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

Consultation Paper

Extraordinary Electricity Tariff Review within the ETR8

Assessment of impact on Maximum Allowed Revenues and Tariff Review

DISCLAIMER

This Consultation Paper has been prepared to consult the stakeholders on assessments of ERO regarding the extraordinary review. It does not represent a decision by the ERO and should not be interpreted as such.

Comments of stakeholders shall be sent with the following subject line

"Comments on Extraordinary Review" by:

22 August 2014

to the ERO email address:

info@ero-ks.org

or to the postal address:

Dervish Rozhaja Str. No. 12, 10000 Prishtina, Kosovo

13 August 2014

Address: Dervish Rozhaja Str., No. 12, 10000 Prishtina, Kosovo
Tel: 038 247 615 ext. 101, Fax: 038 247 620, E-mail: info@ero-ks.org, web: www.ero-ks.org

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1 Introduction

Explosion of 6 June 2014 in the Thermal Power Plant (TPP) Kosova A of the Kosovo Energy Corporation (KEK) has caused considerable material damages and risked a regular supply of electricity in Kosovo. Only after all the analysis relating to the damages caused by this event, the Energy Regulatory Office (ERO) has agreed to open an extraordinary tariff review. In this analysis of ERO, as in all the other Decisions on regulated retail tariffs, ERO has always tried to control and keep low the costs of energy system in Kosovo, so that tariffs are more affordable for regulated customers. It should be noted that in addition to legal obligations, the ERO analysis clearly shows that the solution lies between opening of the extraordinary review to cover these additional costs and disallowing additional costs that would risk the security of electricity supply. ERO considers that power cuts have a much higher cost in comparison to the recommendations herein.

Regulated retail tariffs are determined through three main processes: a) periodic reviews (in the present case 5 year tariffs have been determined in 2013), b) regular annual adjustments (in the present case, the tariffs were determined in 2014), and c) extraordinary reviews (the consultation in question has been opened regarding this issue).

In a letter addressed to ERO, dated 10 June 2014, KEK has estimated that the financial cost to remedy the situation is €7 million which, according to them, exceeds 12% of the value of maximum allowed revenues for the relevant second year (regular adjustments of 2014) in the amount of €139.5 million. Moreover, KEK estimates that it will lose a significant portion of allowed revenues from activity of electricity generation if the explosion had not happened. Consequently, KEK has requested the opening of an extraordinary review of maximum allowed revenues in order to compensate the damage caused by the explosion. **Following the analysis conducted and presented in this paper, ERO recommends firstly to wait for the results of the investigation of the cause in order to understand whether the Extraordinary Event was or not under the control of the Regulated Generator (Paragraph 1.3 (i) Schedule 7 of Generator Rule).**

At the same time, the Kosovo Electricity Distribution and Supply (KEDS) Company, responsible for the supply of electricity and electricity imports has requested extraordinary tariff review. According to the considerations of KEDS, this request is made to cover the difference between generation and consumption in Kosovo, which is significantly affected due to the lack of a significant amount of local generation that should be covered by imported electricity with higher prices. In addition, the explosion resulted in a reduction of energy that is allowed to be exported compared with the level assumed when determining the maximum allowed revenues for KEDS in the last adjustment (2014). **As a result of the event of 6 June 2014, the net impact on KEDS' allowed revenues is €12.4 million, constituting 5.18 % of KEDS allowed revenues in the amount of € 239.96 million. ERO considers that materiality threshold has been passed and recommends adjustments of the allowed revenues for the Public Electricity Supplier in the amount of 5.18 % more than the previously allowed revenues for the Public Supplier on 24 June 2014.**

This consultation paper reviews the estimations of licensees regarding the damages caused by the explosion of June 6 and provides ERO recommendations on covering the financial costs, necessary for a regular supply. Therefore, the most important reason for this extraordinary tariff review is to provide electricity supply security to all customers, to prevent possible power cuts risks. ERO understands consumers who have complaints about the extraordinary review process following the conclusion of regular adjustments, however, on the other side it must comply with all legal provisions in the energy sector including the right of operators to allow reasonable costs for the operation of the power system.

Extraordinary Review Process is a separate process from the regular adjustment processes. It should be noted that the Decision on KEK maximum revenues was approved prior to the extraordinary event and it was in force when the explosion occurred at TPP Kosova A. During the phase of providing comments for regular adjustments, the public electricity supplier (KEDS) commented on the lack of imports, but at that time ERO had approved KEK revenues, which must be accepted by the Public Electricity Supply (KEDS) as the wholesale electricity cost. Under applicable law, any retail tariff change should be duly analyzed, therefore at that time no additional decision was taken regarding this extraordinary event. Moreover, ERO has been restricted to taking a decision on the extraordinary event, since the extraordinary reviews present a different process from the regular adjustments, regulated by different legal provisions.

ERO also shares the concerns of electricity consumers, related to electricity tariffs and their affordability, therefore during regular reviews all costs submitted by licensed operators were analyzed in detail, pushing the entire tariff approval process. Moreover, in order to ensure that customer tariffs will be affordable during regular adjustments (regulatory tariffs year 2014) ERO requested from KEK to increase the generation in TPP Kosova A. Consequently, due to these changes in the power balance, ERO has made the calculations for KEK regulated tariffs and made the Decision on KEK maximum allowed revenues on 16 May 2014.

KEK has officially notified ERO about the explosion in Kosova A on 9 June 2014, however the report of KEK on damages caused by the explosion was received in the ERO on 26 June, two days after the Decision on PES (KEDS) Revenues was approved, dated 24 June 2014. Until the time of publication of this consultation paper, the official report from the competent state authorities on the reasons of explosion in TPP Kosovo A neither was received by the ERO nor was it published for the general public.

2 Extraordinary Review

According to the rules on regulated pricing in the energy sector in Kosovo, the maximum allowed revenues of the licensees shall be approved for a five year period for the Distribution System Operator (DSO) and the System, Transmission and Market Operator (KOSTT), four years period for the Regulated Generator, while the maximum allowed revenues for the Public Electricity Supplier (PES) shall be approved for a one year period. The maximum allowed revenues are approved based on the assumptions for capital investment expected to occur in the sector during the period of adjustment, the projected costs of operations and maintenance, as well as availability of local generation, transmission and distribution capacity for electricity supply. The maximum allowed revenues are adjusted annually to reflect eventual changes between predicted and actual assumptions of energy flows in the system, considered to be out of the control of regulated companies.

Moreover, the maximum allowed revenues of licensee may also be replaced within the relevant years after the regular annual adjustments, upon the initiation of so-called extraordinary reviews ((Article 6 of the Rules on Regulated Generator Pricing) and Article 6 of the Rule on Public Electricity-PES Pricing (hereinafter: Supply Rule)). These extraordinary reviews aim at adjusting the allowed revenues of regulated companies as a result of extraordinary events, if these events have an impact of exceeding the materiality threshold, which according to the rules, is set to be 5% of the maximum allowed revenues of the regulated company. In cases where the extraordinary event in the maximum allowed revenues exceeds the threshold of materiality, then the ERO opens the extraordinary review process and adjusts the maximum allowed revenues of the regulated company.

In the absence of concrete information on the control of KEK concerning the circumstances that have brought the extraordinary event, ERO does not recommend charging the customers with the costs of capital investment needed to repair the generating units, as requested by KEK. Moreover, KEK estimates that it will lose a significant portion of allowed revenues from the activity of electricity generation if the explosion had not happened. ERO will focus its attention on results of the investigation on the causes of the explosion, when they will become public, and will undertake appropriate actions considered necessary by ERO under the applicable law.

Change of costs in the system ultimately affects the maximum allowed revenues of the Public Electricity Supplier, which covers the costs of the system from revenues collected from regulated tariffs. The increase of the average wholesale power purchase cost (WHPC), directly affects the growth of other components of the maximum allowed revenues of the Public Electricity Supplier, the level of which depends on WHPC, such as: working capital (WCLC) that grows by €0.1 million, retail margin (RETM) that grows by €0.3 million and bad debt (BDTA) that grows by €0.6 million. As a result of the events of June 6, the net impact on maximum allowed revenues of the Public Supply is €12.4 million, representing 5.2% of the maximum allowed revenues of the Public Electricity Supplier in the amount of €240 million.

2.1 Extraordinary Event – Application of Regulated Generator

The explosion of June 6 at the TPP Kosova A of the Kosovo Energy Corporation (KEK) has caused considerable material damages and risked a regular supply of electricity in Kosovo. Because of the explosion, generation in TPP Kosova A ERO has been terminated, and so far ERO has not received a detailed report about the cause of this explosion. Although we do not have a report on the causes of the explosion, ERO has received the request for extraordinary review, the document to review the Annual Balance and a report regarding the damages caused by the explosion dated 06.06.2014

According to Article 3, paragraph 2 of the Generator Rule, the maximum allowed revenues shall be determined as follows:

(para. 2.1) Maximum Allowed Revenues shall be set at Periodic Reviews (Article 4)

(ERO explanation: Decision on First Periodic Review in Kosovo was made in 2013)

(para. 2.2) Before the end of each Relevant Year, a Regular Adjustment (Article 5) shall be applied which involves mechanical adjustments to Maximum Allowed Revenues for changes in costs that are considered to be outside of the Regulated Generator's control; and

(ERO explanation: Decision on first regular adjustments in Kosovo was made in 2014)

(para. 2.3) Extraordinary Reviews (Article 6), which involve an adjustment to Maximum Allowed Revenues for material changes in costs and/or revenues caused by an Extraordinary Event, shall be made as necessary

(ERO explanation: Public consultations are being made on this issue)

Article 6 of the Generation Rule, and Schedules 6 and 7 set forth the extraordinary review processes, and define the events that can be qualified as extraordinary. Article 6, paragraph 2 provides that at

Extraordinary Reviews the impact of the Extraordinary Event on Maximum Allowed Revenues for the remainder of the current Regulatory Period shall be calculated. If the impact is greater than the Materiality Threshold, then an Extraordinary Adjustment to Maximum Allowed Revenues shall be made. The Material Threshold shall be 5% of revenues, unless determined otherwise at Periodic Reviews on the mutual agreement of the Regulated Generator and the ERO.

Schedule 6, paragraph 1 explains the extraordinary review process and Schedule 7 defines which events can be qualified as extraordinary, and the latter are explained as follows:

(para. 1) *An Extraordinary Event shall be the occurrence of any one of the following:*

(para.1.1) *Any change in the tax rate, including royalties, applicable to the Regulated Generator shall not be fully recovered through Regular Adjustments;*

(para. 1.2) *Any force majeure events as defined in Schedule 8;*

(para. 1.3) *Any other event, which meets all of the following conditions:*

(i) Was not reasonably under the control of the Regulated Generator;

(ii) Shall not be fully recovered through Regular Adjustments; and

(iii) Shall significantly change the revenues and/or costs of the Regulated Generator over any 12 month period, such that it seems reasonable that the Materiality Threshold (described in Schedule 6) may be breached.

(para.2) *The occurrence of an Extraordinary Event is sufficient to trigger an Extraordinary Review, however as described in Schedule 6, the event must still breach the Materiality Threshold before Maximum Allowed Revenues shall be adjusted.*

The Generation Rule, in a specific manner, both in Schedule 7 and Schedule 8 (Force majeure) explain that an extraordinary event can be defined only events that were not under the control of the Generator in question. ERO requested from KEK, within a time period as soon as possible, to submit a detailed report, containing all findings, causes of the explosion and detailed estimates of the costs related to the abovementioned event. ERO is awaiting the results of investigation concerning the factors that have caused the extraordinary event.

In the absence of concrete information on investigations of the causes of explosion in TPP Kosova A, ERO does not recommend charging the customers with the costs of capital investment needed to repair the generating units. Moreover, KEK estimates that it will lose a significant portion of allowed revenues from the activity of electricity generation if the explosion had not happened. ERO will focus its attention on results of the investigation on the causes of the explosion, when they will become public, and will undertake appropriate actions considered necessary by ERO under the applicable law. ERO will analyze all impacts of this event also in the maximum revenues allowed during the regular annual review. ERO recommends firstly to wait for the results of the investigation of the cause in order to understand whether the Extraordinary Event was or not under the control of the Regulated Generator (Paragraph 1.3 (i) Schedule 7 of Generator Rule).

2.2 Extraordinary Event – Application of the Public Electricity Supplier

Following the explosion of June 6, described above, the KEDS, on August 4, has requested, based on secondary legislation, an Extraordinary Electricity Tariff Review.

In the KEDS' application for extraordinary review, it is highlighted that after the explosion in TPP Kosova A, the generating capacity defined by the regular tariff adjustments will not be sufficient to satisfy demand of electricity.

According to Article 3, paragraph 4 of Supply Rule, the maximum allowed revenues are determined as follows:

(para. 3.1) Maximum Allowed Revenues shall be set at Annual Updates (Article 5);
(ERO explanation: Decision on annual updates in Kosovo was made in 2014)

(para 3.2) The calculation of Maximum Allowed Revenues shall use Input Values set at Input Values Reviews; and
(ERO explanation: Decision on first periodic review in Kosovo was made in 2013)

(para. 3.3) Extraordinary Reviews (Article 6), which involve an adjustment to Maximum Allowed Revenues for material changes in costs and/or revenues caused by an Extraordinary Event, shall be made as necessary.
(ERO explanation: Public consultations are being made on this issue)

Article 6 of the Supply Rule, namely Schedules 5 and 6 set forth the extraordinary review processes, and define the events that can be qualified as extraordinary. Article 6, paragraph 2 provides that at Extraordinary Reviews the impact of the Extraordinary Event on Maximum Allowed Revenues for the remainder of the current Regulatory Period shall be calculated. If the impact is greater than the Materiality Threshold, then an Extraordinary Adjustment to Maximum Allowed Revenues shall be made. The Material Threshold shall be 5% of revenues, unless determined otherwise at Periodic Reviews on the mutual agreement of the PES and the ERO.

Schedule 5 explains the extraordinary review process and Schedule 6 defines which events can be qualified as extraordinary, and the latter are explained as follows:

(para. 1) An Extraordinary Event shall be the occurrence of any one of the following:

(para.1.1) Any change in the tax rate, applicable to the PES, that shall not be fully recovered through annual updates;

(para. 1.2) Any force majeure event as defined in Schedule 7;

(para. 1.3) Any other event, which meets all of the following conditions:

(i) Was not reasonably under the control of the PES;

(ii) Shall not be fully recovered through annual updates; and

(iii) Shall significantly change the revenues and/or costs of the PES over any 12-month period, such that it seems reasonable that the Materiality Threshold (described in Schedule 5) may be breached.

(para.2) *The occurrence of an Extraordinary Event is sufficient to trigger an Extraordinary Review, however as described in Schedule 5, the event must still breach the Materiality Threshold before Maximum Allowed Revenues and Regulated Retail Tariff shall be adjusted.*

ERO finds that under Supply Rule, the explosion of TPP Kosova A is regarded as an extraordinary event for the Public Electricity Supplier (KEDS). According to the processes set out in Schedule 5 of the Supply Rule, KEDS explained the impact of this extraordinary event and ERO recommends inclusion of this event in the regulated retail tariffs.

At the time of determining the tariffs, a certain amount of revenues for the wholesale purchase of electricity to supply regulated customers was allowed to the KEDS, as a retail supplier and wholesale purchaser of electricity. The extraordinary event of the explosion in TPP Kosova A has resulted in reducing the energy generated by generators compared with the projected value and as a result, in the level of energy that the KEDS can purchase from the KEK. Consequently, the KEDS as a public electricity supplier is obliged to apply power cuts to customers for the energy that was projected to be generated by the KEK or to purchase energy imports to cover the difference between the projected and actual generation.

Due to the higher price of imported energy compared to the energy produced by the KEK, a higher share of imports in the domestic consumption portfolio will result in increase of the wholesale energy purchase cost of the Public Electricity Supplier. In the most optimistic scenario of entering into operation of the A4 Unit in November 2014 and A5 Unit in December 2014, the additional energy required for a regular supply will be 427 GWh, while the lost opportunity to export energy will be 142 GWh. Therefore, to cover the amount of energy that is missing from local Generation, the Public Electricity Supplier will have to purchase 427 GWh of electricity from imports and reduce exports by 142 GWh. At the same time, the Public Electricity Supplier costs for purchase of electricity from KEK for the relevant year 2014 have been reduced due to reduction of availability as a result of the explosion at TPP Kosova A.

KEDS has analyzed the additional costs of this extraordinary review and according to the Supply Rule, has presented to ERO the following costs:

- A4 and A5 Units of TPP Kosova A are expected to be out of operation until the end of this year and as a consequence, there will be a highlighted lack of local electricity generation (about 411 GWh), which must be met through imports of electricity. Purchase of this energy in the wholesale electricity market (international market) will cause additional costs to the Public Supplier, exceeding the materiality threshold specified in Rule on Public Electricity Supplier.

- this is the first year when all costs of imported energy are covered by customers, as a consequence of the lack of subsidies for electricity import by the Government of the Republic of Kosovo.
- import of 450 GWh allowed by the ERO in the determination of the maximum allowed revenue for the Public Electricity Supplier is insufficient as a result of the explosion at TPP Kosova A. The KEDS has stated that if during the first half of this year has been imported about 62% of the allowed amount of electricity, and to meet the needs of the consumption have also requested additional 450 GWh of electricity imports, where about 75 GWh are projected for emergency imports.
- the import price is about 65 €/ MWh, whereby other factors that might influence the import pricing have been taken into consideration, depending on the volatile political situation in Ukraine, which may cause difficulties in the supply of gas in Europe.
- based on the quantity and the price stated above, the cost of imports, including emergency imports would be around €27.2 millions, thus it will have also an impact on the increase of the wholesale energy prices by 19% (from 27.3 €/ MWh approved by the ERO it will increase to 32.5 €/MWh).
- due to climatic conditions that have prevailed in the first half of this year, sales decreased by 9%, which will have an impact on non-achievement of the maximum allowed revenues by ERO. The KEDS has also stated that the ERO has been aware of the explosion before making the decision on maximum allowed revenues and that they have requested to include these costs in the final calculation of the ERO.
- The final financial impact according to the estimations of KEDS for the Public Electricity Supplier, excluding other pass-through costs, is €37 million, or 16% higher than the maximum revenues allowed during the last tariff review (regular adjustments of 2014).

The increase of the average wholesale power purchase cost (WHPC), directly affects the growth of other components of the maximum allowed revenues of the Public Electricity Supplier, the level of which depends on WHPC, such as: working capital (WCLC) that grows by €0.1 million, retail margin (RETM) that grows by €0.3 million and bad debt (BDTA) that grows by €0.6 million. As a result, net impact on maximum allowed revenues of the KEDS is €12.4 millions. According to Schedule 5 of the Supply Rule, if the ERO Board approves the proposal for extraordinary adjustment, the new regulated retail tariff will take effect immediately. Results of the evaluation of ERO concerning the extraordinary review are presented in the table below.

Table 1. The impact of the extraordinary event on the KEDS Maximum Allowed Revenues

PES		ETR8 Allowed	ETR8 Review
Indexing parameters			
HICP	%	0.70%	0.70%
Euribor	%	0.60%	0.60%
S-factor	%	12.54%	12.54%
It	%	13.14%	13.14%
Retail allowed costs			
OPMCt = OPMCt-1 * (1 + CPIt-1) * (1 – Et)* (1 – Pt)	€m	12.4	12.4
DEPCt = DEPCt-1 * (1 + CPIt-1) * (1 – Pt)	€m	0.20	0.2
Pass-Through Costs (PSTCt)			
Costs of KOSTT	€m	17.8	18.0
Costs of DSO	€m	63.9	66.4
Additional Revenues			
From KOSTT	€m	3.3	3.5
From DSO	€m	23.8	26.3
Working Capital (WCLCt)			
WCLC= (1 / 12) * It * (RETRt + WHPCt + PSTCt - NTFRt)	€m	2.2	2.3
Wholesale Power Costs (WHPCt)			
WHPC	€m	142.3	154.0
Bad Debt			
BDTA	%	5%	5%
BDTA	€m	12.0	12.6
KREVt			
PES KREVt	€m	15.4	15.4
DSO KREVt	€m	3.0	3.0
KOSTT KREVt	€m	-0.2	-0.2
PES MAR			
PES MAR	€m	239. 96	252. 39
Difference			5.18%