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

Consultation Paper

The Seventh Electricity Tariff Review

ETR7 (2013-2016)

Provisional Evaluation – KEK Generation 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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Adresa: Rr. Dervish Rozhaja Nr. 12, 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

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. KEK 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. KEK has since submitted substantial additional data and justification.

In line with its published Pricing Rules, ERO must set out and consult upon its proposals on the Maximum Allowed Revenues (MARs) 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. ERO must set a MAR for each of the Generation, Distribution System Operator (DSO) and Public Electricity Supply (PES) businesses. As the Government has signed agreements with a private sector investor for the sale of Kosovo Electricity Distribution and Supply business, ERO has chosen to present its Provisional Evaluation for generation separately from that of distribution and supply.

It is also important to note that, although ERO does not regulate KEK's Mining Division, it must set a value on the cost of coal, which forms part of the cost of electricity generation. In the future, it may be that the price of coal will be set by a lignite supply agreement, but at present no such agreement is in force. In order to review the existing price of coal charged between the mining and generation divisions of KEK, ERO has asked consulting engineers EIHP to examine the cost of coal production by the mining division, as well as the cost of generation. ERO has taken their report into account in its Provisional Evaluation.

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 Assumed Lignite Supply Costs

Section 3 – Provisional Evaluation of KEK Regulated Generation

Section 4 – Other Regulatory Parameters

Section 5 – Provisional MARs 2013-2017

2 Provisional Evaluation of Assumed Lignite Supply Costs

ERO's Generation Pricing Rule states that in the absence of a lignite supply agreement, ERO must set an assumed lignite supply cost to recover the costs of lignite supply to the regulated generators, Kosovo A and Kosovo B. The Rule further states that the assumed lignite supply costs "shall be calculated in the same way as the other reasonable costs of the Regulated Generator, comprising assumed depreciation, assumed return on capital, and assumed reasonable operating and maintenance costs." In this section, ERO comments on its assessment of the stated operating and capital costs of KEK's mining business.

2.1 KEK Mining Division's CAPEX Proposals

On 19th October 2012 ERO issued a consultation document (the "October Consultation") setting out its understanding of KEK's submission to date and asking for additional clarification and justification. In particular, ERO asked KEK to explain the capital projects described in its August submission. The capital projects planned in the period are described in Annex A, together with a technical assessment of KEK's justification for the projects.

In addition to planned projects for the forthcoming control period, 2013-2016, KEK's submission contained a number of projects for 2012. During the ETR6 review, KEK had requested a capital allowance of €28 million which had been fully allowed by ERO. These 2012 projects are itemised in *table a* below:

Table a – Mining Division Capital Projects Underway 2012

KEK's proposed capital projects for Mining Division	2012 €000s	2013 €000s	2014 €000s	2015 €000s	2016 €000s	Total €000s
Projects carried over from 2012						
Carry over of 2011 contracts from loans						
Stacker reclaimer*						
Auxiliary equipment*						
Expropriation costs – Hade Village*						
Total 2012 capital projects carried over	**28,000**					**28,000**

KEK has now provided information to justify these as necessary projects. However, it should be noted that the three projects annotated with "*" in *table a* above require further investigation before their inclusion in the 2013-2016 MAR calculation can be confirmed. Provisionally, ERO has included these costs in the MAR calculation, but will require KEK to provide evidence that there is no double-counting between the ETR6 capital allowance and those realized. It also notes that these expenditures should have been properly planned and their need and cost justified in ETR6.

Provisional Evaluation – KEK Generation Detail

Table b below shows capital projects planned by KEK's Mining Division for the period of the new control, 2013-2016:

Table b – Mining Division Proposed Capital Projects 2013-2016

Projects for 2013-2016		2013 €000s	2014 €000s	2015 €000s	2016 €000s	Total €000s
Returning Stations						
Renovation of combined machines A&B						
Heavy machines						
Repair of two excavators / 2 compact excavators						
Wardrobe Building						
Double conveyor belts						
Remote system						
Total Capital Expenditure Projects 2013-2016		15,827	63,500	62,000	19,000	**160,327**
Total Capital Expenditure (all years)	**28,000**	**15,827**	**63,500**	**62,000**	**19,000**	**188,327**

2.2 ERO's Provisional Evaluation of KEK Mining Divisions's Capex Proposals

Table 7 of the EIHP report in Annex 1 shows the capital projects proposed by KEK's Mining Division. EIHP has examined the proposed capital expenditure levels and recommended some reduction in cost to be allowed by ERO

2.2.1 Stacker reclaimer

KEK have advised that a capital overhaul of the Stacker Reclaimer is required. This was originally planned for 2012, but this has been deferred to 2013, synchronised with the Kosovo B capital overhaul. The original budget was higher. however KEK have now received lower firm bids and ERO has therefore adjusted the cost down by €0.7 million.

2.2.2 Auxiliary Equipment

KEK has procured a number of capital items under this heading to modernise its stock of auxiliary equipment, including bulldozers, trucks, dumpers, excavators, loaders, fork-lifters, mini-buses and Land Rovers. This investment of €3 million has already been made and the corresponding equipment has been put in service.

2.2.3 Expropriation Costs – Hade Village

Relocation of the inhabitants of Hade Village is required to allow the necessary expansion of the mine. Resettlement costs have been estimated at €8 million, a cost

which is effectively out of KEK's control, and is based on a document produced by Ministry of Environment and Spatial Planning.

2.2.4 Returning Stations

These are turning stations that need to be assembled in the coal conveyor belt of south-west Sibovc and ERO is satisfied that the investment is required and that this is reasonable.

2.2.5 Renovation of Combined Machines A&B TC – B

KEK have stated that it is necessary to repair these machines to ensure supply coal to Kosovo B station Insufficient detail has been put forward by KEK to justify this cost. For the purposes of the Provisional Evaluation, ERO has included this allowance. However, unless substantive information is received to explain the requirement for this item and to justify its cost, ERO may disallow this sum in its Final Evaluation.

2.2.6 Heavy Machines

KEK proposes to replace outdated heavy machines and equipment. Again, insufficient detail has been put forward by KEK to justify this cost. For the purposes of the Provisional Evaluation, ERO has included this allowance. However, unless substantive information is received to explain the requirement for this item and to justify its cost, ERO may disallow this sum in its Final Evaluation.

2.2.7 Repair of two excavators

KEK believes that two new compact excavators and self propelling conveyor belts are required for the Sibovc mine to ensure a continuous supply of coal to Kosovo A and B stations. However, KEK has advised ERO and its consultants that actual bids received by KEK are some €15 million below the estimated sum originally requested by the Company. ERO therefore proposes to allow this capital purchase in line with the received bids.

2.2.8 Double conveyor belts for SWS

KEK believes that two new double conveyor belts are required for the Sibovc mine to ensure a continuous supply of coal to Kosovo A and B stations. Insufficient detail has been put forward by KEK to justify this cost. For the purposes of the Provisional Evaluation, ERO has included this allowance. However, unless substantive information is received to explain the requirement for this item and to justify its cost, ERO may disallow this sum in its Final Evaluation.

2.2.9 Other capital costs

KEK has planned three other capital projects for the new control period: a new wardrobe building and a remote control system,. ERO considers that these two items

have been adequately justified and that the costs are reasonable and proposed to allow these items in full.

2.2.10 ERO's Provisional Evaluation of KEK Mining Divisions Capex Proposals

ERO's provisional evaluation of the mining capital costs which will form part of the assumed cost of lignite supply, to be funded through the generation MAR, are shown in *table c* below.

Table c – Mining Division Capital Expenditures

Table C below revised

ERO Provisional Evaluation of KEK Mining Division capital expenditure requirement (excluding grants)	2012 € 000's	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	Total € 000's
KEK Proposed capex	28,000	15,827	63,500	62,000	19,000	188,327
ERO Provisional Evaluation	27,300	15,827	57,500	53,000	19,000	172.627
Difference (€ 000's)	-700	0	-6,000	-9,000	0	-15,700
Difference (%)	-3%	0%	-9%	-15%	0%	-8%

2.3 KEK Mining Division's Opex Proposals

In its submissions, KEK put forward its proposed central or headquarters operating costs, which ERO will allocate across the licensed businesses.

Some of the costs put forward are non-controllable, such as taxes. Others are controllable. ERO has reviewed KEK's controllable cost forecasts with the support of consulting engineers. In the case of the following costs, ERO does not find KEK's forecast cost levels fully justified

2.4 ERO's Provisional Evaluation of KEK Mining Divisions's Opex Proposals

2.4.1 Reallocation of HQ costs

In its submission KEK presented its operating costs under a number of headings: salary costs, electricity and other utilities, maintenance, materials and supplies, provisions for environmental issues, other operating expenses and internal expenses. It allocated these costs not only to the licensed activities but also to KEK corporate Headquarters. In regulatory terms, however, all these costs must be allocated to licensed activities in order that they can be recovered through an appropriate MAR. ERO has therefore adjusted the submitted costs. In making the adjustment, ERO has used KEK's apportionment of costs in 2012, and applied these forewards. The evaluation below is on the adjusted costs.

2.4.2 Staffing Levels

KEK has stated that its staffing levels in the mine will reduce from 3,177 in 2012 to 2,891 by the end of 2017. This is largely driven by retirements.

ERO is of the view that these staffing levels may well be capable of further reduction and that the business should be capable of improving its productivity. In setting the Efficiency Factor for KEK Generation it intends to incentivise the company to seek improvements in productivity.

2.4.3 Salary and related costs

KEK has proposed a 5% annual increase in real-terms salaries across the company over and above inflation. ERO sees no justification for such real-terms increases, particularly at the low productivity levels evidenced by KEK. It is for KEK's management to set salary levels, but it will need to find savings elsewhere in the business, without affecting performance. ERO therefore proposes that salary costs for KEK's mining division should remain at 2012 levels in setting the assumed cost of lignite.

2.4.4 Repairs and Maintenance

The historic repairs and maintenance costs of KEK have shown no regular pattern, and the forecast levels of maintenance and repair are equally variable. KEK have not provided any clear justification for the forecast amounts. In the light of this uncertainty, ERO has proposed to set the forecast maintenance allowance at the level of average costs of €1033 / 000t of coal.

2.4.5 Electricity and other Utilities

In respect to electricity and other utilities costs, KEK has reported costs in two categories: fuel, and gas and water costs. These costs are ancillary to the mining activity, and annual sums incurred can be expected to vary with the quantity of coal excavated. However, the unit cost of these services expressed per 000t of coal is expected to remain constant over the years.

KEK's submission in respect of fuel showed rising costs which the Company explained as resulting from the rising unit cost of fuel, forecasting a step increase of 12% from €321/000t of coal in 2012 to €363/000t of coal in 2013, and then increasing with varying magnitudes in unit costs through to 2016. No clear argument was supplied by KEK to support this step increase in unit fuel costs in 2013, nor to support the future variable pattern in fuel price movements. ERO has therefore retained the 2012 value of €321/000t of coal for the control period, recognizing that, as with other costs these will be adjusted throughout the control period to take account of actual

inflation. This reduces KEK's forecast fuel costs by €2.4 million for the 2013-2016 period.

KEK's proposed gas and water unit costs are forecast to be a flat €24.10/000t of coal in 2013-16 over the forthcoming regulatory period which is slightly higher than historic unit costs reported, although historic values reported have shown unexpected variations. ERO would expect that the unit costs would remain fairly stable, while the cost would vary with the quantity of coal produced. ERO has assumed a value of €24/000t of coal which is an average value for 2008-2011 period. The result is a minor downward adjustment of approved gas and water costs of €3000 for the 2013-2016 regulatory period.

2.4.6 Other operating expenses

Under "other operating expenses" KEK has total forecast costs of €139,775 million in the period 2013-2016. Of this sum, €103,152 or 74% represents the non-controllable lignite royalty which must be paid by KEK to Government. The remaining 26% comprises transport of personnel to and within the mine, security, reallocation of headquarters' costs, licences and "other". The "other" category was revealed to represent the cost of lubricants, diesel, gasoline and chemicals and gases, which form a considerable cost at €10,424,000 over the period 2013 to 2016.

2.4.7 Transport

KEK have forecast a steadily increasing cost of transport services, which represents the cost of moving personnel around within the mine, as well as conveying them to and from the mine itself. KEK's forecast shows a real increase in transport services of some 22% over the period between 2013 and 2016 at a time when staff numbers are reducing. KEK have not provided any justification for this increase, and ERO concludes that it would be more appropriate to assume a zero increase from the €115,000 value put forward for 2013.

2.4.8 Security Costs

KEK have forecast annual security costs in the same amountt as the previous year at. Given the physical extent of the mines, ERO does not consider this sum unreasonable and proposes to allow it in full as part of the assumed lignite supply cost.

2.4.9 ERO's Provisional Evaluation of KEK Mining Division's Opex Proposals

The table below summarises the total Mining operating expenditures proposed by KEK for the period 2013 to 2016, together with ERO's proposed evaluation of those same expenditures for the purposes of calculating the assumed lignite supply costs for regulated generation. It should be noted that the table below excludes efficiency

and the Lignite Royalty which is a major and non-controllable operating cost to give a truer picture of Mining opex.

Table d – Mining Division Operating Expenditures

ERO Provisional Evaluation of KEK Mining Division operating expenditure	2013	2014	2015	2016	Total 2013-2016
	€ 000's	€ 000's	€ 000's	€ 000's	€ 000's
KEK Proposed opex	46,115	47,540	48,653	49,237	191,545
ERO Provisional Evaluation	42,221	41,992	41,460	41,040	167,714
Difference (€ 000's)	-3,894	-5,548	-7,193	-8,197	-23,831
Difference (%)	-8%	-12%	-15%	-17%	-12%

2.4.10 Assumed Return on Capital

ERO must, in calculating the assumed lignite supply costs to be allowed as part of the Generation MAR, make an assumption about an appropriate return on capital for the mining activity.

ERO has set the Weighted Average Cost of Capital for Mining based on previous evaluations of required Return on Equity, actual cost of debt financing and actual gearing level (subject to gearing restrictions given in ERO's previous discussions on WACC).

ERO initially assumed a commercial return on equity for all regulated companies in the sector. ERO further sought guidance from the government as to the level of return on equity that the government might require as the sole owner of publicly owned companies. The government has indicated that they will consider a lower return from operators in the public ownership compared to a return that might be expected by a private owner. ERO's provisional evaluation therefore is that a level of 8.0% post-tax return on equity is appropriate for publicly owned companies. ERO has therefore used this return on equity in evaluating the Mining division's WACC.

The resulting WACC for Mining is set at 5.50% (real, pre-tax).

2.4.11 ERO's Provisional Evaluation of Assumed Lignite Supply Costs

The Assumed Lignite Supply Costs are summarized in the following table:

Provisional Evaluation of MARs for KEK's Mining businesses	2013 (€m)	2014 (€m)	2015 (€m)	2016 (€m)	Total (€m)
Mining	89.3	89.9	92.0	92.6	363.8

3 Provisonal Evaluation of KEK Regulated Generation

3.1 Kosovo A - Proposed Capex

The capital projects planned for Kosovo A in the period are described in Annex A, together with a technical assessment of KEK's justification for the projects.

In addition to planned projects for the forthcoming control period, 2013-2016, KEK's submission contained a number of projects for 2012. KEK has now provided information to justify these as necessary projects, although ERO notes that these costs should have been justified as part of the ETR6 process. ERO will need further information from KEK to be satisfied that there is no double-counting between ETR6 allowance and these proposals for the 2013-2016 MAR. For the present, ERO has included these in the new MAR calculation. These 2012 projects for Kosovo A are itemised in *table e* below.

Table e – Kosovo A Ongoing Capital Projects

KEK's proposed capital projects for Generation Kosovo A	2012 €000s	2013 €000s	2014 €000s	2015 €000s	2016 €000s	Total €000s
Projects carried over from 2012						
Capital overhaul Unit A3						
Hydraulic Ash Transporter						
Electrostatic Precipitator Unit A5						
Electrostatic Precipitator Unit A3						
Transformer Unit A3						
Environmental monitoring equipment						
Air Compressors A units						
Total 2012 capital projects carried over	**40,417**					

In addition, *Table f* below shows capital projects for Kosovo A planned by KEK's Generation Division for the period of the new control, 2013-2016:

Provisional Evaluation – KEK Generation Detail

Table f – Kosovo A Proposed Capital Projects 2013-2016

Projects for 2013-2016	2012 €000s	2013 €000s	2014 €000s	2015 €000s	2016 €000s	Total €000s
TCA-2620 Running meters & high rise fencing gates						
Surveillance cameras						
New fire engine						
Capital Refurbishment Unit A4						
New Electrostatic filters Unit A4						
Air compressors - TCA						
Boiler Supply Pump Unit A3						
Boiler Supply Pump Unit A4						
Installation of water coolers Units A3, A4, A5						
Capital overhaul of unit A5						
Annual refurbishment Units A3 and A4						
Annual refurbishment Units A3, A4, A5						
Annual refurbishment Units A3, A4, A5						
Total Capital Expenditure Projects 2013-2016		**22,861**	**19,530**	**12,750**	**10,000**	**65,141**
Total Capital Expenditure (all years)	**40,417**	**22,861**	**19,530**	**12,750**	**10,000**	**105,558**

3.1.1 Capital Overhaul Unit A3

The capital overhaul of Unit A3 planned for 2012 was initially estimated very low . During the review period, KEK has contracted various companies to carry out the necessary works, according to the items presented that are contracted for each activities data show an increase .

According to information received from KEK, the capital overhaul is going to be completed by the end of year 2012. The works encompass repairs on the steam turbine, electro-generator and the boiler.

3.1.2 Hydraulic Ash Transport Kosovo A

The new Hydraulic Ash Transport System for Kosovo A is necessary in order to stop the practice of transporting ash on an open conveyor to an ash pile that is not covered. It will significantly contribute to alleviation of the dust emission problems in nearby communities. The new system will allow ash to be mixed with water and transported by pipe to a depleted section of the mine.

The project is planned for year 2012. The same project has been completed for Kosova B. Expected investment cost is found to be reasonable.

3.1.3 TCA - 2620 Running meters (Inclusive of 4 High-rise fencing gates)

KEK has proposed to erect fencing is necessary to divide and protect real estate property of Power plant Kosovo A from the neighboring Coal divisions. KEK have provided details of the specification and justification for this cost,. ERO considers this reasonable and proposes to allow this cost in full.

3.1.4 Surveillance Cameras

KEK proposes to install security cameras intended to monitor the Kosovo A power plant facility installed at 60m intervals on the new security fencing ERO considers this reasonable and proposes to allow this cost in full.

3.1.5 New Fire engine for Generation

KEK intends to purchase a new fire engine with a 40m ladder as the existing equipment cannot reach high enough. ERO considers this reasonable and proposes to allow this cost in full.

3.1.6 Capital Refurbishment Unit A4 and A5

KEK must undertake a capital overhaul of Unit A4 in 2013, and Unit A5 in 2014 because maximum operating hours have been reached on this Unit. KEK will carry out works on both the turbo-generator and boiler as part of a package. EIHP have recommended holding KEK to the original estimate.

ERO is satisfied that these overhauls will bring benefits of increased equipment safety and functionality, increased efficiency and unit availability, as well as increased staff safety and ERO proposes to allow a total for both Unit A4 and Unit A5.

3.1.7 Refurbishment Units A3, A4

KEK plans to carry out capital repairs on Units A3 and A4 in 2014 during the units' annual outages in order to maintain their operating performance and sustainability. ERO considers this reasonable and proposes to allow this cost in full.

3.1.8 Refurbishment Units A3, A4, A5

During the annual outages of 2015 and 2016, KEK similarly plans to carry out capital repairs and refurbishment on the all three of the operating units of Kosovo A. In their submission to ERO, KEK have estimated that the total annual cost. ERO accepts the rationale for carry out these annual works, but can see no justification for an increase in unit cost in real terms. ERO therefore proposes to allow a cost of €2.5 million lower than the one requested from KEK for the three units in each of years 2015 and 2016.

3.1.9 New Variable Speed Boiler Supply Pumps, Unit A3, A4

KEK advise that the feed pumps serving the boilers in Unit A3 and A4 require replacement with variable speed supply pumps. KEK estimated a higher cost for this capital purchase.

However, during discussions with KEK it is clear that this item has previously been procured at a cost of lower cost, and ERO proposes to allow realized costs.

3.1.10 ERO's Provisional Evaluation of Capex for Kosovo A

ERO's provisional evaluation for Kosovo A capex is set out in *table g* below.

Table g – Kosovo A Provisional Evaluation of Capital Projects

ERO provisional evaluation of capex for Kosovo A	2012	2013	2014	2015	2016	Total
	€ 000's	€ 000's	€ 000's	€ 000's	€ 000's	€ 000's
KEK's requested capex	40,417	22,860	19,530	12,750	10,000	105.557
ERO's proposed capex	40,417	22,118	16,760	9,260	7,500	96,055
Difference (€ 000's)	0	-0,742	-2,770	-3,490	-2,500	-9.502
Difference %	0%	-8%	-14%	-27%	-25%	-10%

3.2 Kosovo A Proposed Opex

3.2.1 Reallocation of HQ costs

ERO has reallocated headquarters costs for Kosovo A in the same manner as described for Mining Division in section 3.2.1 above.

3.2.2 Staff Costs

In its calculations KEK has assumed a 5% growth in unit employee costs for Kosovo A station over and above the cost of inflation. ERO seems no justification for this increase in staff costs in real terms. It therefore proposes to allow for salary costs to stay stable at 2012 levels for the period of the control.

3.2.3 Electricity and Other Utilities

KEK forecast expenditure of some €30 million over the period 2013-2016 on "Electricity and other utilities" for Kosovo A, a cost item which consists of: fuel cost (not including cost of coal), cost of lubricant and other chemicals, and costs related to transmission of electricity.

Cost of fuel, which refers to the cost of heavy fuel oil is obtained as a multiple of projected unit costs of fuel oil and expected quantities of fuel oil to be used. EIHP have examined the assumptions behind these values and considers that they are reasonable. ERO therefore proposes to allow these amounts in full.

3.2.4 Maintenance Costs

Maintenance category consists of repairs service and maintenance service items. For the observed regulatory period repairs services are not foreseen. The licensee has

envisaged only maintenance services with the growing unit cost trend, expressed per MWh of generated electricity.

EIHP has adjusted downward the requested amount, assuming standardized cost of €0.92/MWh of generated electricity, the value achieved during year 2011. ERO considers this adjustment appropriate, and maintenance costs are therefore adjusted downwards by €3.35 million.

3.2.5 Materials and supplies costs

Material and supplies costs have been estimated by KEK at €4.85 million for 2013-2016 period. EIHP believes materials and supplies unit costs should be constant in real terms, expressed as €/MWh. Given that unit cost has varied substantially in the last two years precedeeing the regulatory period, EIHP has used an average value for 2010-2011 period which equals €0.673 per MWh of generated electricity. Consequently, this item has been adjusted downwards by €0.4 million.

3.2.6 Other Operating Expenses

Under "other operating expenses" for Kosovo A KEK has total forecast costs of €11.4 million in the period 2013-2016. This comprises reallocation of headquarters' costs, costs of security, licences and "other" expenses.

Regarding ***allocation of HQ costs***, these have been adjusted downwards, following the same approach used for other licensees.

Security costs have been requested at the level of €0.4 million/year for the whole of regulatory period, and is equal to the value estimated for 2012.

Licensee costs

KEK have forecasted a varying level of cost to cover "licences". ERO proposes to review its approach on setting licence fees early in the New Year, once the new annual budget has been passed by the Assembly and will set an appropriate allowance at that time.

Other expenses have been adjusted downwards using average value for 2011-2012 period, i.e. €396,000 /year.

Overall, adjusted *other operating expenses* are lower by €1.3 million than the amount requested by KEK in its submission.

3.2.7 ERO's Provisional Evaluation of KEK Kosovo A Opex Proposals

The table below summarises the total operating expenditures proposed by KEK for Kosovo A for the period 2013 to 2016, together with ERO's proposed evaluation of

those same expenditures. It should be noted that the table below excludes the internal cost of coal which is paid by Kosovo A to the Mining Division.

Table h – Provisional Evaluation of Kosovo A Opex

ERO provisional evaluation of opex for Kosovo A	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	Total € 000's
KEK's requested opex	20,664	21,084	21,375	21,424	84,547
ERO's proposed opex	19,272	18,985	18,783	18,561	75,602
Difference (€ 000's)	-1,392	-2,099	-2,592	-2,863	-8,945
Difference %	-7%	-10%	-12%	-13%	-11%

3.3 Kosovo B - Proposed Capex

The capital projects planned for Kosovo B in the period are described in Annex A, together with a technical assessment of KEK's justification for the projects.

In addition to planned projects for the forthcoming control period, 2013-2016, KEK's submission contained a number of projects for 2012, shown in *Table h* below. However as described in Section 2.1 above, it is not clear that the proposed projects does not contain an element of double counting in relation to the ETR6 capital allowance. As with the mining capex, ERO has provisionally allowed these projects, but reserves the right to disallow them in all or part if KEK does not adequately demonstrate that these projects are not covered in ETR6.

Table i – Kosovo B Ongoing Capital Projects

KEK's proposed capital projects for Generation Kosovo B	2012 €000s	2013 €000s	2014 €000s	2015 €000s	2016 €000s	Total €000s
Projects carried over from 2012						
Capital Overhaul Unit B1						
Circuit Breakers Units B1 and B2						
Variable speed drives for B Units						
Rotors for boiler pumps for B Units (4)						
Electric Motors for B Units						
Unforeseen/Unplanned work						
Total 2012 capital projects carried over	**27,570**					

In addition, *table j* below shows capital projects for Kosovo B planned by KEK's Generation Division for the period of the new control, 2013-2016:

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Table j – Kosovo B Proposed Capital Projects 2013-2016

Projects for 2013-2016	2012 €000s	2013 €000s	2014 €000s	2015 €000s	2016 €000s	Total €000s
TCB-2550 Fencing & high rise fencing gates						
Surveillance cameras						
New fire engine						
High pressure cylinders, milling system & others						
New outer casing high pressure turbine Unit B1						
Five year overhaul Unit B1						
Five year overhaul Unit B2						
Modernisation of coal milling and transport system						
Total Capital Expenditure Projects 2013-2016						**56,072**
Total Capital Expenditure (all years)	**27,570**	**15,072**	**4,000**	**22,000**	**15,000**	**83,642**

3.3.1 TCB - 2550 Fencing (Inclusive of 4 High-rise fencing gates)

As with the site of Kosovo A, KEK also proposes to erect fencing is necessary to divide and protect real estate property of Power plant Kosovo B from the neighboring Coal divisions. KEK have provided details of the specification and justification for this cost, ERO considers this reasonable and proposes to allow this cost in full.

3.3.2 Surveillance Cameras

KEK proposes to install security cameras intended to monitor the Kosovo B power plant facility installed at 60m intervals on the new security fencing. ERO considers this reasonable and proposes to allow this cost in full.

3.3.3 New Fire engine for Generation

As with Kosovo A, KEK intends to purchase a new fire engine for Kosovo B Station with a 40m ladder as the existing equipment cannot reach high enough.ERO considers this reasonable and proposes to allow this cost in full.

3.3.4 Opening of High Pressure Cylinders and others

In the last version of templates received this item was broken down into "Modernizimi I transmisionit te sistemit te mullinjeve (16 mullinje)" and "KF, oxhaku, dhe tjera". Given that no official translation was provided, EIHP believes first item refers to the replacement of 16 mills. 5 mills have been already replaced and this cost has been incurred. EIHP did not find enough supporting evidence for the replacement of additional 11 mills. Without further justification for the additional

expense, ERO proposed to allow only costs for which supporting data has been provided.

A second item, "KF, oxhaku, dhe tjera" refers to the refurbishment of common systems (cooling towers, chimney, chemical water treatment). This amount was found reasonable, and ERO proposed to allow this amount in full.

3.3.5 New Outer Casing for High Pressure Turbine, Unit B1

The high pressure turbine casing for Unit B1 is cracked and its operation in this condition is considered unsafe. The turbine is an Alstom turbine and the casing must be designed and built by that company. There is a 12 month lead time. Alstom's estimate has now been received and ERO therefore proposes to allow this cost, but at the reduced estimate value of €1 million.

3.3.6 Capital Refurbishment, Unit B1

KEK proposes to carry out its 5 year overhaul of Units B2 (2015) and B1 (2016) during the forthcoming control period. The works will include overhauls of the units' steam turbine, electro-generator and boiler. EIHP have advised that this includes items which it does not consider need to be purchased new by a prudent operator (e.g. unit door for B1 and B2). ERO has therefore reduced KEK's allowance for these capital items by €2 million for each overhaul,.

3.3.7 ERO's Provisional Evaluation of Capex for Kosovo B

ERO's provisional evaluation for Kosovo B capex is set out in *table k* below.

Table k – Provisional Evaluation of Kosovo B Capex

ERO provisional evaluation of capex for Kosovo B	2012 € 000's	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	Total € 000's
KEK's requested capex	27,570	15,072	4,000	22,000	15,000	83,642
ERO's proposed capex	17,343	11,572	2,500	13,000	13,000	57,415
Difference (€ 000's)	-10.227	-3.500	-1.500	-9.000	-2.000	-26,227
Difference %	-37%	-23%	-38%	-41%	-13%	-31%

3.4 Kosovo B Proposed Opex

3.4.1 Reallocation of HQ costs

ERO has reallocated headquarters costs for Kosovo B in the same manner as described for Mining Division in section 3.2.1 above.

3.4.2 Staff Costs

As with Kosovo A and other licensed activities, KEK has assumed a 5% growth in unit employee costs over and above the cost of inflation. ERO seems no justification for this increase in staff costs in real terms. It therefore proposes to allow for salary costs to stay stable at 2012 levels for the period of the control for Kosovo B.

3.4.3 Electricity and Other Utilities

KEK forecast expenditure of some €26 million over the period 2013-2016 on "Electricity and other utilities" for Kosovo B, a cost item which consists of: fuel cost (not including cost of coal), cost of lubricant and other chemicals, and costs related to transmission of electricity.

Cost of fuel, which refers to the cost of heavy fuel oil, is obtained as a multiple of projected unit costs of fuel oil and expected quantities of fuel oil to be used. EIHP have examined the assumptions behind these values and considers that they are reasonable. ERO therefore proposes to allow these amounts in full.

ERO has adjusted KEK's forecast of electricity transmission costs down by €0.9 million, assuming constant unit cost of transmission of electricity of €0.53 / MWh which was recorded in 2012

3.4.4 Maintenance Costs

This item consists of repairs service and maintenance service items. For the observed regulatory period repairs services are not foreseen. The licensee has envisaged only maintenance services with the declining unit cost trend, expresses per MWh of generated electricity. ERO concurs with EIHP's assessment that it has found requested values reasonable and has not made any adjustments.

3.4.5 Other Operating Expenses

Under "other operating expenses" for Kosovo B, KEK has total forecast costs of €12.6 million in the period 2013-2016. This comprises reallocation of headquarters' costs, costs of transport, security, licences and "other" expenses.

Regarding ***allocation of HQ costs***, these have been adjusted downwards, following the same approach used for other licensees.

Transport service costs, as proposed by the licensee, were adjusted downwards to 2011 level during 2012-2016 years, the only historic year for which this cost has been recorded.

Security costs have been requested at the the same level as previous year and is equal to the value estimated for 2012.

Licensee costs ERO proposes to review its approach on setting licence fees early in the New Year, once the new annual budget has been passed by the Assembly and will set an appropriate allowance at that time.

Other expenses have been adjusted downwards using value for 2012.

Overall, adjusted *other operating expenses* for Kosovo B are lower by €2.6 million than the amount requested by KEK in its submission.

3.4.6 ERO's Provisional Evaluation of KEK Kosovo B Opex Proposals

The table below summarises the total operating expenditures proposed by KEK for Kosovo A for the period 2013 to 2016, together with ERO's provisional evaluation of those same expenditures. It should be noted that the table below excludes the internal transfer cost of coal.

Table I – Provisional Evaluation of Kosovo B Opex

ERO provisional evaluation of opex for Kosovo B	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	Total € 000's
KEK's requested opex	17,385	17,668	17,976	18,242	71,272
ERO's proposed opex	16,253	16,245	16,245	16,273	65,016
Difference (€ 000's)	-1,131	-1,423	-1,731	-1,969	-6,256
Difference %	-7%	-8%	-10%	-11%	-9%

4 Other Regulatory Parameters

4.1 Efficiency Factor

ERO is required by the Pricing Rule to set an efficiency factor that will apply to operating and maintenance costs. A single factor will be set for the whole MYT period at a level that reflects the gains that might be expected during the period by an efficient operator. In setting the level of the efficiency factor, ERO has considered the costs of running the business by the Generation and Mining Divisions and taken account of productivity levels in international comparator companies. It has also considered the levels of efficiency factor that have been successfully applied in regulatory regimes elsewhere.

ERO concludes that there is scope for significant efficiency gains in the Generation and Mining activities, particularly as this will be the first time that an efficiency factor has been applied to the company and experience shows that companies are able to demonstrate higher efficiency gains at this early stage of incentive regulation. ERO considers that a value of 4% per annum is an appropriate efficiency factor in the MYT period, representing both a challenging incentive for the Generation and Mining Divisions to reduce its costs and achieve

gains if it out-performs this level of improvement, while at the same time giving benefits to customers through downward pressure on tariffs.

4.2 WACC

ERO has set the Weighted Average Cost of Capital for Generation based on previous evaluations of required Return on Equity, actual cost of debt financing and actual gearing level (subject to gearing restrictions given in ERO's previous discussions on WACC).

ERO initially assumed a commercial return on equity for all regulated companies in the sector. ERO further sought guidance from the government as to the level of return on equity that the government might require as the sole owner of publicly owned companies. The government has indicated that they will consider a lower return from operators in the public ownership compared to a return that might be expected by a private owner. ERO's provisional evaluation therefore is that a level of 8.0% post-tax return on equity is appropriate for publicly owned companies. ERO has therefore used this return on equity in evaluating the Generation division's WACC.

The resulting WACC for Generation is set at 6.89% (real, pre-tax).

5 Provisional MARs 2013-2016

Following its assessment of KEK's capital and operating cost proposals, the provisional evaluations described above, and its proposed regulatory parameters, ERO has calculated the MARs for KEK's licensed activities in line with the Generation Pricing Rule. These are set out in the following table.

Table m – Provisional Evalution of MARs for KEK's Regulated Generators

Provisional Evaluation of MARs for KEK's Generation businesses	2013 € 000's	2014 € 000's	2015 € 000's	2016 € 000's	Total € 000's
Kosovo A and Kosovo B	155,227	156,477	158,485	158,866	629,055