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ETR4_KOSTT Response to ERO Comments on Preliminary Application for Allowed Revenues and Tariffs

Prishtine,
08 February 2010

Introduction

This document is the response from KOSTT to the Regulator's comments on the Kosovo System and Market Operator's application for Allowed Revenues and Tariffs for the fourth electricity tariff review (ETR4) issued in 19th January 2010. The purpose of the document is to provide additional information to respond to the Regulators comments and assist in providing clarity and an underlying rationale for the application.

The document is set out in a logical fashion to reference and respond to the points in the order they are raised in the Regulator's comments.

Overall Requested Increase (Ref ERO Comments Part 1 Introduction)

Your comments on the preliminary application indicate an increase in the requested allowed revenues for 2010 of 11.8%. It is understood that this is based on a calculation that includes the adjustment to the total allowed revenues. An alternative method of calculation would be to simply calculate the total requested increase in 2010 as a percentage of the 2009 Allowed Revenues as follows:

	€m
2010 Requested Revenues (Final application)	19.119
2009 Allowed Revenues	18.447
Increase	672
Percentage increase	3.6%

The actual revenues received in 2009 were €18.792m. The requested allowed revenues therefore represent an increase of only 1.7 % on the actual revenues in 2009

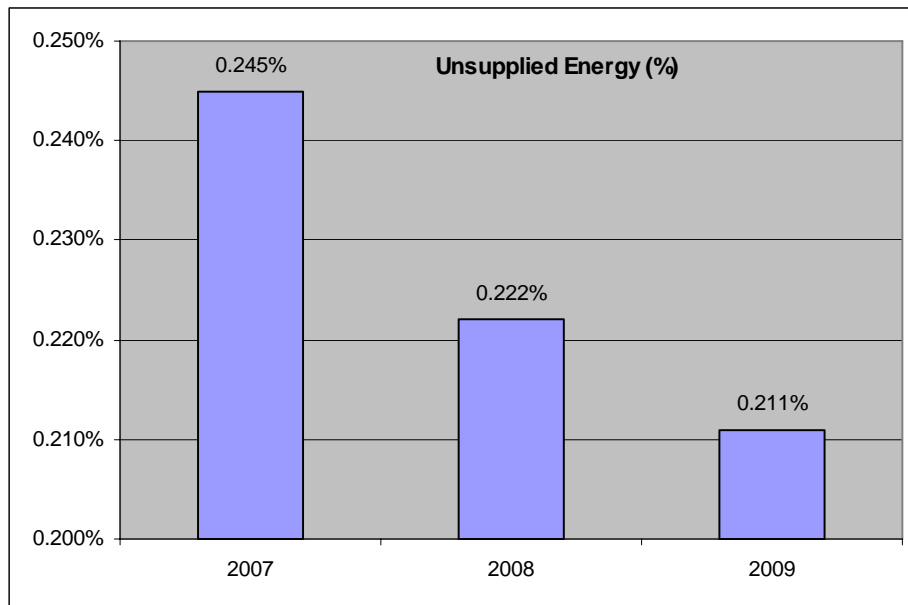
The ERO's final tariff model calculations for 2009 (RTR3~RTM~17APR09~v9~etr3) shows that KOSTT's total allowed revenues of €18.447m represent 13.2% of the €139.787m total allowed revenues recovered from electricity tariffs (KEK and KOSTT). This proportion of the overall regulated revenues means that the 3.6% requested increase in allowed revenues will account for only a 0.5% (13.2% x 3.6%) increase in consumer tariffs in return for continued improvements in the transmission system to deliver greater availability and quality of supply.

Continuing Improvements

In year 2009 values of unsupplied electricity decreased for about 16% compared to 2007.

This relatively modest increase needs to be viewed in the context of significant improvements to the Kosovan electricity system that KOSTT has achieved:

- Reduction of transmission losses from €6.580m in 2008 to €5.519m in 2009 (€1.070m saving);
- Levels of unsupplied energy due to transmission continue to fall significantly across the three year period for which tariffs have been set for KOSTT



- On 25 January 2010 KOSTT met a record level of demand of 1,170MW without any shedding of demand for transmission reasons. In 2007 KOSTT's transmission system was only capable of meeting demand in the order of 900MW.

To continue with this trend of improvements to the transmission system, as well as meeting the additional requirements of ENTSO-E, KOSTT needs to be allowed sufficient revenues for ongoing capital investment and for the training, retention and motivation of its staff.

Maintenance Expenses (Ref ERO Comments Part 2 Operating Expenses 2.1 Maintenance Expenses)

We note your comments on the requested and actual maintenance expenditure for 2010 and 2009 and the capitalisation treatment employed. In addition to the information supplied with the original application we restate that the basis of application is:

- Consistent with previous years;
- In accordance with the Regulatory Accounting Guidelines sections 4.6 and 4.7;
- Pragmatic in allowing KOSTT to fund the vital investment programme that has resulted in year on year reductions of losses and increases to supply since KOSTT's formation in 2006.

We acknowledge that it is not a particularly elegant solution to meeting Kosovo's transmission investment needs and anticipate that the dialogue opened with ERO in 2009 to consider changes to the value of pre-2006 assets may result in a more sustainable funding solution.

The following projects which will be capitalised are included in the 2010 maintenance submission.

Expenditure Item	€
garage extensions	150,000
Software (corporate systems – Finance, procurement, HR etc)	200,000
renovation of building façade	300,000
roof construction	140,000
Upgrade of Local SCADA Systems for inter TSO interface(real time data exchange)	100,000
Realised AGC costs	100,000
Kosovo B Substation_ replacement of HV equipment	1,600,000
Replacement of conductors, isolators and related connection equipments on line 126/5	340,000
	2,930,000

The garage extension, façade renovation and roof construction are necessary to install the SCADA system and to improve the security of the control centre.



Personnel Expenses (Ref ERO Comments Part 2 Operating Expenses 2.2 Personnel Expenses)

Headcount and Office Availability

Your comment correctly notes that the actual number of KOSTT employed personnel in 2009 was 219, 15 employees less than the applied for and allowed headcount number of 234, representing a shortfall of 6%. Nevertheless, the work load of KOSTT grew as planned and the employees worked extremely hard to overcome the lack of resources. KOSTT management employed two significant tactics to meet the additional workload, namely:

- Increased overtime working – the total overtime worked during the period was the equivalent of 7 fulltime members of staff;
- Increased use of temporary contracting staff – temporary staff used were the equivalent to an additional 6 fulltime members of staff.

One of the main contributory factors hindering KOSTT meeting the 2009 planned headcount of 234 was a lack of space. Discussions are on-going with KEK to make additional space available and it is expected that KOSTT will have some additional space at its disposal from February 2010.

Our submission for 2010 requests an allowable headcount of 240 – and increase of 21 on the 219 actual for 2009, but only an increase of 8 when the additional 13 fulltime equivalent positions worked in 2009 are considered.

The necessity for more staff in 2010 is based on:

- Recruitment of the additional staff covered by overtime and temporary working in 2009 as premises become available;
- Implementation of the SCADA/EMS project; and
- Preparation for implementation of the SS Ferizaji 2 project in 2011. Staff will be recruited and trained during 2010 in order to be trained and fully operational for 2011.

Staff Costs

The allowed staff expenditure for 2009 was 2,272.3 m€, and for 2010 KOSTT has applied for the value of 2,626.3 m€ for staff expenditure. KOSTT management tightly controlled staff costs to within €25 of the planned average during 2009 as shown in the table below.

Allowed 2009		Actual 2009	
2009 allowed cost(€m)	2,272.3	2009 actual cost (€m)	2,132.0
2009 allowed heads	234.0	2009 actual heads	219.0
2009 allowed average (€m)	9,710.7	2009 actual average (€m)	9,735.1

A 13% increase in average staff costs has been requested in the submission for 2010. This comprises a number of components, including performance and motivational elements as follows:

- KOSTT has implemented the Kosovo Essential Labour Law on non-discrimination of the working staff and approved payment of work experience for managerial staff as well as non-managerial staff (KOSTT Board of Directors has approved calculation and payment of work experience also the managerial staff during 2010, that will be €40,860 or 11.5% of the increase);
- KOSTT will offer 5% motivation and performance pay in 2010 in order to encourage staff to meet the strategic plans and goals for the year (The value of performance at 5% would require budget at value of 131.315 € or 37.1% of the requested increase);
- KOSTT continues to seek highly qualified individuals and the new posts for the operation of SCADA/EMS and SS Ferizaji 2 will increase both the proportion of staff with highest level qualifications and, therefore, the overall average salary.

KOSTT needs to ensure that its remuneration package is sufficiently attractive to retain its most highly skilled individuals as there are examples where some of these individuals have been offered higher salaries overseas.

Additionally, KOSTT invests significantly in the professional training of its staff to enable staff to meet new legislative and other requirements, continue to improve their working methodologies and provide a safe workplace environment. In order to benefit from this investment one of strategic objectives is to reduce the risk of losing trained professional staff by being an attractive employer.

Motivational performance pay has proved highly effective in KOSTT to date as demonstrated above. Securing the services of its staff as they become more highly trained and experienced will become an increasing challenge for the organisation.

Staff Costs Comparison to KEK

Budget for staff expenditure in KOSTT represents 13.1% of total income, calculated according to international practices. The comparable figure for KEK is believed to be about 30%.

According to Annual Reports of other European TSOs, published on their websites, this comparable statistic during 2008 was:

- EMS (Serbia): 16.8%¹
- ELIA (Belgium): 18.2%²
- HEP (Croatia 2007): 15.5%³

It is generally the case that average transmission company salaries are higher than distribution companies. This is to be expected as the overall level of qualification and higher skilled staff is greater. An example of this differential is provided in the following data from UK 2009 regulatory accounts.

Figures per 2009 regulatory accounts	National Grid (Transmission)	Central Networks East (Distribution)	Central Networks West (Distribution)
Total salary cost	£141m	£55m	£67m
Number of Employees	2,352	1,199	1,345
Average salary Cost	£59,950	£45,871	£49,814
		Distribution Average	£47,842

The percentage of professionally qualified staff in KOSTT is 46%. This far exceeds that of KEK which is believed to be in less than 10%.

All the above demonstrates the necessity for the increase in the staff expenditure for 2010. The increase of **€354m**, represents only the minimum increase to achieve our plans and aims for 2010.

¹

http://www.ems.rs/stranice/poslovne_informacije/re%20izvestaj/2008/Konsolidovani%20finansijski%20izvestaji%20JP%20EMS%20za%202008.%20g%20i%20izvestaj%20nezavisnog%20revizora%20po%20konsolidov%20fin.%20izvestajima%20JP%20EMS%20za%202008.pd

² http://www.elia.be/repository/Lists/Library/Attachments/681/FY_2008_ResultsElia-v5.ppt

³ <http://www.hep.hr/hep/en/financial/Income.aspx> and <http://www.hep.hr/hep/publikacije/godisnje/2008godisnje.pdf>

Ancillary services

ERO questions are:

- So far ERO did not receive any information on conditions of this contract. How is supply of the reserve from these generators related, with their duty to supply whole their capacity towards public supplier if necessary?
 - *KOSTT wishes to inform you that agreement with KEK has been signed while agreement with KESH has been drafted and is expected to be signed. These agreements have been send to ERO.*
- Did KOSTT make any payment to KEK for purchase of these services (in cash)? If yes, this should be discounted from allowed revenues of KEK Generation from sale to Public Supplier.
 - *Agreement for ancillary services has been signed on 26.01.2010 and so far KOSTT did not make any payment, this issue is arranged with agreement. Payments will start after implementation of the agreement.*
- Is KOSTT planning to pay KESH for procurement of secondary reserves? ERO is not aware for such payment in the past.
 - *KOSTT will pay for procurement of secondary reserve to KESH based on conditions of the agreement expected to be signed.*
 - *KOSTT can not make a comprehensive planning for payment of secondary reserve since it depends from signing date and conditions stipulated in the agreement.*
- On what are based costs of ancillary services in tariff application? Total is shown to be €1,591,000 which is less than value to be paid to KEK Generation and before payments to OST and KESH are added.
 - *Required value of Secondary Reserve is calculated based on formula from UCTE Operation Handbook , Policy 1.:*

$$R = \sqrt{a L_{\max} + b^2} - b$$

R – Minimal value of secondary regulation in MW

L_{\max} – Peak load in regulation area

$a = 10 \text{ MW} ; b = 150 \text{ MW}$

Which means that value of reserve changes depending on maximal peak.

For year 2009 maximal annual planed peak (according to Annual Power Balance 2009) was 930MW that resulted with a demand of secondary reserve of $R = \pm 28.8$ MW. Price for ensuring reserve from neighboring operator EMS is calculated to be 6.3€ per MW. Determined capacity of reserve should be available during whole year (8760h). From these values cost of secondary reserve for year 2009 has been calculated to be 1 591 000 €.

$$(28.8 \times 8760 \times 6.3 = 1\,591\,000 \text{ €})$$

For year 2010 planed peak is 1020MW (according to Annual Power Balance 2010) which as result has a Secondary Reserve in range of (± 22.1 to ± 30.8) MW.

Price used in calculation of annual cost for Secondary Reserve for year 2010 is 7€ per MW, price that has been proposed in the Agreement for Ancillary Services KOSTT-KEK (realization of obtaining Ancillary Services agreement is in process, concretely Secondary Reserve, from hydro power plants of Albania – KESH).

$$\sum (R \times 720) \times 7 = 1\,623\,888 \text{ €}$$

R – value of required reserve for each month during the year

2010	January	February	March	April	May	June	July	August	September	October	November	December
R(MW)	30.3	30.3	29.2	25.7	24.4	22.4	22.1	22.9	26.2	27.6	30.3	30.8

Since capacity needs to be available during the whole year (8760 hours) while PP Kosovo B (the only generation unit equipped with AGC in Kosovo) has been stated that is not in condition to guarantee this reserve during the whole year without discontinuation, than KOSTT is forced to look for other reasonable alternatives and technically feasible to meet the requirement to have the secondary reserve available without discontinuation. Actually the possibility to procure this service from hydro generation units in Albania (KESH).

Therefore calculated value €1 623 888 is expected to cover annual cost for ensuring full capacity of Secondary Regulation for year 2010.

- At what level are costs of year 2010, compared to actual costs of year 2009, which have been reported significantly lower? Can cost split for secondary services be provided (split per volume, price and source)?
 - Level of costs for secondary services for year 2010 has been calculated based on adequate reserve which should be available 24 hours to cover load change. Calculation of expenses for secondary reserve realized in 2009 is done based on realized average according to past years. Realization for year 2010 will also be shown in the table view. However, cost of these services will be higher, but efficiency will be increased, since as a regulation area we will be able to collect revenues from transit and capacity allocation.

- If KOSTT is not paying ancillary services, how are the revenues received to cover these costs spend?
 - *Since EMS does not pay services for allocation of capacities from revenues dedicated for investment in transmission respectively in interconnection, revenues for ancillary services are the ones used for this purpose.*

Other Operational Expenses (Ref ERO Comments Part 2 Operating Expenses 2.4 Other overheads)

This cost category includes general expenses that are necessary for KOSTT activities. A figure of €1,385,784 is requested for 2010, prepared on a consistent basis with 2009. The expenses are further broken down as follows:

	€	€ Cumulative	% Cumulative
Training	330,400	330,400	24%
Facility Security	205,000	535,400	39%
Staff Health Insurance	127,000	662,400	48%
Fuel	93,202	755,602	55%
Internet and Telephony	99,180	854,782	62%
Electricity	68,000	922,782	67%
Marketing and Tendering	62,800	985,582	71%
Temporary Contracts	58,000	1,043,582	75%
Allowances	52,082	1,095,664	79%
Sundry Smaller Items <50k€	290,120	1,385,784	100%

Sundry smaller items include memberships, vehicle registration costs, safety equipment, heating, water, literature, audit costs etc.

A number of the cost categories require increases from the 2009 figures as there have been, and are planned, a number of significant milestones for KOSTT at the end of 2009 and during 2010 as follows:

- The opening of Peja 3 substation in Autumn 2009 increased the overheads associated with electricity, security, telephony, water, insurance and other sundry costs related to property;
- The new SCADA systems due to be commissioned in the 4th quarter of 2010 require an additional investment in training and development that has already started. The training is expensive and, by necessity, much will be undertaken outside of Kosovo;
- Preparation for ENTSO-E membership again is necessitating additional training costs, along with travel to meetings.

Capital Expenditure (Ref ERO Comments Part 3 Capital Expenditure)

Benefits of Planned Investment Programme

The capital expenditure programme set out in the detailed Investment Plan, has been designed to achieve four principle objectives as follows:

- Overall increases to the transmission network capacity;
- Reduction of transmission losses (planned and unplanned);
- Improved quality of supply; and
- Improved system reliability including achieving N-1 security standard.

Appendix 1 attached to this response provides a summary of each key project identifying the contribution each makes to the above objectives and, therefore the consequences of delaying or failing to make the investment. While benefit of individual projects can be estimated, the integrated nature of the system means that the wider benefits will be achieved through the holistic plan. The three types of investment listed are all essential ingredients of the planned programme:

- Reinforcement of transmission lines;
- Revitalisation of sub-stations;
- Projects supporting system operation.

The high level of the investment programme leads to some short-term increases in the level of losses due to the number of planned outages required during this period of high level capital investment.

Level of Commitment of Donor Funding

The ERO requested details of the extent of commitment of donor funding. 100% of the donor funding in the tariff application for 2010 is committed.

2010 Expected Borrowings and Terms

The Ministry of Finance has finalised an agreement for Loans and Financial Contribution with KfW with a total value of €33,500,000 for finalisation of the project- Transmission Line 400 kV Albania-Kosova , Transformer and Load frequency control equipment. KOSTT is the beneficiary of this loan.

The loan value will be €17,000,000 euro and the Financial Contribution (Donation) will be €16,500,000.



The loan repayment period is 12 years with a grace period of 3 years

The rate of interest is to be calculated on bases of effective cost of financing from KfW plus a margin of 150 base points.

The commitment fee will be at 0.25% of the unspent loan value.

The management fee will be at 1 % of the unspent loan value.

Asset Valuations

The preliminary application indicated a partially financed asset of €1.025m. This related to the burning of a transformer in Kosovo A, requiring an urgent replacement. MEF made a commitment to fund installation of new transformer in the value of €2,844,981. Later it turned out that MEF would provide only €1,196,991 for the replacement. KOSTT had entered contractual obligations for the work to be carried out, and so was obliged to finance the remaining cost of this replacement with a value during 2009 of €1,255,557.

The figure of €1.025m was a preliminary figure for the amount of €1,255,557 which was the final outcome for 2009.

The ERO also asked how the asset value of €53,825,000 for 2009 was derived. This figure in the preliminary application was a technical error which has been corrected in the final application.

In the final application we have also revised the opening asset value figure so that it does not include advance payments as it had done in previous years. We understand that this revised approach is in accordance with the ERO's preferred methodology.

Energy Balance

KOSTT have reviewed our figures for the Energy Balance in our previous submission and confirm that they are correct. We do not know how KEK have derived their figures and so cannot comment on them or the reasons they might differ from ours.

Concluding Remarks

We hope this document has fully addressed the issues raised in the ERO comments of 19th January 2010 and clearly demonstrates the commitment of KOSTT to on-going improvements for consumers. KOSTT plans to deliver these improvements in a very demanding timescale while pursuing longer term strategic goals of ENTSO-E membership for the benefits of consumers for a very modest requested increase in the overall electricity tariff.

If there is any more information that we can supply that can be of use to ERO please let us know and we will be very pleased to assist.

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