

Water and Waste Regulatory Office

Bulk Water Supply Tariff Policy

December 2007

Water and Waste Regulatory Office

Mission

“Water and solid waste utilities delivering a consistent, good quality and efficient service to all customers throughout Kosovo.”

Vision

“To regulate the water and solid waste sectors in a transparent and equitable manner in accordance with good European practice which ensures that the water and solid waste utilities deliver a qualitative, sustainable, reliable and affordable service throughout Kosovo, with respect for both the environment and for public health.”

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Table of Contents

1.	INTRODUCTION	1
1.1	TARIFF SETTING PROVISIONS OF THE WWRO REGULATION (UNMIK REGULATION No. 2004/49)	1
1.2	OBJECTIVES	1
2.	JURISDICTION	1
2.1	BULK WATER SUPPLIER	1
3.	PRINCIPAL TARIFF POLICY OPTIONS	2
3.1	SECTOR DISTRIBUTION OF COSTS.....	2
3.1.1	<i>Multi-sector cross-subsidisation</i>	2
3.1.2	<i>Uniformity of tariffs</i>	2
3.2	ENVIRONMENTAL CONSIDERATIONS	3
3.2.1	<i>Water use control</i>	3
3.2.2	<i>Abstraction charges</i>	3
3.3	COST RECOVERY	3
3.3.1	<i>Definition</i>	3
3.3.2	<i>Time taken to achieve full cost recovery</i>	4
3.3.3	<i>Efficiency expectations</i>	4
3.3.4	<i>Recovery of capital investment costs</i>	4
3.3.5	<i>Grants and gifted assets</i>	5
3.4	CAPITAL STRUCTURE, VALUE AND RETURN	6
3.4.1	<i>Capital structure</i>	6
3.4.2	<i>Regulatory capital value</i>	6
3.4.3	<i>Return on capital</i>	6
3.4.4	<i>Taxation</i>	7
4.	PROCESS	7
4.1	MAJOR TARIFF REVIEWS	7
4.2	INTERIM REVIEWS	7

1. INTRODUCTION

1.1 Tariff setting provisions of the WWRO Regulation (UNMIK Regulation No. 2004/49)

This policy, issued by the Water and Waste Regulatory Office (WWRO), presents the WWRO's interpretation and elaboration of its statutory obligations with respect to regulated tariffs for bulk water supply services.

In particular, Section 38 of the WWRO Regulation (*Rules Issued by the Regulator*) requires the WWRO to create rules for the setting and approving of tariffs. This policy is the foundation upon which such detailed rules can be developed.

Section 10 of the WWRO Regulation prescribes certain tariff obligations including:

- Expectations of efficiency (10.3 b)
- Sufficiency to meet capital and recurrent costs (10.3 d)

The statutory obligations as set out in the WWRO Regulation permit a degree of regulatory discretion based upon professional judgement, understanding of the regulated entities (and their specific circumstances) and other socio-economic criteria.

Taking into consideration representations from stakeholders this final tariff policy statement has been prepared.

1.2 Objectives

The interests of the various stakeholders do not necessarily coincide; for example consumer interest in low tariffs is in conflict with investor interest in financial sustainability. It is the function of the WWRO to ensure that the tariffs provide an optimum balance between these interests and ensure the best possible value, including tariff and improved quality of service for society. This Tariff Policy is designed to deliver this best overall balance.

2. JURISDICTION

2.1 Bulk water supplier

The WWRO regulation is specific in defining a *bulk water supplier* as 'a Person that supplies Bulk Water to a Water Service Provider'. The current regulation effectively excludes the provision of bulk water supply to industrial concerns and other

recipients. Consequently, this tariff policy is restricted to setting tariffs for water provided to the seven licensed water service providers. Bulk water provided to other users is an unregulated commercial activity and prices are subject to the mutual agreement of the parties concerned.

BWSPS 1: Jurisdiction

This Tariff Policy applies to the provision of bulk water to the licensed water service providers. It does not apply to bulk water provided to other parties.

3. PRINCIPAL TARIFF POLICY OPTIONS

3.1 Sector distribution of costs

3.1.1 Multi-sector cross-subsidisation

Regulation 2004/49 (Section 10.3 (d) states that tariffs shall be determined with regard to ‘the sufficiency of a Service Tariff to meet the operating and maintenance costs of the Service Provider and any capital expenditure plans of the Service Provider that have been approved by the Regulator’. WWRO interprets this as prohibiting any form of cross subsidisation between different sectors served by the bulk water service provider. It is recognised that the different tariffs applied to different sectors (regulated and unregulated) will result in differing returns to the bulk water service provider. However, the WWRO bulk water tariffs shall be set at levels that reflect, as far as possible, the true costs of supply regardless of tariffs applied to other sectors.

BWSPS 2: Multi-sector cross subsidisation

Tariffs shall be set to reflect the true costs of supply and shall not be allow for any cross -subsidy effects.

3.1.2 Uniformity of tariffs

The cost of bulk water supply is assumed to vary considerably depending upon the location of the delivery point within the bulk water supply infrastructure system. It is therefore not appropriate to apply a uniform bulk water tariff to all water supply service providers but that separate prices for each provider reflecting the costs of supply at each point.

BWSPS 3: Uniformity of tariffs

A uniform tariff for all water supply service providers is not appropriate. Tariffs shall be set to reflect the costs of supply at the abstraction point in the bulk service provider's system.

3.2 Environmental considerations

3.2.1 Water use control

There is no justification for the imposition of demand management tariffs for raw water supply and is therefore not supported.

BWSPS 4: Demand management tariff structures

Demand management tariffs for bulk water supply are not supported by WWRO.

3.2.2 Abstraction charges

The bulk water service providers currently do pay raw water abstraction charges but an abstraction charging system has been developed and is expected to be implemented by MESP shortly. The WWRO supports the imposition of such charges on the grounds of meeting the economic cost of water and the incentives it provides for water loss reduction.

BWSPS 5: Raw water abstraction charges

The imposition of raw water abstraction charges is supported by the WWRO

3.3 Cost recovery

3.3.1 Definition

Cost recovery in the water sector is subject to various definitions. WWRO considers that cost recovery should be that which is sufficient for the service provider to finance its activities and earn a return on the capital they have invested. The detailed methodology will set out a mechanism for determining the tariffs that can achieve this goal through the establishment of regulatory accounting guidelines. This will include the adoption of the 'asset management' approach to capital maintenance of underground assets in line with good regulatory practice.

BWSPS 6: Definition of cost recovery

Cost recovery is defined as a revenue stream that is sufficient to finance the service providers' activities plus a reasonable return on the capital they have invested.

3.3.2 Time taken to achieve full cost recovery

By taking an initial position on the opening regulatory capital value (RCV) of assets upon which a return can be earned it is possible to establish an immediate position with respect to full cost recovery. A significant portion of the assets are effectively gifted to the service providers and currently do not qualify for regulatory capital value and thus will not earn a return on capital. Once these assets are replaced the RCV and the return will increase over time.

BWSPS 7: Time frame for attainment of cost recovery

Cost recovery shall effectively be attained immediately on the basis of being sufficient to finance the service providers' activities but the return on capital shall increase progressively as new investments in the sector are undertaken either to enhance services or to replace existing gifted assets that currently do not qualify as part of the regulatory capital value.

3.3.3 Efficiency expectations

Tariffs shall reflect realistic but nonetheless challenging expectations of improved efficiency from the bulk water service providers.

BWSPS 8: Efficiency improvement expectations

WWRO should set the efficiency improvement expectations in consultation with the bulk water service providers. The targets should be realistic but nonetheless challenging.

3.3.4 Recovery of capital investment costs

By applying the asset management approach the WWRO shall apply various methodologies for the recovery of capital investment. The fundamental principles are:

- Depreciation should not be applied to grant financed or gifted assets or, alternatively, should be balanced by an equivalent amortisation of the value of the asset or grant.
- New investments for service enhancements shall be added to the regulatory capital value but depreciation shall only

be charged for non-infrastructure (above ground) assets whereas no depreciation shall be charged to infrastructure assets (underground assets plus dams and canals) and their values shall be maintained in perpetuity.

- Capital maintenance (repair and replacement) of infrastructure shall be regarded as expenses and passed through to tariffs based upon infrastructure asset management plans.
- On the basis that the bulk water service providers shall be entitled to a return on infrastructure investment in perpetuity and that all capital maintenance is expensed there is no justification in allowing for depreciation on such assets.
- Where depreciation is charged it shall be calculated on a current cost basis, which for simplicity shall be based upon historic costs adjusted through a simple RPI indexation formula until such time as a more appropriate approach is developed.

BWSPS 9: Recovery of capital investment costs

Capital investment made by the service providers shall be returned through the application of the asset management approach whereby capital maintenance of infrastructure is expensed but current cost depreciation is applied to non-infrastructure assets. Depreciation, where employed, shall only apply to those assets financed by the service providers

3.3.5 Grants and gifted assets

The bulk water supply service providers shall not be reimbursed for investments they do not finance, e.g. grants and gifted assets. Consequently, depreciation on such assets should not be passed through to tariffs. Similarly, capital maintenance in infrastructure assets financed by grants shall not be passed through to tariffs.

BWSPS 10: Treatment of grants and gifted assets

The WWRO shall treat assets funded by grants and gifted assets differently from those assets financed through the service providers' own financial resources. The WWRO shall apply depreciation rules that fairly reflect the return of capital invested and in accordance with the asset management concept.

3.4 Capital structure, value and return

3.4.1 Capital structure

Conventional economic theory rules that capital structure has no bearing on the performance of a business and as such the capital structure is a bulk water service provider management issue rather than a regulatory concern. Consequently, the return on capital (once applicable) shall be based upon a return on the regulatory capital value, including the value of debt.

BWSPS 11: Capital structure

The capital structure of the service providers shall be recognised in the setting of the original regulatory capital value of the assets upon which a return on capital can be earned.

3.4.2 Regulatory capital value

The regulatory capital value (RCV) is defined as the value of assets upon which a return can be earned. At the outset the regulatory capital value shall be calculated as either:

- The value of debt plus working capital plus investments financed through the service providers' own financial resources (excluding debt) plus a nominal value of remaining (gifted) assets (which may be zero), or
- A nominal value determined by the WWRO to reflect the margins earned by the bulk water service provider by applying a 'fair' rate of return.

Subsequent investment (excluding capital maintenance in infrastructure assets) less depreciation (calculated on a current cost basis) shall be added to the regulatory capital value. In accordance with the asset management concept the RCV shall be adjusted for inflation at periodic tariff reviews.

BWSPS 12: Regulatory capital value (RCV)

The WWRO shall establish an opening regulatory capital value (RCV) for each service provider based upon the level of debt and the investments made by the service providers' own financial resources.

3.4.3 Return on capital

The bulk water service providers shall be entitled to a fair return on the regulatory capital value. The rate of return shall be determined on the basis of the appropriate risk related return

through the application of the Capital Asset Pricing Model (CAPM) or similar. In the absence of appropriate market information WWRO may employ surrogate data, e.g. the 'risk free' rate for EURO index-linked treasury bonds plus country risk plus the risk premium for the water sector, e.g. as determined by OFWAT in its tariff determinations.

BWSPS 13: Return on capital

WWRO shall determine an appropriate return on the regulatory capital value of the service providers. This shall be determined on the basis of a risk free rate plus sector risk and appropriate country risk premiums.

3.4.4 Taxation

Non-recoverable taxes shall be reflected in tariffs where appropriate. Where taxes apply they shall be passed through to tariffs and the return on capital shall be based upon a 'post-tax' return with the value of taxes included in the cost build-up.

BWSPS 14: Taxation

Non-recoverable taxes shall be included in tariffs. The return on capital shall be determined on a 'post-tax' basis.

4. PROCESS

4.1 Major tariff reviews

BWSPS 15: Major tariff reviews

For the year 2007/8 tariffs shall be determined on an annual basis in which time the Tariff Policy can be developed with a complete set of rules that can facilitate longer periods between reviews.

4.2 Interim reviews

In accordance with Regulation 2004/49 section 10.5 the WWRO shall review tariffs annually or 'at any other time the rules or an agreement with the Service Provider . . . specify.' The WWRO shall set tariffs tri-annually with the intervening annual review required by the regulation limited to inflationary adjustments and other extra-ordinary events.

BWSPS 16: Interim reviews

The WWRO shall undertake periodic interim reviews of the tariffs taking into account inflation and extraordinary changes in the operating environment.