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

Consultation Paper

The Seventh Electricity Tariff Review

ETR7 (2013-2017)

Provisional Evaluations - Overview

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 Executive Summary

ERO has completed its Provisional Evaluation of the maximum allowed revenues (MARs) for regulated electricity licensees. In developing the MARs, ERO has followed the provisions of primary legislation and its own Pricing Rules. This document sets out ERO's provisional proposals for the implementation of Electricity Tarff Review 7 (ETR7).

ERO proposes that the MARs will be set for five years for the transmission and distribution network businesses, four years for regulated generation, and one year for public supply.

Following consultation on these provisional MARs and a Public Hearing to be scheduled for early February, ERO will make its final Decision. Licensees will then propose tariffs in line with the final MARs, to come into force from 1st April 2013. In order to harmonise the regulatory accounting year with the statutory accounting year, the first year of the revenue controls will run from 1st April to 31st December.

The companies have proposed levels of capital and operating expenditure for the period of the controls. ERO has examined these closely with the support of consulting engineers. For KOSTT, the proposed capex levels have been adequately justified, and ERO proposes to allow these in full. KEK has not fully justified its forecast costs, and further reductions may be made in ERO's final decision if further explanation and justification is not provided for proposed investments in mining. ERO has proposed a number of adjustments to company capex proposals:

ERO Capex Adjustments by licensee	Company Forecast €m	ERO Evaluation €m	Reduction %
KEK Mining	160	145	-9%
KEK Generation A	65	56	-14%
KEK Generation B	40	40	0%
KOSTT	120	120	0%
DSO	114	100	-12%
PES	2	2	0%

Similarly, operating costs are proposed to be reduced across the Board:

ERO Opex Adjustments by licensee	Company Forecast €m	ERO Evaluation €m	Reduction %
KEK Mining	191.5	167.7	-13%
KEK Generation A	84.5	75.6	-11%
KEK Generation B	71.2	65.0	-9%
KOSTT	61.5	38.7	-37%
DSO	86.9	76.6	-12%
PES	71.4	61.6	-14%

Provisional Evaluation - Overview

In order to incentivise the companies to find cost savings over the period, ERO proposes efficiency factors that will apply to licensees' operating costs each year. ERO's proposal is that an efficiency factor of 4% per annum should be applied to Mining, Generation and KOSTT. For the distribution business, factors have been preset by ERO in Feburary 2012 at 0% for the first three years of the control. ERO proposes to apply a 5% efficiency factor for the last two years of the Regulatory Period.

WACC represents the expected cost to licensees of financing their investments. The WACC for KEK Distribution and Supply was fixed at 12% (real) by a Board Decision in February 2012. The WACC for other licensees is calculated as the weighted average of the estimated return on equity and the actual cost of long-term debt for each licensee and ranges from 5.50% for mining to 6.89% for Generation.

Taken together, ERO's provisional evaluation of MARs will allow licensees to continue to invest in the power system. The chart below shows the provisional total MAR and expected trend in average tariff over the control period.

The MAR provisional evaluations are presented in the following table:

		---------- Provisional Evaluation ----------				
		2013	2014	2015	2016	2017
KEK Mining	€m	89.3	89.9	92.0	92.6	87.2
KEK Generation (exc. lignite)	€m	63.3	63.7	63.6	63.5	66.1
Other net power purchase costs	€m	8.8	13.6	15.2	15.2	34.3
KOSTT TSO+MO (exc. losses)	€m	14.7	15.2	16.0	16.8	17.7
KEDS DSO (exc. losses)	€m	30.8	33.5	36.0	37.6	39.1
KEDS PES (exc. power purchase)	€m	32.3	32.5	30.5	30.9	32.2
Total	€m	239.2	248.5	253.4	256.5	276.6

2 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 the adequacy of revenues, ERO must 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 licensees were asked to present their submissions to ERO and the public on 3rd September. Since that date, ERO has worked closely with the licensees to clarify initial submissions. Licensees have since submitted additional data and justification.

ERO wishes to thank licensees for their active participation in the review processes to date. This has enabled ERO and its consultants to obtain a clear understanding of the nature and extent of licensees' costs, and their forecasts for the ETR7 period.

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. It summarises the ERO's provisional position on a number of key elements that make up the total price of electricity. It also describes ERO's approach to, and position on, a number of broader issues that affect all licensees. Together with this document, ERO has set out a detailed document assessing the revenue requirements for each individual licensee.

3 Alignment of Regulatory Year with Calendar Year

To date, the sector has reported to the regulator on the basis of an April to March financial year. By contrast, companies report statutory accounts on a calendar year basis. ERO considers that a move to harmonise the two reporting years is important to improve its ability to reconcile regulatory accounts with statutory accounts, giving it a better understanding of licensees' financial positions. ERO also considers that it will be easier for licensees to keep their accounts if the financial years are the same. ERO raised this question in its initial consultation on the Multi Year Tariff in June this year and received no objections from licensees. ERO therefore proposes that the 2013 control will come into force on 1st April, and end on 31st December, a nine-month control.

4 Duration of Controls

ERO's Pricing Rules set out the duration of revenue controls for the regulatory periods for each licensee as follows:

- 4 years for regulated generation
- 5 years for the transmission and distribution networks
- 1 year for the public electricity supplier (PES)

Current expectations are that, following the planned decommissioning of Kosovo A in 2017 and commissioning of KRPP, it will be necessary to take Kosovo B out of service for an extended period for extensive rehabilitation including possible conversion to CHP operation. As there is no certainty over the date of this rehabilitation, its scope or costs and KEK has been unable to provide data on this, ERO considers it appropriate to set this initial multi-year tariff control for generation for the four-year period 2013-16. This will allow a new control to be set from 2017 onwards when the investment requirements for Kosovo B and the future supply situation following the decommissioning of Kosovo A is clearer. This adjustment also has the advantage of allowing a staggering of future price control periods so that it is not necessary to review the controls for all licensees at the same time.In order to ease the workload involved in setting multi year revenue controls in the future, the Pricing Rules envisaged a transitional period before these durations came into force so as to stagger the timing of future reviews.

ERO's reporting formats required licensees to provide forecast data from 2013 through to the end of 2017. These forecasts have allowed ERO to understand the likely path of the cost of the whole supply chain through the full five year period. However, in setting the MAR revenue controls, ERO will follow the provisions of the Pricing Rules. ERO therefore proposes that the controls for KEK's regulated generation business will therefore commence on 1st April 2013 and last until 31st December 2016. The controls for KEK's Distribution System Operator (DSO) business and KOSTT's System and Market Operator businesses will also enter into force on 1st April 2013, but will last until 31st December 2017. As a result of the re-alignment of the regulatory year described above, the control for KEK's PES business will last from 1st April to 31st December 2013.

5 Underlying Changes in Forthcoming Control Period

The multi year tariffs will cover a period of time in which the electricity sector will undergo significant changes, some of which may have a bearing on the cost of electricity in coming years. These factors are described below, and ERO's indicative approach in each case is set down.

5.1 Future Generation Investments

The Government's Energy Strategy proposed two significant areas of private sector participation in the generation sector: the construction of a new coal-fired power plant, "Kosovo E Re", and the rehabilitation of Kosovo B1 and B2 to bring the station into full compliance with EU environmental requirements. The Strategy also foresees the closure of Kosovo A station at the end of 2017. Originally expected to be a combined transaction, the Government recently announced that the tenders for Kosovo E Re construction and Kosovo B rehabilitation will be separated. As yet, no re-tendering has been officially announced for either transaction.

5.2 Lignite Royalty

The Assembly of the Republic of Kosovo has approved a decision to increase the royalty on lignite from 0.27 cents per tonne to 3 euros per tonne, effective from 1st January 2013.

In its last Electricity Tariff Review (ETR6), ERO included an allowance for the increased lignite supply cost for this period to be spread across the whole 12 months of the 2012-13 control, smoothing the price increase. Electricity prices from 1st April 2013 will see the full effect of the lignite royalty.

5.3 Energy Balance and Imports

Customer demand and Kosovo energy availability are key drivers of future electricity prices. For the purposes of the review, ERO has worked with the licensees to update the Kosovo energy balance for the five years from 2013 and this is shown in *table a* below.

Table a

2013 Energy Balance (simplified)		Actual	----------	Provisional Evaluation ---			-------
		Nov 11 -Oct 12	2013	2014	2015	2016	2017
Distribution connected sales	GWh	2,998.9	3,201.6	3,383.2	3,535.2	3,667.2	3,776.1
Distribution losses	GWh	1,538.5	1,208.3	1,091.9	991.3	882.7	767.9
		33.9%	**27.4%**	**24.4%**	**21.9%**	**19.4%**	**16.9%**
Unbilled supplies	GWh	210.0	212.0	220.0	230.0	240.0	250.0
Transmission connected sales	GWh	516.9	621.9	621.9	621.9	621.9	621.9
LOMAG and KEK consumption	GWh	293.0	295.0	330.0	330.0	330.0	330.0
Transmission losses	GWh	107.6	109.9	111.1	112.0	112.0	106.2
		1.8%	**1.8%**	**1.8%**	**1.8%**	**1.8%**	**1.8%**
Exports	GWh	284.3	492.0	451.0	440.0	403.0	84.0
TOTAL DEMAND	**GWh**	**5,949.4**	**6,140.8**	**6,209.2**	**6,260.4**	**6,256.8**	**5,936.1**
Distribution connected generation	GWh	27.9	35.0	36.0	38.0	36.0	38.0
Transmission connected generation	GWh	5,266.0	5,672.0	5,688.0	5,720.0	5,732.0	5,265.0
Imports	GWh	655.4	433.8	485.2	502.4	488.8	633.1
TOTAL SUPPLY	**GWh**	**5,949.4**	**6,140.8**	**6,209.2**	**6,260.4**	**6,256.8**	**5,936.1**

5.4 Privatization of KEK Distribution and Supply

In October 2012 the Government signed a Sale and Purchase Agreement with a consortium of investors for the regulated distribution and public electricity supply businesses of KEK. The businesses are scheduled to transfer to the ownership and control of the consortium on 6th May 2013, after certain conditions have been fulfilled.

In its submissions KEK has indicated that a primary objective of its investment plan is to target capital expenditure on the worst-performing parts of the distribution network. ERO would not expect the new owner of the business to depart radically from the approach presently intended by KEK. If, however, the investor wishes to revise the projects then the investor has to convince the ERO that the alternative projects secure an equivalent or a greater customer benefit. In such cases, changes in the MAR and the RAB of the licensee would follow in the following Periodic Review.

5.5 Cost Reflectivity

EU and Kosovo legislation require cross-subsidies within electricity prices to be eliminated. ERO is in the process of evaluating cross-subsidization in Kosovo and identifying measures to eliminate it in accordance with law.

Given other major cost drivers, and in particular the introduction of the full lignite royalty increase into the tariffs, ERO believes that the rebalancing of tariffs should be introduced gradually over the full price control period.

While the rebalancing of the tariffs to remove the cross-subsidy should have a positive impact on the costs of doing business in Kosovo, boosting the country's economy, vulnerable domestic customers may need protection to shelter them from the impact of price rises. As social protection issues fall within the domain of central Government, ERO calls for considering additional, targeted financial support to protect vulnerable customers who are least able to afford price rises.

6 Development of MARs

ERO is required to set the maximum allowed revenue for each separate regulated business for KEK and KOSTT. The Pricing Rule for each licensed business defines precisely what costs are allowable for each regulated activity. As each company has more than one licence, the process also requires ERO to examine the allocation of central costs, such as headquarters costs, to each licensed business. The overall cost of electricity supply will be the sum of all MARs, and the overall tariff will be set to recover that sum from the different tariff categories.

The next section sets out ERO's provisional evaluation of the allowed costs of each licensed activity. At this stage, certain external costs, such as the regulator's licence fee and the inter-TSO compensation mechanism are excluded. These elements will be included in ERO's Final Decision on ETR7.

7 MARs – Adjustments and Components

7.1 ETR6 Adjustments

A transitional one-year control (ETR6) came into force on 1st April 2012 for all licensees. As part of the current review, ERO has asked licensees to forecast their actual outturn position on the current control. Those forecasts will need to be updated before ERO issues its final Decision on the multi year MARs in February 2013. When licensees have finalised their accounts in relation to the current regulatory year, any differences between the position reported to ERO for the purposes of setting the MARs and the audited position will be adjusted through the correction factor in the revenue controls.

7.2 Allocation of Headquarters' Costs to Licensed Businesses

In their projected cost submissions the companies presented their 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. KEK and KOSTT completed the reporting formats in slightly different ways. 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 licensees' submitted headquarters' costs. In making the adjustment, ERO has used KEK's apportionment of costs in 2012, and applied these forwards to each year of ETR7.

7.3 ERO Capex and Opex Adjustments

In line with primary legislation and the Pricing Rules, licensees may recover their full operating and capital expenditures where these have been adequately justified, and where cost levels are found to be reasonable. Licensees may also earn depreciation on all capital assets in the regulatory asset base and may make a return on those assets not funded by grants.

ERO, with the support of two firms of consulting engineers, has closely examined costs by the licensees. Since September, ERO has had extensive meetings with both companies.

ERO has, for the purposes of these Provisional Evaluations, largely accepted the licensees' investment proposals for the period of the controls. For KOSTT, ERO considers that the proposed capital projects have been satisfactorily justified and are the result of a prudent and appropriate planning process. In the case of KEK, ERO considers that some €102 million of capital projects in mining have been proposed without sufficient justification. At this stage, ERO has included a provision for these projects in the MAR Provisional Evaluations. However, if KEK does not provide adequate justification for these projects, ERO may remove them from its Final Evaluation. For KEK DSO, ERO considers that a modest reduction in capital expenditure allowance is appropriate, reflecting the relatively high purchase costs reported by the company for some types of equipment.

Table b

ERO Capex Adjustments by licensee	Company Forecast €m	ERO Evaluation €m	Reduction %
KEK Mining	160	145	-9%
KEK Generation A	65	56	-14%
KEK Generation B	40	40	0%
KOSTT	120	120	0%
DSO	114	100	-12%
PES	2	2	0%

Provisional Evaluation - Overview

In terms of operating expenses, ERO has reviewed and adjusted the operating cost levels proposed by licensees. For each licensee, ERO has removed increases in salary levels above the general rate of inflation that were proposed by the companies. The corresponding adjustments to overall levels of operating costs are detailed in the detailed Provisional Evaluations for each licensee, and are summarised below.

Table c

ERO Opex Adjustments by licensee	Company Forecast €m	ERO Evaluation €m	Reduction %
KEK Mining	191.5	167.7	-13%
KEK Generation A	84.5	75.6	-11%
KEK Generation B	71.2	65.0	-9%
KOSTT	61.5	38.7	-37%
DSO	86.9	76.6	-12%
PES	71.4	61.6	-14%

7.4 Weighted Average Cost of Capital (WACC)

ERO has set the Weighted Average Cost of Capital based on existing Board Decisions on these, 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 WACC for publicly owned companies.

The resulting WACCs are summarized in the following table:

Table e

ERO's WACC estimates for licensees (real)	KEK Mining	KEK Generation	KOSTT
Post-tax cost of equity	8.0%	8.0%	8.0%
Pre-tax cost of equity	8.9%	8.9%	8.9%
Cost of debt	4.0%	3.9%	3.5%
Gearing*	0.7	0.4	0.4
WACC	**5.50%**	**6.89%**	**6.73%**

* calculated as debt / debt + equity

7.5 Efficiency Factors

Efficiency factors are widely used in the regulated energy and other utility sectors around the world to incentivise efficient operation and provide enhanced value for customers. The ERO Pricing Rules require ERO to set Efficiency Factors that will apply to operating and maintenance costs. The Pricing Rules give guidance on how ERO should set the factors. In particular, it should take into account both historic and forecast costs and quality of service. It should compare energy utility costs and efficiency both in Kosovo, and internationally.

By setting a non-zero value of efficiency factor, the MARs are automatically adjusted each year of the control by inflation and that percentage factor. A positive efficiency factor would reduce revenues in real terms, a negative factor would allow them to increase in real terms. These factors will be defined at each periodic revidw, and will last for the whole MYT period. ERO proposes to set a single efficiency factor for each licensee which will represent expected gains by an efficient operator. It should be noted that for KEK Distribution and Supply, the Efficiency Factor has been pre-set by a Decision of the ERO Board in February 2012.

The setting of such efficiency factors is not the result of calculation, but rather they are an informed judgement based on available information. In setting the efficiency factors, ERO has considered best practice in the application of incentive regulation and has taken into account productivity studies in the EU.

International experience suggests that utilities can make the greatest productivity gains in the early years of the introduction of efficiency factors. ERO's study of international practice has indicated typical values in the range 0% to +4%.

ERO's provisional assessment shows that the Kosovo electricity sector does not appear to be grossly inefficient by comparison with operators carrying out similar functions elsewhere in the region. Nevertheless ERO considers that considerable savings may be possible. In proposing the factors below, ERO leaves it to the companies concerned to identify where savings may be made, and notes that where companies achieve efficiency gains beyond the levels suggested by the efficiency factors, this wll result in increased MARs for those licensees.

ERO's proposed efficiency factors	2013	2014	2015	2016	2017
Mining	4.00%	4.00%	4.00%	4.00%	n/a
Generation	4.00%	4.00%	4.00%	4.00%	n/a
KOSTT	4.00%	4.00%	4.00%	4.00%	4.00%
DSO&PES	0.00%	0.00%	0.00%	5.00%	5.00%

8 Provisional Evaluation of MARs

This section summarises ERO's provisional MAR by each licensee, taking into account the adjustments and components described in section 6 above.

8.1 Provisional MARs

The table below shows ERO's provisional evaluation of the MARs for each licensed activity. Although ERO does not set a separate MAR for the Mining activity, the same assessment must be made for Mining in order to set the Assumed Lignite Supply Cost. The results have been shown here in comparable format for ease of interpretation.

Table g

		----------		Provisional Evaluation		----------
		2013	2014	2015	2016	2017
KEK Mining	€m	89.3	89.9	92.0	92.6	87.2
KEK Generation (exc. lignite)	€m	63.3	63.7	63.6	63.5	66.1
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KOSTT TSO+MO (exc. losses)	€m	14.7	15.2	16.0	16.8	17.7
KEDS DSO (exc. losses)	€m	30.8	33.5	36.0	37.6	39.1
KEDS PES (exc. power purchase)	€m	32.3	32.5	30.5	30.9	32.2
Total	€m	239.2	248.5	253.4	256.5	276.6