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REGULATORNI URED ZA VODOVOD I OTPAD
WATER AND WASTE REGULATORY OFFICE



Tariff Policy

for Water Supply and Wastewater Services

Water and Waste Regulatory Office

16 March 2011

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.”

Water Supply and Wastewater Services Tariff Policy

March 2011

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1. INTRODUCTION

1.1 Tariff setting provisions of Law No. 03/L-086 and the WWRO Regulation (UNMIK Regulation No. 2004/49)

For the purposes of this policy references to the Law No. 03/L-086 and the WWRO Regulation (UNMIK Regulation No. 2004/49) are referred to as the 'Law'

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 water supply and wastewater services.

In particular, Section 38 of the Law (*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 Law prescribes certain tariff obligations including:

- Consultation process (10.2)
- Expectations of efficiency (10.3 b)
- Connection charges to be met by recipients (10.3 c)
- Sufficiency to meet capital and recurrent costs (10.3 d)
- Harmonisation of tariffs (10.3 e)

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

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 Service providers

This policy document is based upon the current institutional environment whereby the seven regional water supply companies (RWCs) are the sole licensed providers of urban water supply and sanitation services that operate on the basis of natural local monopolies. The tariffs for bulk water supply services provided by NPH 'Iber Lepenci' to the power and agricultural sectors and also to certain water supply service providers by shall be addressed in an additional policy statement.

The physical jurisdiction of the service providers' service areas is not static and may require adjustment to take into account new municipal areas incorporated in the service providers' areas of supply.

WSWWPS 1: Jurisdiction

This Tariff Policy applies to the activities of the seven regional water supply and wastewater companies (RWCs). It does not apply to bulk water supply services provided by NPH 'Iber Lepenci'.

This Tariff Policy recognises that the physical jurisdictions of the service providers are subject to change from time to time and the impacts therein shall be accommodated in the tariff determination process.

3. PRINCIPAL TARIFF POLICY POSITIONS

3.1 Social fairness and tariff structures

3.1.1 Service providers' role with respect to social responsibility

The Law (Section 10.3) states that tariffs shall be determined with regard to WWRO rules, and the Section 10.3 (f) the responsibility of the Provisional Institutions of Self Government, not Service providers, to help low-income customers to pay their invoices. Consequently, the service providers should be allowed to operate on a fully commercial basis.

WSWWPS 2: Social responsibility

The Government (local and central) is the agency responsible for meeting the needs of disadvantaged including helping them to meet the costs of public services.

3.1.2 Water supply and wastewater services – separate tariffs

The tariffs for water supply and wastewater services need to be determined as separate services and there should be no cross-subsidy between the two services. Costs and revenues for the two services must, therefore, be recorded separately as set out in the Regulatory Accounting Guidelines for tariff determination and monitoring purposes.

WSWWPS 3: Water supply and wastewater services as separate business activities

The tariffs for water supply and wastewater services shall be determined on the basis of separate business activities and that there shall be no cross subsidy between these two activities.

3.1.3 Tariff structures

The tariffs for water supply comprise fixed and volumetric charges based upon metered consumption of water supply. Customers without a wastewater connection shall not be charged for wastewater services. The tariffs for wastewater services shall be determined on the basis of volume of water sold except where a customer has a wastewater connection but not a water supply (or has an additional own source water supply) where charge based upon estimated or metered wastewater generated shall apply. In the future wastewater charges could include provisions for the quality of effluent generated through the Mogden formula or equivalent.

WSWWPS 4: Water supply and wastewater tariff structures

The tariffs for water supply and wastewater services shall be determined on the basis of volume of water sold except where a wastewater services customer has its own water supply where charges based upon estimated wastewater generation shall apply.

Customers without a wastewater connection shall not be charged for wastewater services.

3.1.4 Uniformity of tariffs

Although the costs of services within a service provider's service area are likely to vary by system and by town it is impracticable (without complex accounting systems in place) to determine separate tariffs for each area. Consequently, tariffs should be uniform throughout each service provider's service area. If however, a new area is adopted by a service provider that has a current tariff lower than the service provider tariff the adjustment to the service provider tariff may need to be spread over several years to avoid price shocks.

WSWWPS 5: Uniformity of tariffs

Tariffs shall be uniform throughout each service provider's service area except where new service areas are adopted by a service provider and the tariff needs to be raised to meet the current service provider tariff in which case a progressive increase (over no more than three years) may be appropriate.

3.1.5 Customer groups

The unit costs of supply may vary between different customer groups, e.g. the unit cost of supply to large industrial customers may be significantly less than that for domestic customers. On the other hand, domestic customers may suffer from affordability constraints not experienced by non-domestic customers. This Tariff Policy accepts that in the short term the affordability constraints may take precedence over economic efficiency. The current approach is to impose higher tariffs on non-domestic customers than for domestic customers. This cross-subsidy should be phased out over time and a gradual reduction of the degree of cross subsidy shall be reflected in the multi-year tariff review. This reduction, however, shall only apply to water supply services in the first instance and not wastewater (see WSWWPS 17: The polluter pays concept).

WSWWPS 6: Customer groups

In the short term tariffs for water supply services shall be set on the basis that non-domestic customers shall pay a higher tariff than domestic customers. This cross subsidy should be phased out over time and gradual reduction should be reflected in the multi-year tariff review process. This approach does not, however, apply to wastewater services.

3.1.6 Rising block tariffs and lifeline tariffs

Although there are social arguments for lifeline tariffs, i.e. a reduced unit tariff for that volume of water necessary for basic needs, there are many inherent

economic and practical disadvantages of such a tariff structure, especially with respect to the impracticalities of applying such a system to apartment blocks served by a single connection. Consequently the concept of rising block tariffs and lifeline tariffs is not supported by the WWRO and the current uniform volumetric tariff structure should remain.

WSWWPS 7: Rising block and lifeline tariffs

The structure of tariffs should be uniform as per the current system.

3.1.7 Fixed monthly charges

The current tariff structure allows for a combination of fixed and volumetric charges. The WWRO believes that this system should remain. In recognition that the cross-subsidies on the volumetric charges are to be phased down over time the cross-subsidies for the fixed charge element should also be phased down accordingly.

WSWWPS 8: Fixed monthly charges

The service providers shall be entitled to impose a fixed monthly charge but the value shall be limited to no more than the costs of customer services activities, e.g. meter reading, meter replacement. Any cross subsidies in fixed charges from non-domestic to domestic customers shall be phased out at the same rate that other cross subsidies are phased out.

3.1.8 Fixed monthly charges for wastewater only customers

Fixed charges generally apply to water supply services except where a customer has its own source of water supply but is using the service provider's wastewater services where a fixed charge shall apply even if the customer does not purchase water from the service provider.

WSWWPS 9: Fixed monthly charges

Wastewater only customers shall be subject to fixed monthly charges.

3.2 Levels of service

It is recognised that the level of service in many areas is below minimum acceptable levels (EU standards or similar). It is arguable that those customers that suffer from low levels of service should pay a lower unit tariff than those enjoying a higher level of service. It is impractical, however, to structure tariffs on this basis and alternative compensatory mechanisms would be better employed.

WSWWPS 10: Levels of service

Tariffs shall not vary according to level of service. The WWRO shall, however, employ its regulatory powers to enforce compliance with minimum quality and service standards.

3.3 Service expansion

3.3.1 Connection fees

The current tariff structure allows for connection fees to cover the costs of making the connection from the main to the customer. The WWRO position is that such charges shall remain in place.

Note, the charge is payable only in relation to the service provider customer and not a group of customers. In some instances the service providers have imposed a connection charge on a developer to provide a supply to multiple dwellings and then imposed another charge to each dwelling. This practice is not the intention of the connection charge and should only be imposed on the individual dwellings and not the developer for the connection of the block as a whole.

WSWWPS 11: Connection fees

The service providers may apply connection fees (separate for water and wastewater services) to cover the costs of the saddle, service pipe, valve, meter etc. plus administration fees etc. as employed at present. Such fees may be paid by government of donors agencies for social cases.

Connection fees are only applicable to end customers of the service provider and not intermediaries for multiple customers.

3.3.2 Infrastructure development charges

Service expansion (water and wastewater) places additional infrastructure demands on the service providers, e.g. network expansion, pumping facilities etc. A significant proportion of the additional service expansion water supply demand is attributable to new apartment blocks and commercial / industrial demands. In the case of apartment blocks they are financed by developers rather than individual households. It is therefore recognised as fair and reasonable to impose infrastructure development charges on property developers and new commercial / industrial enterprises. It is recognised, however, that the institutional mechanisms are not yet in place for infrastructure development charges to be imposed in the short term and that the forthcoming review (2012 – 2014) will not include provisions for infrastructure development charges and as such infrastructure expansion shall be included in the water supply and wastewater tariffs.

WSWWPS 12: Infrastructure development charges

The service providers shall be able to impose an infrastructure development charge on new developments to cover the costs of service expansion to meet the increased water demands. The value of the charge should equate to the long run marginal cost of the necessary capital investments calculated on the basis of number of dwellings, or, in the case of commercial / industrial concerns, an amount determined on the basis of expected demand.

In the short term, and until such time the necessary institutional framework for such charges are established, there shall be no infrastructure development charge and infrastructure expansion shall be included in water supply and wastewater tariffs.

3.4 Environmental considerations

3.4.1 Water use control

In the short term it is neither practicable nor appropriate to impose demand management tariff structures (tariffs for high consumption set at a high level to deter over-consumption). In the future, the WWRO may permit demand management tariff structures based upon sound scientific evidence of water resource constraints. The employment of such structures shall be such that the service providers should not gain additional profit from them.

WSWWPS 13: Demand management tariff structures

Demand management tariffs shall not be employed in the short term although may be adopted in the longer term subject to economic benefits based upon scientific evidence.

3.4.2 Abstraction charges

The service providers currently pay raw water abstraction charges. 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.

WSWWPS 14: Raw water abstraction charges

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

3.4.3 Water loss management

Notwithstanding the complications of evaluating the costs and benefits of water loss control the WWRO supports the concept of leakage brought down to its economic level, i.e. where the costs of further leakage reduction exceed the benefits. In the short term, however, it is recognised that the levels of leakage are, based upon scientific judgement and in comparison with efficient water supply industries elsewhere in the world, well in excess of their economic levels and that significant reductions should be achievable and economically viable.

WSWWPS 15: Water loss management

In the short term WWRO shall set targets for levels of service and non-revenue water although in the medium to longer term the target should be the 'economic level of leakage'. WWRO shall monitor loss control activities to ensure that losses are kept to economic levels and allowed for in the tariff structure. The tariff determination methodology shall carefully consider the balance between the costs of development of new water resources against the costs of loss control.

3.4.4 Compliance with environmental standards

It is impracticable to demand that the service providers provide full and immediate compliance with all EU and Kosovo environmental protection standards. A phased approach to compliance is considered more appropriate. The timetable for compliance and any interim standards are not for WWRO to determine but are a responsibility of the government.

WSWWPS 16: Compliance with environmental standards

Compliance with environmental obligations to be introduced in accordance with a timetable set by government during which time the utilities can undertake the investment necessary and the costs can be introduced to the tariff gradually as such investment takes place

3.4.5 Polluter pays concept

The Tariff Policy supports the polluter pays concept and provide for higher charges on non-domestic customers deemed to generate effluents that are more polluting than domestic wastewater, e.g. higher levels of suspended solids and biochemical oxygen demand (BOD). On the basis that non-domestic customers are more likely to generate polluting effluents there is a case for charging them at a higher tariff than domestic customers. Once treatment facilities are developed and the costs of treatment properly determined this surcharge could be properly evaluated. The difference between non-domestic and domestic wastewater tariffs should not therefore be considered as a cross-subsidy and as such should not be phased out over time.

In the longer term at the tariff policy should be amended to a more sophisticated approach through the application of the Mogden formula (where the wastewater charges are based upon a combination of wastewater quality and volume of wastewater generated) thereby promoting on-site treatment by the effluent producers.

WSWWPS 17: The polluter pays concept

Based on the rationale that effluents from non-domestic customers are, in general, more polluting than domestic wastewater the wastewater charges for non-domestic customers shall be set at a higher level than for domestic customers. In the longer term wastewater charges for non-domestic customers could be determined on the basis of the Mogden formula.

3.5 Cost recovery

3.5.1 Definition

Cost recovery in the water sector is subject to various definitions. WWRO considers that cost recovery should be sufficient for the service providers to finance their 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 concept of return on the Regulatory Asset Base (RAB).

WSWWPS 18: Definition of cost recovery

Cost recovery is defined as a revenue stream that is sufficient to finance the activities of the service providers plus a reasonable return on the capital they have invested but still providing a service in compliance with their statutory and regulatory requirements.

3.5.2 Time taken to achieve full cost recovery

By taking an initial position on the opening RAB upon which a return can be earned it is possible to establish an immediate full cost recovery, i.e. as the RAB increases with new investment so will the return on capital.

WSWWPS 19: 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.

3.5.3 Efficiency expectations

Tariffs shall reflect realistic but nonetheless challenging expectations of improved efficiency from the service providers, notably improved revenue collection performance and reductions in non-revenue water (NRW). The expectations shall be set out in the service providers' business plans supporting their tariff applications and shall be subject to the scrutiny of WWRO.

WSWWPS 20: Efficiency improvement expectations

The service providers shall present in their business plans details of their proposed efficiency improvement expectations. These plans shall be subject to WWRO scrutiny and approval. Regular monitoring of performance against the efficiency expectations shall constitute a major aspect of WWRO's monitoring activities.

3.5.4 Recovery of capital investment costs

The regulatory approach to the recovery of capital investment comprises several methodologies and are described in detail in the Regulatory Accounting Guidelines (RAG)

- Depreciation shall not be applied to grant financed or gifted assets.
- 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 underground 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.
- Where depreciation is charged (non-infrastructure assets) 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.

WSWWPS 21: Recovery of capital investment costs

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

3.6 Capital structure, value and return

3.6.1 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 service provider management issue rather than a regulatory concern. Consequently, the return on capital shall be based upon a return on the RAB.

WSWWPS 22: Capital structure

The capital structure (equity:debt) of the service providers shall have no bearing on the determination of tariffs in that the return on capital provided for shall be the return on the RAB regardless of how the assets are financed (except for grants and gifted assets where they are not included in the RAB).

3.6.2 Regulatory asset base (RAB)

The regulatory asset base (RAB) is defined as the value of assets upon which a return can be earned. The RAB shall be determined as the opening value determined in the 2009-2011 tariff review plus all subsequent investments less depreciation, adjusted to current cost values in accordance with current cost accounting principles.

WSWWPS 23: Regulatory asset base (RAB)

The RAB shall be defined as the opening RAB value plus all net (after depreciation) new investment adjusted to current cost values.

3.6.3 Working capital

The working capital requirements of the service providers are deemed to have been included in the opening RAB. The WWRO takes the position that the management of working capital is a management rather than a regulatory issue. Consequently, any changes in working capital shall not result in adjustments to the RAB.

WSWWPS 24: Working capital

The working capital of the service providers is included in the opening RAB. Changes in working capital will not result in adjustments to the RAB.

3.6.4 Return on capital

The service providers shall be entitled to a fair return on the RAB. 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 cost of capital in the Kosovo financial market adjusted to reflect the risk category of the water industry, or the cost of capital in other financial markets applied in EU countries, or those of other countries.

WSWWPS 25: Return on capital

WWRO shall determine an appropriate return on the regulatory capital value of the service providers based upon financial market conditions in Kosovo or outside.

3.6.5 Taxation

The return on capital shall be determined on a 'pre-tax' basis. Taxes on profits shall be deemed to be included in the return on capital. Other non-recoverable taxes, e.g. VAT on unpaid bills, shall be included as a cost in the revenue requirement and included in the tariff.

WSWWPS 26: Taxation

The return on capital shall be determined on a 'pre-tax' basis. Other non-recoverable taxes shall be included in tariffs.

3.7 Major tariff reviews and interim adjustments

In accordance with the Law (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.

The multi-year (three years) tariff review process that started with the 2009 – 2011 review shall continue on this basis.

WSWWPS 27: Major tariff reviews

Tariff reviews shall be conducted tri-annually with adjustments for inflation only permitted the interim years except where circumstances change sufficiently to require an interim review.

Description for abbreviation;

WSWWPS (Water Supply and Wastewater Policy Statement)