KPMG Baltic SIA,
Vesetas 7 street, Riga, Latvia, LV-1036.

Estonian Water Works Association.
Adala 10 street, Tallinn,
Estonia, 10614.

Attention: Mr. Veiko Kaufmann, Chairman.

24/09/2010.

We provide you with the following report dated September 24th, 2010 comparing components of the proposed Estonian Water Regulation to the UK OfWat regulatory system.

The report referred to above has been prepared solely in connection with our advice to the Estonian Water Works Association (EWWA) and for use in accordance with the terms of our engagement letter dated Sept 13, 2010. The scope of the work is set out in our engagement letter. Those terms of reference comprise the agreed scope of our enquiries, directed at those issues which you determined to be critical to your needs.

Our work commenced on September 16, 2010 and was completed on September 24th, 2010. In preparing our report, our primary source of information has been the proposed Estonia Water Regulations issued by the Estonian Competition Authority and current OfWat regulations. We do not accept responsibility for the content of this information, which remains the responsibility of other parties.

We understand that our report will be a supporting appendix to a letter written by the EWWA to the Estonia Competition authority and that this report will become public record. KPMG Baltics SIA consent is given to provide our report to the Estonian Competition Authority on condition that the wording as attached in Appendix 1 (the 'Important Notice') is printed at the front of our report.

It is a further condition of such disclosure to third parties that the directors of EWWA accept the risk and will not hold KPMG Baltics SIA responsible if the disclosure of the report to third parties or any public reference (virtual or otherwise) to our name or our work results in or leads to any action or claim against the directors or any other adverse consequences.

Yours faithfully

Matthew Hadley
Partner
KPMG Baltics SIA

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IN CONJUNCTION WITH THIS REPORT

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Comments on Estonian Draft regulation, presented to KPMG 16/09/2010.

KPMG has reviewed the Estonian draft water regulation changes. Our comments are based upon a comparison of the draft regulation to the regulatory framework currently implemented by the Water Services Regulatory Authority (Ofwat) in England & Wales and our own regulatory economics experience. We have chosen to compare the Estonia draft regulation to the regulations issued by OfWat because the Estonian regulator (ECA) has referenced Ofwat data and methodologies on a number of occasions in the past and the UK has one of the leading regulatory frameworks in the world and provides a useful comparator to benchmark the draft Estonian regulation. Specifically:

- Ofwat's approach has been followed by regulators throughout the UK, Ireland, Australia and New Zealand and is widely regarded as a mature and transparent regulatory framework.
- The UK framework covers over 20 companies of varying sizes and diverse financial structures (e.g. some companies are listed on the stock exchange, others are financed through a whole business securitization, and others are mutualized). As a result the UK framework is one of the most flexible in the world and is capable of being applied to a wide variety of situations.
- The UK was one of the first countries in the world to privatize its water companies meaning the framework is one of the oldest and most established. As a result, the UK model has developed over a very long period and reflects the experience gathered over the past 20 years including of different types of regulation such as rate-of-return, price cap and marginal cost based methods. It is a very extensive and detailed regulatory system that includes mechanisms for dealing with a very wide range of issues and scenarios.

As a general note, it seems like the draft regulation is not entirely clear on why regulation of the water sector in Estonian is required nor are the objectives of the regulation clearly stated. These are fundamental regulatory issues as companies need to understand the strategic objectives of the regulatory framework in order to make prudent and sound long term investments into the water industry.

From consumers' perspective – without a proper understanding of why water prices (and changes in those prices) are justified, consumers will be less likely to support prices. This may impact companies' ability to collect payments from customers and may have political implications if price levels are unpopular.

Further, the design of the regulatory framework is intrinsically linked to the strategic objectives it is trying to achieve. Therefore, the absence of clear objectives for the regulation makes it difficult to optimally design regulation and to appropriately incentivize companies, investors and consumers.

Usually, regulation targets for water companies include engineering parameters aimed at assuring that water consumers receive the needed amount of water, at the needed specifications.

Issues such as service down time, leakage rates, and pressure fluctuations are considered within the regulatory framework. In addition, the regulator also considers EU directives on environmental performance, and the chemical quality of water. Important considerations also include customer service quality parameters such as response to client calls for service and time to connect.

The above parameters are for illustration and may change from market to market depending on the specific development needs for each community.

The above are fundamental planning inputs for Water companies, in that they dictate the amount of capital investments, operating and maintenance expense needs by the water sector. The capital investment and operational budgets developed as a result provide a range of financial outputs and performance indicators, which are used by the regulator in the process of designing a proper regulatory system.

Performance data from water companies is usually monitored annually ("June returns" in the UK), whereby water companies are required to submit a range of data, dictated by the parameters described above. The water companies are also required to validate this data by employing a range of independent Financial and Engineering consultants. The regulator is usually engaged in monitoring the performance of these Input parameters by deploying various benchmarking methods that include Econometric and statistical analysis as well as Unit Cost data.

A crucial aspect of water sector regulation in the UK and in many EU countries is the structured consultation process the Regulator and sector stakeholders are undertaking, in which the Regulator initiates a discussion by issuing a "Green paper" followed by a draft document for discussion, the Regulator would then invite the formation of Work groups/meeting forums/conferences to facilitate discussion. The result of this process, which has a defined schedule and objectives, is the release of a final regulatory framework.

In the UK, and elsewhere around the world, regulation and privatization have often gone hand-in-hand; companies have been privatized to raise funds for the government and because the government has had insufficient funds to pay for required investment in the infrastructure (in the case of the UK, in part, to meet EU requirements). As a result, regulation has been introduced to ensure consumers interests are protected from the now-privately owned (and profit maximizing) companies.

It is incumbent upon government to determine the objectives of regulation in consultation with companies, investors and consumers. Once those objectives have been determined we recommend the regulatory framework should:

- clearly set out and justify those objectives; and
- be designed to reflect these objectives.

Going forward, each time the regulator makes a decision they should refer to the objectives, explain what the decision does to achieve those objectives and explain how the specifics of the regulatory model achieve those objectives. This is the approach in the UK where the regulator, Ofwat, sets prices every five years following a (roughly two year) consultation with

stakeholders (which include government agencies, companies, investors and consumers). In its Final Determination Ofwat explains:

1. what companies need to deliver over the next five years (e.g. improvements to water infrastructure to meet EU drinking water quality standards);
2. how those objectives link to Ofwat's statutory duties (e.g. improving water quality is in consumers' interest);
3. the evidence Ofwat has had regard to in reaching its decision, such as macroeconomic conditions, the feedback from stakeholder engagement, changes in relevant (UK and EU) legislation etc; and
4. the regulatory mechanisms it has used to ensure that its objectives are achieved (e.g. penalties if water quality standards are not improved). As part of this process Ofwat clearly explains what service standards the companies are expected to achieve, the rewards and penalties companies will incur if the standards are not achieved and the incentives available to companies to deliver services at lower cost. Ofwat also explains the situations in which its decision may be reconsidered.

Noting the above it is clear that price regulation is a complex process which takes into account a wide range of evidence from a diverse group of stakeholders in order to achieve a set of broader objectives. In this context the price control cannot be viewed as an end in itself, but rather a means to an end.

Assuming it is the wish of the Estonian regulator and all water sector stakeholders to create a regulatory system that is similar to the one practiced in other major European countries, we would recommend a consultation process, similar to the one described earlier is initiated in Estonia and that a reasonable schedule is set to allow the implementation of this process, eventually leading to the formation of the final version of the Estonian regulatory framework.

In the table below we identify several issues with the Estonian draft regulation, explain why these are important issues and compare the draft regulation with the one adopted in the UK.

Draft Estonian Regulation			
Clause	**KPMG comment**	**Why does it matter?**	**Approach in the UK**
General	The draft regulation essentially proposes rate of return regulation.	The type of regulation goes to the very heart of the incentives provided to companies to become more efficient. Rate of return regulation would be appropriate if a company was already very efficient, but price cap regulation would provide stronger incentives to become more efficient. If Estonian water companies could reasonably be expected to become more efficient if incentivized then price-cap regulation may be a more appropriate form of regulation than rate of return regulation. The draft regulation does not explain why it has proposed rate of return regulation. In the interests of transparency and clarity the regulation should set out the different regulatory models that could be implemented and then explain why one model has been preferred.	The UK and many other countries tend more towards price cap regulation. In the UK this is known as "RPI-X" regulation. However, when companies were first privatized in the UK the regulatory regime was closer to rate of return regulation than price cap regulation. More recently the UK has begun to set prices for some services (such as wholesale access to the water network) on the basis of Long Run Marginal Cost (LRMC). If Estonia wished to follow the UK model it may wish to initially adopt rate of return regulation, but signal an intention to adopt incentive based regulation in future. Or outline a regulatory action plan, identifying regulatory objectives to reach the correct regulatory methodology for the country.
3	The draft regulation does not explain the reasons for regulating water companies nor state the strategic objectives of the regulation? The regulator should consider performing a consultation	The objectives of regulation are critical to designing regulation as well as to providing confidence to investors – predictable regulation reduces regulatory risk and increases the likelihood of investment in the sector. Lowers borrowing costs, improves transparency, enables customers, companies to clearly understand the role of the regulator.	In the UK the regulator aims to mimic a competitive market in order to further customers' interests, but also seeks to enable efficiently operated and financed companies to earn a reasonable rate of return. The latter objective enables companies to attract and retain capital investment (both debt and equity), but also acts in customers interests

Draft Estonian Regulation		Why does it matter?	Approach in the UK
Clause	**KPMG comment**		
	process, coupled with an economic and strategic analysis of the water sector, similar to what is practiced by other EU regulators		because the worst possible outcome for customers is that the company goes bankrupt and water services cease.
	It is not entirely clear from the draft regulatory document how the price control package will ensure that companies are able to finance their operations. Considering prevailing practice by EU and UK regulators, the Estonian regulator should consider putting in place a set of clearly defined financial performance indicators leading into a well defined control package for consumers and operators alike.	Providing reassurance to investors that a reasonable rate of return will be earned on their investment is critical to attracting investment into the sector (which may be critical to achieving desired water quality standards if significant capital investment is required). The test is evaluated by considering projected financial ratios such as gearing, interest coverage ratios and dividend coverage ratios. If a company is able to achieve strong financial ratios then the company will be able to attract debt and equity finance at a reasonable cost because the company will be able to meet its interest payment obligations and to provide a reasonable dividend to its shareholders.	Most regulators in the UK specifically consider whether the proposed price control package will enable the regulated company to achieve a set of financial ratios over the price control period that are consistent with an investment grade credit rating (where investment grade is S&P's BBB or Moody's Baa rating or better). The regulators consult with rating agencies and other stakeholders to determine which financial ratios to consider and the appropriate level for those ratios. The ratios and thresholds are published, but the test 'scores' are not usually published. The main ratios used by Ofwat are adjust cash interest cover (AICR) (defined as funds from operations less capital charges divided by net interest) and gearing (defined as net debt divided by RAB). Ofwat required large (small) companies to achieve AICR > 1.6 (1.8) and gearing < 65% (60%).

Draft Estonian Regulation		Why does it matter?	Approach in the UK
Clause	**KPMG comment**		
			In the UK this test is an important way of checking whether the WACC is high enough – if the ratios are not strong enough then the WACC needs to be increased, but if the ratios are too high the WACC can be decreased. The test is not, however, applied rigidly, and companies may have stronger or weaker ratios than desired in some cases. Ofwat has previously allowed companies a "financeability uplift" to ensure the financial ratio test are satisfied i.e. Ofwat has increased some companies' revenue to make the overall price control package attractive to investors.
7	Regulation should clearly state how to calculated opening RAB.	The value of RAB is critical to determining the value of a business as well as the allowed return (via WACC x RAB). The discussion of depreciation (or capex) (CLAUSE 6) implies that assets at the time regulation begins will be recorded at their residual value. This could be problematic for a number of reasons. The economic value in use of the assets may be very different to their residual value if there has been asset price inflation or if the assets useful lives are longer than their accounting lives. The assets might also be incorrectly valued if they were inefficiently or unnecessarily constructed.	In the UK the water regulator looked at the value of floated equity to give a guide to the value of the RAB for the water sector. Specifically the RAB was calculated as the average market capitalization over the first 200 trading days plus the value of outstanding debt. A similar approach was taken for UK electricity distribution networks. In other sectors in the UK, such as airports, the opening RAB was calculated by converting historical asset cost data into current cost values. Specifically, net book values of existing assets were 'grossed up' to (then) current prices using an appropriate

Draft Estonian Regulation			
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		If companies are unable to predict their RAB, or feel it can be adjusted arbitrarily by the regulator without clear reason it will undermine long term planning and investments which will ultimately lead to a worsening of service.	inflation index. For example, if an asset was purchased ten years before the RAB was first calculated for 100, it was depreciated on a straight line basis over 20 years and prices had increased by 50% since the asset was purchased, the asset would have appeared in the starting RAB at a value of 75 = [(1 – 10/20) x 100] x 1.5.
6	The treatment of depreciation should consider what the impact of differing asset lives may be on the revenue of the company once the "vesting" (or existing) assets are fully depreciated.	Depreciation is a key component of a company's allowed revenue.	In the UK, especially for electricity networks, changes to asset lives were needed to ensure sufficient revenues were available to attract and retain finance. Similar adjustments to asset lives for UK water companies have not been necessary.
	The regulation should include references to quality and service standards.	Firstly, without such a reference the tariffs being charged will have little meaning and will not be comparable between companies. Secondly, if service standards have not been defined then it will make it almost impossible to make sound and fair judgments on investment appraisal decisions. This could lead to the CA making ill informed decisions about whether or not to permit an investment. Thirdly, if companies are performing to different service standards then inter-company comparison and benchmarking will be extremely difficult. In this case how does the	

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		CA intend to carry our intercompany performance measures?	

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8.	The regulation should not seem to be favoring one water company size over another. We had also noticed that the WACC calculation does not make any distinction between large and small companies.	The WACC should be set high enough to attract and retain private sector finance from international investors for all companies regardless of the way companies are actually owned (unless the regulator explicitly wants to discourage some ownership types). Any other approach to WACC will constrain ownership structures and lead to less efficient ownership arrangements (on the assumption that an unconstrained optimization of ownership type is superior to a constrained optimization). Regulation should be flexible enough to incorporate different ownership structures. This does not necessarily mean that different WACCs needs to be set for different sized companies, but if the regulator wishes to enable smaller companies to compete with larger companies in the capital markets (as they would surely need to do in a fully competitive industry) the smaller companies will need to be able to offer a higher rate of return to offset the higher cost of investing in smaller companies. As many of the companies in EVEL are small companies we feel it is imperative that the impact of the size of the undertaking will have on the WACC	UK regulators have refrained from favouring one ownership structure over another. Indeed, Ofwat has allowed a higher WACC for small companies in an attempt to enable a diverse range of ownership structures to be retained. The higher WACC for small companies has mainly been implemented to compensate small companies for the costs of raising debt. Specifically, the fixed costs of raising finance constitute a larger proportion of the finance raised for smaller companies e.g. if the cost of issuing a bond is £5m regardless of the face value of the bond, the debt raising costs for a small company that issues a £100m bond are proportionally greater than the debt raising costs for a large company that issues a £500m bond. In the UK small water companies are allowed a slightly higher WACC as they cannot access debt markets as cheaply as the larger companies (see earlier discussion). For example, Bristol Water

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8	The regulation does not provide a clear definition on whether the WACC is real or nominal, pre- or post-tax or vanilla. Regulation should be clearer on this and it should be consistent with RAB - is it to be indexed or not.	Investors are motivated by real (not nominal) post-tax returns on their investment. (Taxes are dealt with below). Because investors demand real returns the investor must be able to earn a sufficient rate of return to offset inflation and still deliver an adequate real rate of return. Compensating investors for inflation can be done in two ways: (i) through the use of a nominal WACC in combination with an asset base that is measured at current cost (not historic cost), or (ii) a real WACC in combination with an asset base indexed for inflation. Adopting a regulatory model that is not one of the two above will mean investors are not adequately compensated for inflation. This will make it harder for companies to attract investment as the real rate of return offered to investors will be lower. It is imperative, therefore, that the regulatory model (i.e. the WACC and the RAB) adopted in Estonia is internally consistent.	In the UK and generally elsewhere the WACC is set in real terms and the RAB indexed to inflation for utilities, but for telecoms the WACC is nominal and the RAB is not indexed (though changes in asset values are taken into account). In the UK the WACC is set on a vanilla (pre tax debt, post tax equity) basis for all water companies and a separate allowance made for tax for each company. The use of a vanilla WACC and a company-specific tax allowance enables Ofwat to set prices that more accurately reflect the likely tax costs for each business – these tax costs can vary significantly from company to company due to the financial arrangements (e.g. some companies are financed through a highly geared whole business securitization structure) of those companies and because differences in capex programmes can give rise to different tax deductions.
9.2	The draft regulation may imply that the WACC is taking the form of a Pre-Tax value, as the regulation does not provide details about inclusion of a tax	Tax is a real cost to companies and investors are interested in post-tax returns. Therefore it is essential that the price control provides sufficient revenue to the company to enable it to pay its taxes. If the regulation does not then	A vanilla (pre-tax debt, post-tax equity) WACC is used in the UK for water companies. Some other sectors use a pre-tax WACC e.g. airports. Either approach is fine provided it is consistent with the rest of the

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	shield	the returns to investors will not be sufficient to attract and retain investment. Further, regulation should be clear and transparent on this topic.	regulatory framework e.g. if a pre-tax WACC is used then no separate allowance for tax is needed.
	The regulation does not contain information on the mechanism for RAB indexation. This may suggest the WACC is meant to be nominal.		The use of a nominal WACC would not be consistent with the approach in the UK where a real WACC and an indexed RAB have been adopted for all sectors except telecoms.
8	Some features of the WACC calculation are overly prescriptive – the reason for expressly stating that German bonds should be used for the risk free rate may need to be substantiated (CLAUSE 8.11), as well as the reason for limiting the range of beta comparators to Europe and USA.	Transparency and clarity about the approach to regulation are generally good. However, consultation with the regulated companies is also important to ensure an appropriate outcome is reached. In the present case the suggested approaches are not the only possible approach and may not be the 'best' approach either. The use of German bunds as a measure of the risk-free rate is defensible (though evidence on other AAA rated government bonds could also be considered), provided an appropriate Estonian country-risk premium is also included to reflect the additional risk of investing in Estonia.	Ofwat is not this prescriptive and nor is any other UK regulator. UK regulators generally consider evidence from the UK to inform WACC parameters. The approach adopted is generally fairly similar at each successive price control review, but regulators typically refrain from making statements that limit their discretion at the subsequent price control review.
8.8	The choice of 50/50 debt/equity in the WACC calculation seems	For the same reasons explained above the failure to consult with the industry about an	The treatment of gearing in the WACC calculation is consistent with taking a

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	unnecessarily specific, and requires substantiation, as well as the statement that "the regulator may intervene in the financing decisions of undertakings and dictate a certain capital structure" is not a common practice taken by the UK regulator and other regulators we are familiar with.	appropriate gearing ratio may lead to an inappropriate conclusion. The regulator should not intervene in the financing decisions of companies as the companies are better placed (with greater expertise) to determine the optimal financial structure. Regulatory interventions of this kind would deter investors from investing in these businesses.	notional gearing approach to WACC as used in the UK and elsewhere. In these cases a single gearing ratio is assumed for the industry reflecting the regulator's view of the optimal (least cost) capital structure. By applying a single assumption about gearing to all companies the regulator leaves the actual gearing decision to companies i.e. companies are free to finance themselves however they prefer in order to minimize financing costs. By allowing more efficiently financed companies to benefit from those cost savings the regulator incentivizes companies to reduce financing costs. The reduction in cost can then be passed on to consumers in the form of lower prices at future price controls. However, UK regulators have used a higher gearing ratio in some cases. For example, Ofwat assumed gearing of 57.5% for water companies, while Ofgem recently assumed gearing of 65% for electricity distribution companies.
7.17 and 6.10	The treatment of stranded assets could be reconsidered as the current wording may increase investment risk and therefore the required rate of return.	Excluding assets from the RAB means that investors do not earn the rate of return on those assets over the entire asset life anticipated at the time the investment was made. This means that returns to investors are	In the UK regulators are mindful of that if their decisions strand assets there may be implications for the cost of capital. Reflecting this concern some regulators have explicitly not excluded stranded assets from the RAB if

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		less than what was expected and what was required to justify the investment. Stranded assets can, therefore, increase uncertainty and risk, which in turn can lead to investors demanding a higher rate of return on future investments. The regulator should also be aware that sudden reductions in the RAB will affect gearing ratios and can affect loan covenants, which can have serious implications for companies.	they appeared to be sensible investments at the time i.e. if the regulator had approved the investment at the time it was made based on the information available at that time.
4	The regulation asks for cost data on a range of services, however, it is a usual practice to explain why this information is required and how common costs should be allocated between services. The regulation also asks for separate cost reporting for different water regions, but does not describe how costs should be allocated to different regions, usually this is stipulated in regulation. The regulation does not specify whether full accounting separation is required or simply	The regulation's requirements may represent an unreasonable burden on the regulated company - it needs to be clearer about why so much information is required. Failure to assess the accuracy of the data and the assumptions used in its calculation means that data from one company is not comparable to another company's data. This severely limits the usefulness of the data for benchmarking purposes. Many of the water companies in Estonia are small and will have their own individual approach to data collecting, and will certainly use different accounting standards. If the CA is not able to apply a clear set of standards fro	UK regulators clearly explain what data is required and what it is used for. The regulators also provide extensive guidance (such as through Ofwat's Regulatory Accounting Guidelines) on how the data should be estimated. Regulators in the UK employ a range of engineering and economic consultants to help assess the quality of the data collected and the methods used in collecting that data. Extensive benchmarking of companies against each other is then undertaken.

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	different line items within the accounts. Regulation should specify how the data will be verified and assessed.	data/cost recording and monitoring then it is highly likely that regulation can only be applied in an inconsistent manner. Furthermore, inconsistent data recording will make inter-company efficiencies will be much harder to understand and will keep prices higher for longer. In addition, the CA will need to establish an independent monitoring and auditing process to ensure customers receive the service standards they are paying for through the tariff. Finally, all these measures, cost recording, benchmarking, relative efficiency targets, quality standards monitoring and audit must be discussed and agreed with all the water companies before implementation. If not the regulation will fail as it will not be transparent. Finally, given the size of many companies and the fragmented nature of the industry data collection, verification and regulator management will be burdensome and costly to many companies. Therefore will all costs associated with providing regulatory information be automatically passed through and included in the tariff?	
2.12	The price control period of 12	The length of the price control is a key	In the UK it is five years. In most places it is

Draft Estonian Regulation			
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	months is very short compared to a 5 year regulatory period currently used in the UK. Estonian regulator could consider applying longer control period.	determinant of the incentives provided to companies to reduce costs. The shorter the length of the price control the more frequently price controls must be held. This increases cost for both regulators and companies. It also increases uncertainty for investors. By setting a longer price control it is also possible to more effectively incentivize companies to reduce costs and to provide rewards for improved quality standards. None of these factors is discussed in the regulation. Perhaps the intention is to move to longer price controls with more incentives and rewards in future, but if that is the case then the regulation needs to say this more clearly.	four or five years, but sometimes it is shorter when regulation is first introduced. By setting a longer price control it is also possible to more effectively incentivize companies to reduce costs and to provide rewards for improved quality standards. None of these factors is discussed in the regulation. Perhaps the intention is to move to longer price controls with more incentives and rewards in future, but if that is the case then the regulation needs to say this more clearly. A longer price control and more incentives would be more consistent with the approach in the UK - here companies are allowed to keep cost savings for five years before they are passed on to customers; companies are also penalized and rewarded for the quality of water they provide (whether it is consistent with EU water quality directives) and for the quality of customer service they provide; companies also need to reduce leakages to a minimum economic level.
9	The regulation should specify what happens if the company earns too much or too little revenue and/or profit.	Whether a company earns more or less revenue than allowed for in the price control is a key driver of whether a company's shareholders earn an excessive rate of return or whether those shareholders do not earn a sufficiently high return to justify the	In the UK companies are protected to some degree from unexpected fluctuations in revenue. If revenue is less than forecast – due to, say, lower demand than expected – the shortfall in revenue is added to the revenue the company is allowed to earn at the next

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		investment. In the former case customers pay too much for their water; in the latter case companies go bankrupt. If Estonia chose not to include such a mechanism it would mean the Estonian companies would be riskier than companies in the UK, which would push up WACC via the beta term.	price control review i.e. the company is allowed to earn higher revenue than it otherwise would have been so that the company is no worse off. This mechanism effectively shifts volume risk onto consumers and away from shareholders, which makes investing in the UK less risky than would otherwise have been the case.
9	The draft regulation ultimately calculates a price per unit of water. (or whatever service is in question). It needs to be clarified, does this imply that water charges would simply be on a per unit basis and there would be no "connection" charge?	Having a fixed charge plus a volumetric charge arguably more closely reflects the water company's costs - an upfront cost to connect water to the building regardless of how much water is used plus a volumetric charge for each unit of water. The volumetric charge would usually be lower if there is a fixed upfront charge as the volumetric charge only needs to cover the (typically low) marginal cost of supplying each additional unit of water. On the other hand, fixed charges can be inequitable (as they cost low income families proportionally more) and provide weaker incentives to minimize water use, which may have environmental consequences.	The use of a fixed charge and a volumetric charge is the traditional approach (but not the only way) to setting water charges in the UK.
5.7.3	It seems that costs related to "other activity" are excluded	Whether “other activities” are included or not determines whether water customers benefit	For UK electricity companies non-price controlled activities must have prices that

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	from water and sewerage prices.	(through lower charges) from the water company's other profitable activities. It also shapes the incentives on companies to undertake unregulated activities – if a company cannot earn a profit on these activities it is less likely to undertake them. This is fine, depending on how revenues and prices for these other activities are determined. However, the Estonian regulator needs to say which approach it will take and why. There should be no restrictions on "other activities" undertaken by companies which are not the licensed water company. Specifically, the owner of an Estonian water company should not be prevented from operating other businesses (including in other sectors) provided those other activities are undertaken by a separate legal entity to the licensed water company.	reflect costs - the price control effectively ignores these activities as they do not subsidize the price controlled activity nor do they require a subsidy. In UK airports the price control takes into account other activities through a single till approach - profits from other activities are used to subsidize airport charges. In UK water there are limits (2.5% of revenue) on other activities which ensure they are small, but the costs and revenues are taken into account in setting water and sewerage charges i.e. a single till approach is used. Many UK water companies are part of larger Group structures. The "other activities" (i.e. unregulated activities) the licensed water undertaker (or its subsidiaries) can undertake is limited, as described above. However, other companies within the Group are able to undertake any unregulated activities they wish without any limitations. Many UK water Groups have overseas subsidiaries, or have contracting businesses that undertake water operations and maintenance on behalf of other companies. Some Groups have interests outside of the water sector.
7.10	Unfinished construction is not included in the RAB.	Under the draft regulation this is a smaller problem than it could have been because the	If the control was for a longer period, as in the UK, it may be necessary to project the RAB

Draft Estonian Regulation		**Why does it matter?**	**Approach in the UK**
Clause	**KPMG comment**		
		proposed price control is only for one year at a time. It is also worth noting that not including unfinished construction into the RAB means a higher rate of return is required as it is earned over a shorter asset life. Further, the WACC may be higher as the investor now bears more construction risk as if the project fails it will not be in the RAB and no return will be earned on the investment. This could be especially problematic for smaller companies who may not have the available cash to fund larger projects without making a return. Additionally, uncertainty over whether an investment will be allowed is likely to mean needed investments will be postponed.	into the future based on when projects are anticipated to be finished. An ex-post adjustment can then be made if projects were not finished.
2	The list of definitions does not include several terms used in the document (for example "non core activities" in CLAUSE 7.8 or "working capital" in CLAUSE 7.3 which might or might not include cash; "net external turnover" in CLAUSE 7.4). Some terms are defined again when they are used. The	In order for the regulation to be transparent it must be clearly drafted. An appropriate glossary would assist investors (and others) to understand the regulatory framework more clearly.	

Draft Estonian Regulation		Why does it matter?	Approach in the UK
Clause	KPMG comment		
	definitions section is not very informative.		
5.7.1	Bad debt costs are excluded from operating expenses. This item should be analysed in more detail in order to assess the impact on companies' results. A threshold could be applied limiting the allowed bad debts that could be included in the tariff.	The regulation should enable a company to recover all efficient and reasonably incurred costs of providing water services. Excluding such costs increases uncertainty and risk for the investor and jeopardizes the ability of companies to attract and retain finance.	This approach is inconsistent with the approach in the UK where bad debt is included as an operating cost. Specifically, Ofwat predicts a level of bad debt for the industry and reflects this as an operating cost – if bad debt turns out to be higher or lower than forecast the company bears the risk or reaps the reward.
5.7.4	The regulation should be clearer about excluding holding gains/losses from the regulator's decision. This clause requires the regulator to ignore any "change in the value of assets" when determining prices. We would suggest the regulator provides more clarity on this topic.	The draft regulation is unclear about whether a nominal WACC and/or indexed RAB will be used. If a nominal WACC is used then holding gains/losses need to be taken into account to ensure that an investor/company is properly compensated for the inflation over the life of the investment – excluding holding gains/losses leaves the investor open to losses on their investment in real terms.	If a nominal WACC and a non-indexed RAB are used, then excluding holding gains/losses is inconsistent with the approach taken by Ofcom for telecoms companies. If the Ofwat approach were adopted then a real WACC and an inflation-linked RAB would be used. No adjustment for holding gains/losses would be necessary.