period of 2008-2011 of 5.4%, which is broadly in line with Kosovo CPI.

ERO sees no justification for real terms increases in salary costs and in setting the allowance for the forthcoming period proposes to keep salaries at 2012 levels.

3.3 Repairs and Maintenance

Subsequent to the initial submissions DSO provided details of maintenance and repairs historic and forecast volumes in response to SKM's request, but were not able to provide units costs associated with the O & M activities. This was explained as being due to the fact that KEK do not undertake any sort of activity based costing.

The forecast, as presented, is a 4% year on year increase from the allowed expenditure for 2012. The rationale for this percentage increase in costs is linked to DSO's forecast growth in network size of 4% each year. SKM's modelling of the network capex suggests that the average load-related expenditure on the network of €9.2 m is equivalent to a 1.5% annual increase in network size, rather than the 4% assumed by DSO

The unit cost for each of these R&M (Repair and Maintenance) activities is not available from the present KEK accounting systems and further information was not available from KEK that would have allowed further quantitive analysis of the submission. As presented they do not support an increase of 4% per year. ERO therefore proposes to allow the 2012 expenditure throughout the 5 year MYT with an increase of 1.5% each year to account for growth in asset size.

3.4 Other controllable opex

ERO's assessment of the other DSO itemised categories of opex covered the following line items:

- Fuel;
- Other Expenses

It was observed that these line items were forecast by KEK to increase year-on-year from the estimated 2012 value, with the percentage increase being linked to the forecast increase in customer numbers.

ERO notes that these costs will be largely dependent on staff numbers as opposed to customer numbers. As KEK DSO do not forecast any increase in staff numbers over the Regulatory Period and ERO therefore recommends these allowances be held at 2012 levels.

3.5 ERO's Provisional Evaluation of DSO's Opex Proposals

For KEK DSO activities, the recommended reduction in controllable costs is €10.3m over the period, representing 12% of the total controllable costs.

ERO provisional evaluation of DSO's controllable opex	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	2017 € 000's	Total € 000's
DSO's proposed controllable opex	15,935	16,689	17,454	18,090	18,799	86,967
ERO's proposed controllable opex	15,177	15,250	15,234	15,399	15,476	76,626
Difference (€ 000's)	-758	-1,439	-2,220	-2,691	-3,323	-10,341
Difference %	-5%	-9%	-13%	-15%	-18%	-12%

4 Provisional Evaluation of PES's proposed Capital Expenditures

KEK's PES business is not asset-intensive and the Company's proposed capital expenditures are not significant. The proposed amount is in line with historic expenditure levels. SKM has proposed that the proposed expenditures are allowed in full, and ERO has accepted this recommendation in making its provisional evaluation. The proposed capex is shown in the table below.

KEK PES – Proposed Capex	Annual capex (€)
Computers for customer care department	50,000
Supply printers for billing	35,000

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Printers for cash desk	40,000
Supply with photocopying apparatus	20,000
Vehicles	250,000
Total Annual Capex	€ 395,000

5 Provisional Evaluation of PES's proposed Operating Expenditures

The final KEK submission, dated 23-11-2012, included a total PES opex request of €528.8 m (including HQ allocation) and is detailed within Appendix B. The main areas of PES operating cost are:

PES Proposed Opex	2013-2017 €m
Salary costs	46.0
Electricity Purchases & transmission charges	454.0
Depreciation	6.6
Maintenance and Repair	3.3
Other costs	19.0
Total	528.9

5.1 Staffing levels

The Company's submission proposes to maintain PES staff at present levels of 1,380. There are 32 retirements scheduled over the 5 year MYT tariff period which are not factored into the forecast staff numbers.

The increase in customer numbers each year (~3%) should act as a driver for increasing PES staff numbers. KEK's plan to fix headcount at existing levels therefore has an implied built-in efficiency of 3%.

5.2 Salary and related costs

In the light of the PES staffing levels, ERO, in setting an allowance for salary costs, proposes to hold expenses in this category at 2012 levels.

5.3 Other controllable opex

The KEK PES submission proposed "Other Controllable Opex" under the following line items, and are shown here along with their proposed annual percentage increase in costs:

Category	2012 € 000's	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	2017 € 000's
Fuel	540	567	591	611	631	648
Repairs & Maintenance	282	296	309	319	330	338
Materials and Supplies	310	326	339	351	363	372

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Other Expenses	1,640	1,723	1,796	1,856	1,918	1,968
Annual % increase	N/A	1.055	1.042	1.034	1.033	1.016

Similar to the KEK DSO approach, it was observed that these line items were forecast by KEK to increase year-on-year from the estimated 2012 value, with the percentage increase being linked to the forecast increase in customer numbers.

As with the other controllable costs, ERO concurs with SKM that these costs will be largely dependent on staff numbers as opposed to customer numbers. As KEK PES do not forecast any increase in staff numbers over the 5-year MYT period and ERO therefore proposes that these allowances be held at 2012 levels.

5.4 ERO's Provisional Evaluation of PES's Opex Proposals

KEK has foreseen that these costs should increase yearly due to the increase in customer numbers.

The KEK submitted costs for each year, together with their proposed annual percentage increase in costs are shown in the table below:

For KEK PES activities, the recommended reduction in controllable costs is €9.7m over the period, representing some 14% of the total controllable costs.

ERO provisional evaluation of PES's controllable opex	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	2017 € 000's	Total € 000's
PES proposed controllable opex	13,044	13,699	14,355	14,875	15,481	71,454
ERO's proposed controllable opex	12,337	12,337	12,337	12,337	12,337	61,684
Difference (€ 000's)	-707	-1,362	-2,018	-2,538	-3,114	-9,770
Difference %	-5%	-10%	-14%	-17%	-20%	-14%

6 Other Regulatory Parameters

6.1 Loss Allowance

ERO has set the level of losses to be recovered through regulated tariffs based on ERO's Decision 399 of 6 February 2012. In doing so ERO has reduced the 2011 allowed level of losses by 3% (percentage points) to 27.4%.

6.2 Loss Sharing Factor

The loss sharing factor has been set in accordance with ERO's Decision 399 of 6 February 2012 at 0%. The implication of this is that any potential benefits or losses that may be gained by reducing losses by more or less than ERO's target are borne by the DSO.

6.3 Efficiency Factor

The efficiency factor for the first three years of the Regulatory Period has been set according to ERO's Decision 399 of 6 February 2012 at 0%. ERO proposes that the efficiency factor for the final two years of the Regulatory Period is set at 5% per year.

6.4 WACC

The Weighted Average Cost of Capital for the DSO has been set according to ERO's Decision 399 of 6 February 2012. According to that Decision, the WACC applicable to the DSO for the next Regulatory Period should be 12% (real, pre-tax).

7 Provisional MARs 2013-2017

The provisional MAR for the DSO division of KEK which includes O&M costs, depreciation, allowed return and purchase of losses is summarized in the following table:

Provisional Evaluation of MARs for DSO licensed businesses	2013 €m	2014 €m	2015 €m	2016 €m	2017 €m	Total €m
Total	73.9	72.8	71.9	69.5	69.2	357.3

The provisional MAR for the PES division of KEK which includes O&M costs, depreciation, retail margin, working capital and allowed bad debts is summarized in the following table:

Provisional Evaluation of MARs for PES business	2013 €m	2014 €m	2015 €m	2016 €m	2017 €m	Total €m
Total	32.3	32.5	30.5	30.9	32.2	158.5