

RATE REGULATION – request for information – comments

PGE Polska Grupa Energetyczna S.A.

General information:

Energy companies set their tariffs for energy in accordance with the principles laid down in the Act of 10 April 1997 - Energy Law and the secondary law acts – the Ministry of Economy regulations (two regulations: first applies to electricity and gas, second applies to heat), which describe detailed rules of calculating tariffs and settlements.

Apart from the above, in other regulations there are specified legal boundaries of conduct administrative proceedings on the approval of energy tariffs by the President of the Energy Regulatory Office (ERO). Energy companies set their own rates and submit them for approval to the President of ERO in the regulated areas mentioned below (answer for question 2).

The President of ERO approves or denies its tariff approval in case of non-compliance with the rules and tariffs Article. 44-46 of the Act - Energy Law.

The tariff is a set of prices and rates and conditions for their application, developed by a company and introduced as obligatory for specified therein customers in the manner specified by law (Article 3 § 17 of the Act).

Tariffs should in particular provide:

- payment of reasonable costs¹ of a company's activities in the field of energy production, transmission, distribution or energy sale, including a reasonable return on the assets or capital involved in the business,
- protect the interests of consumers against unreasonably high prices and rates.

In the course of administrative proceedings concerning the approval of the tariff, the President of ERO analyzes the application to verify whether the tariff prepared by the company meets the requirements of the Energy Law. In particular, President of ERO analyses and evaluates costs planned by a company for the duration of the tariff, which form the basis for the calculation of prices and rates. If the ERO proves (on the basis of cost verification) that a company has made over-estimation of such costs the ERO President is entitled to refuse to approve tariffs .

Tariff decisions of the President of ERO should not expose a company to operate at a loss, it should ensure the achievement of a reasonable return.

According to art.49 of the Energy Law, the President of ERO could release energy company from tariff submission if it acts on the competitive market. Such release has taken place since 2001 in generation of energy and wholesale turnover and since 2007 for whole retail electricity, except for setting prices for households. The gas wholesale turnover has been released since February 2013.

¹ Reasonable costs underlying the calculation of prices and charges are not identical category of deductible expenses.

Answers:

Question 1

PGE Capital Group is a vertically integrated capital group operating in the energy sector. PGE Capital Group companies' revenue is subject to rate regulation in the area of energy sale (retail for households) and energy distribution, in the area of heat (mainly heat prices and also distribution rates).

- a) Financial Statements preparer
- b) In general the jurisdiction is Polish Accounting Act and local accounting rules and accepted practices. However quoted companies (and its subsidiaries) are entitled to use IFRS to prepare its standalone statutory financial accounts.
- c) PGE Capital Group prepares accounts in accordance with IFRS
- d) Joint stock companies – but with significant influence of the State Treasury

Question 2 – Objective of rate regulation is to replace competition on the natural monopoly area, really effective rate regulation system should give the regulated entities incentives to act like in competitive environment.

ERO President approves tariffs for:

- electricity transmission (TSO)
- electricity distribution (OSD)
- sale of electricity for households
- heat distribution and retail
- gas transmission (TSO)
- gas distribution (OSD)
- gas retail

Example - Distribution Tariffs

The first step in determining tariff for the year it is agreeing by the ERO supply volumes in each group of customers. Then ERO President determines the amount of costs in the following groups:

- operating costs
- taxes
- depreciation
- purchase costs of transmission services
- power purchase costs to cover the amount of the balance difference
- return on equity
- temporary charge (related to the liquidation of long-term contracts)

On the basis of these costs are calculated charges for distribution services which are in Tariff. Tariff is submitted to the ERO President, the ERO President approves tariff (charges and conditions applied) or calls the OSD to make adjustments in the tariff (usually in charges growth level)

- a) Current situation in our country - rather restrict prices, ex ante set regulated income, supply and demand on historical basis. Regulatory Office plans to change rate regulation policy according to distributors in 2015, main change – more incentives for DSOs investments.

There is also open discussion about release prices for the households soon.

- b)
- i. In our country mixture of two mentioned method are used by Regulatory Office.
 - ii. Partly yes, area of efficiency and grid investments
 - iii. Energy Regulatory Office sets in tariffs steady price per unit for particular period.
 - iv. The low level of the prices shouldn't be the main factor which is taken under consideration during tariffs setting process.

Question 3

- a) All rate regulated companies should have licenses, issued by Regulatory Office, such licenses give rights to operate in the market.
- b)
- i. There is a cost of acquiring the license and it depends on kind of activities. This is percentage of yearly income. The license cost is paid annually, at the beginning of each year (usually until the end of march). And because it is yearly payment, it is initially accounted for as a prepayment and amortized during the year.
 - ii. License can be revoked and renewed but not transferred.
- c) and d) Right to recover justified costs approved by Regulatory Office.
- e) Distribution as a natural monopoly has no possibilities to stop activity under rate regulation. Rate regulation in retail area depends on level of competition on the market. Tariffs should disappear when market becomes fully competitive.

Question 4

Enforcing of rights is realized on the base of law provisions. Regulated entity prepares the project of the tariff and applies for Regulatory Office approval.

- a) Tariffs are set ex ante. Our rate regulation model does not provide revisions after the tariff period (rates are set for year)
- b) Rights and obligations are closely related with business
- c) Licenses are granted to realize defined tasks, when entity ceases to realize these tasks loses license.

Question 5

No, tariffs include prices and entity has the right to use these prices during certain period. Whole income company receives depends on current market situation (demand, wholesale energy prices level ect.)

a) There is no mechanism for recovery costs planed in tariffs) There are possibility to change the rates during period of regulation (usually one year), but it requires decision of Regulatory Office President. Application of the entity should be very strongly justified.

c) Not applicable