

Water and Waste Regulatory Office

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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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 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:

- 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 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.

Following an initial consultation process in May 2007 and subsequent representation from stakeholders this policy statement has been finalised as described below.

1.2 Objectives

The interests of the various stakeholders do not necessarily coincide; for example consumer interest in low tariffs is in conflict with company/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 service providers are the sole licensed providers of urban water supply services that operate on the basis of natural 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 has been addressed in an separate policy statement.

WSPS 1: Jurisdiction

This Tariff Policy applies to the activities of the seven water supply service providers. It does not apply to bulk water supply services provided by NPH 'Iber-Lepenci'.

3. PRINCIPAL TARIFF POLICY OPTIONS

3.1 Social fairness and tariff structures

3.1.1 *Service providers' role with respect to social responsibility*

Regulation 2004/49 (Section 10.3 (f)) states that tariffs shall be determined with regard to 'the responsibility of the Provisional Institutions of Self-Government, not the service providers, to help low-income Customers pay their invoices'. Consequently, the service providers shall be allowed to operate on a fully commercial basis.

WSPS 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 *Uniformity of tariffs*

It is recognised that the costs of water supply services will vary between service providers owing to utilisation of available resources, economies of scale, topography and other factors. Furthermore, the costs of services within a service provider's service area are also likely to vary by system and by town for similar reasons. In the short to medium term tariffs should be uniform throughout each service provider's service area. In the longer term the WWRO should consider the opportunity to employ

variable cost reflective tariffs by town or system but only when financial and technical reporting systems are sufficiently robust to facilitate the required detailed analysis.

WSPS 3: Uniformity of tariffs

Tariffs shall be uniform throughout each service provider's service area in the short to medium term but in the longer term consideration can be given to variable cost reflective tariffs within the service area subject to appropriateness and sufficiency of financial and technical reporting.

3.1.3 Customer groups

The unit costs of supply may vary between different customers 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 but over time the tariff structure should be more cost reflective.

In the short term tariffs should be set on the basis of affordability constraints but should move towards uniform tariffs in the medium term. In the longer term large scale individual customers, e.g. heavy industry and energy generation activities, may be able to negotiate reduced tariffs that are reflective of the real costs of supply.

3.1.4 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.

WSPS 4: Rising block and lifeline tariffs

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

3.1.5 Fixed monthly charges

WSPS 5: 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. In the medium to longer term the tariff structure could be designed to allow customers to choose a volumetric tariff with no fixed charge.

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.

WSPS 6: 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

WSPS 7: Connection fees

The service providers may apply connection fees 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.

3.3.2 Infrastructure development charges

Service expansion places additional infrastructure demands on the service providers, e.g. network expansion, pumping facilities etc. A significant proportion of the additional service expansion related 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.

WSPS 8: 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 dwelling size or, in the case of commercial/industrial concerns, an amount determined on the basis of expected demand. The developer may make a single contribution to such an infrastructure development charge or may elect to pay over a longer period (to a maximum of ten years) with the annual payment determined on a net present value basis at a fair discount rate reflecting the cost of capital of the service provider.

In the short term, where there is no detailed information as to the costs of infrastructure expansion the service provider shall be able to impose a flat charge per new dwelling created limited to an amount set by the WWRO.

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.

WSPS 9: Demand management tariff structures

WWRO should not employ demand management tariffs in the short term (up to five years) although it should leave the option open for the concept to be adopted in the future once the WWRO has commissioned research into the necessity and viability of demand management.

3.4.2 Abstraction charges

The service providers currently pay raw water abstraction charges the Ministry of Environment and Spatial Planning (MESP). 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.

WSPS 10: Raw water abstraction charges

The imposition of raw water abstraction charges by MESP 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 (i.e. physical losses) 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.

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 water loss control activities by service providers 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 water 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 Central Government.

WSPS 11: 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

3.5 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 'asset management' approach to capital maintenance of underground assets as developed by the Office of Water Services, the water and wastewater industry economic regulator for England and Wales.

WSPS 12: Definition of cost recovery

Cost recovery is defined as a revenue stream that is sufficient to finance their activities 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 regulatory capital value of assets upon which a return can be earned it is possible to establish an automatic progression to full cost recovery, i.e. as the regulatory value increases with new investment so will the return on capital. In the long run steady state condition full cost recovery will be achieved, the timing of which will depend upon the scale and timing of new investment in the sector.

WSPS 13: 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).

WSPS 14: Efficiency improvement expectations

WWRO should set the efficiency improvement expectations in consultation with the service providers, KTA (or their successor institutions) and their respective Board of Directors. The targets should be realistic but nonetheless challenging.

3.5.4 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 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.
- On the basis that the service provider 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.

WSPS 15: 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, should only apply to those assets financed by the service providers

3.5.5 *Grants and gifted assets*

The service providers should 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 should not be passed through to tariffs.

WSPS 16: Treatment of grants and gifted assets

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

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 (once applicable) shall be based upon a return on the regulatory capital value, including the value of debt.

WSPS 17: 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.

3.6.2 *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 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). Subsequent investment (excluding capital maintenance in infrastructure assets) less depreciation 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.

WSPS 18: 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.

3.6.3 Working capital

The working capital requirements of the service providers shall be added to the RCV but adjusted to reflect cash flow needs, i.e. full allowance of accounts receivables may not be added.

WSPS 19: Working capital

The working capital of the service providers shall be determined in the basis of real cash flow needs and shall be added to the regulatory capital value.

3.6.4 Return on capital

The 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.

WSPS 20: 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.

3.6.5 Taxation

Until such time that service providers generate taxable profits the issue of taxation on profits is superfluous. Any other 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.

WSPS 21: 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

WSPS 22: 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 periodically with the intervening annual review required by the regulation limited to inflationary adjustments and other extra-ordinary events.

WSPS 23: Interim reviews

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