

Explanatory note to the draft decree of the Minister of Economic Affairs and Communication “Terms and conditions and procedure for establishing a price for water service”

Introduction and the purpose of the decree

The decree is established on the basis of § 16 sections 9 and 10 of the Public Water and Sewer Services Act (PWSSA).

According to §16(10) of the PWSSA “The Minister of Economic Affairs and Communication (Minister of EC) establishes the conditions and procedures for the water services via a decree, as in accordance with this current section.” The purpose of the decree on “Terms and conditions and procedure for establishing a price for water service” (Decree) is to establish the basis, which the Competition Authority (CA) needs to rely on, should it decide to use the right given to it in the PWSSA and establish a temporary water price for a water undertaking.

Content of the draft Decree

The Law on Establishing Restriction on prices for Monopolies (the Anti-Monopoly Bill or AMB) has amended the **District Heating** Act, the PWSSA and the Criminal Code with the aim of better safeguarding of the rights of consumers in their relationships with utilities undertakings that offer universal services that are in the dominant position and in order to secure that the regulation of district heating and water prices works. One of the means of achieving this aim foreseen in the AMB is the CA’s right to establish temporary prices for heating and water undertakings, which may be used as an extraordinary measure, should the undertaking not follow the price regulation.

The possibility of establishing temporary prices for water undertakings is envisaged in § 16(9) and (10) of PWSSA. Similarly, § 9 (10¹) and (10²) of the District Heating Act envisage the possibility of establishing of temporary prices for heating undertakings. Despite the analogy in regulation, it is important to point out a difference between the establishing of temporary prices for heating and for water undertakings. Establishing of a temporary heating price is envisaged, above all, if the input prices (predominantly the price of fuel) decrease and the heating undertaking does not adjust its price in accordance with the legal requirements. In case of water services, we are dealing with *ultima ratio* enforcement provisions, which must safeguard the transition to a new price regulation in instances where other measures foreseen in the law like the possibility to fine the undertaking for non-compliance or instigating a misdemeanour or criminal proceedings enable to achieve this transition.

According to the draft, the Decree “Terms and conditions and procedure for establishing a price for water service” consists of four paragraphs. The Decree has an Appendix „Guidance material for the establishment of the temporary water price“, which is part of the Decree and which consists of five paragraphs.

Decree § 1- Purpose and scope

§ 1 of the Decree stipulates the purpose and scope of the Decree, according to which, based on the PWSSA, the CA has a right to impose a temporary water services price for a water undertaking in accordance of the procedure and means foreseen in this Decree

§ 16 (9) and (10) of PWSSA stipulates that the CA has a right to establish a temporary water services price for a water undertaking in a situation, where the water undertaking is applying prices that do not accord with the requirements of the law and where the undertaking has not complied with the CA’s

prescription. In this case, based on a discretionary right, the CA must assess the need to establish a temporary water service price that would be mandatory for the water undertaking despite the water undertaking not having applied for the approval of its tariffs. Establishment of temporary water services price is done in accordance with the terms and conditions and procedure foreseen in this Decree, taking as a base the existing pricing structure of the water undertaking, the reasonable costs of the economic year preceding to the prescription and reasonable allowed profit limit at the time of establishing the price. The price established by the CA shall be applicable until the water undertaking approves its new water services prices with the CA.

According to the law, the CA can impose a temporary water services price only for those undertakings that are under its regulation. Water undertakings that have to apply for approval of their tariffs to local self-governments and water undertakings that have not been appointed as water undertakings by local self-governments remain outside of the scope of the definition of a water undertaking for the purposes of this Decree and temporary prices cannot be imposed on them. On the basis of the law, the CA may impose a temporary price for water services rendered by the water undertaking to clients or other water undertakings in respect of one or many charges listed in § 14(1) of PWSSA (that concern various water services and fixed fees). The price setting regulation does not extend to connection fees.

The law has not stipulated procedural rules for the establishment of temporary prices for water services. The procedures of establishing the price are stipulated by way of the Decree, taking into consideration the general procedures stipulated for the pricing regulation of water services.

Decree § 2- Definitions

Decree § 2 stipulates the definitions used in the Decree and its Appendix.

Decree § 3- Procedure of establishing the temporary water services price

Decree § 3 stipulates the procedures of establishing the temporary price for water services.

The CA has a discretionary right to decide to establish the price, if the water undertaking provides the water service with a price, which does not accord with conditions set out in § 14(2) of the PWSSA, whereas the water undertaking has not complied with the CA's prescription to bring the applied price in line with the law. § 14(2) of the PWSSA envisages the basis of pricing of water services, incl. requirements for reasonable costs and profits. Since the establishment of a temporary price for water services is an extreme measure, then prior to its implementation the CA must weigh other legal options to secure the fulfilment of the prescription. Such measures include imposition of a fine for non-compliance, instigating misdemeanour proceedings and instigating criminal proceedings. This does not mean that the CA can in no way establish a price before all other legal means have been exhausted. The CA has a discretionary right to choose the most appropriate measure in each case, depending on the circumstances. E.g. if it transpires that the water undertaking does not intend to bring applied prices in line with the law despite administrative, misdemeanour or criminal proceedings instigated against it, then the CA does not have to wait until these proceedings run their course, but may impose a temporary service price for water services for a water undertaking, which shall take effect regardless of the resistance of the water undertaking.

The proceedings of establishing a temporary price for water services shall commence with a notice to establish such a price. If the circumstances have changed following the prescription issued to the water company or if the CA deems it necessary to submit additional reasoning for establishing the price, then these shall be added to the notice to establish a temporary price and shall be sent to the water undertaking together with a deadline for response the length of which shall depend on the

weight of the new material in the notice compared to the prescription issued to the water undertaking. During this deadline the water undertaking has a right to submit its views in the establishment of price proceedings and make a reasoned proposal for conducting additional consultations. This would amount to affording the water undertaking with the right to be heard and, on the other hand, an opportunity to request additional information and explanations from the water undertaking. Should the CA not deem the collection of additional information necessary, or, should the water undertaking not provide the requested information by the specified deadline, the CA has a right to terminate consultations and notify the water undertaking accordingly. Following this, the CA must decide whether to establish a price or not. The decision shall be made within the same deadline as is foreseen for the approval of the tariff application in the price regulation proceedings.

The commencement of the running of the deadline is tied to three alternative bases at the CA's discretion. The deadline of the CA's decision shall be counted from the response deadline given to the water undertaking or, in case this is prolonged, from the extended response deadline or, if consultations have begun, then from the time such consultations end. In the case that the water undertaking has not responded to the CA by a given deadline or submitted the information requested, then the CA can potentially extend the response deadline and the deadline for making the decision shall extend accordingly. At the same time, the CA has a right not to wait for the additional information from the water undertaking and/or terminate commenced consultations at any time if the water undertaking has been afforded the right to be heard and the CA reaches a decision without additional information. Thus, the CA has been afforded enough possibilities to avoid the intentional procedural delay by the water undertaking.

In the procedure for the establishment of a temporary price for the water services one needs to differentiate between the delivery of the decision establishing the price and the publication of the price. The temporary price for water services shall take effect in a general way starting from the delivery of the decision to the water undertaking, unless a different deadline has been specified in the decision. According to the Act of Administrative Procedure, an administrative act is delivered either by postal service, electronically or by the CA in person against a signature. After the decision is delivered, the price is published on the website of the CA. Establishing the temporary price for water services is an exceptional occurrence, to which the general procedure of establishing prices does not apply to, i.e. publication of the price by way of a notice in the paper and 30 days in advance. In addition, the CA has a right to publish the decision establishing the price, with omission of business secrets. The decisions of approval of prices are not generally published, but in the instance of establishing temporary prices one may presume a higher public interest towards the economic activity of the water undertaking and the reasons that have led to the establishment of the price.

Disputing the temporary price for water services does not give rise to halt the application of the decision to establish the price nor does it preclude the right of the clients of the water undertaking to be guided by the established price. This does not mean that the application of an interim injunction in administrative court proceedings would be precluded, although it is to be expected that establishing a temporary price for water services will be disputed by the water undertaking. Establishing the price presumes that the water undertaking and the CA have unresolved disputes on the subject of the reasonableness of the price. Therefore, it is likely that the water undertaking will not agree with the price established for it. Until the final judgment is enforced, one should generally be guided by a presumption that the decision to establish the price is legal. A view to the contrary would put the clients of the water undertaking in an uncertain situation, where it is not clear, which price applies and should be noted when paying the bills.

Decree § 4- Conditions of establishing the temporary price for water services

Decree § 4 specified the conditions based on which the CA establishes temporary price for water services.

Decree § 3 stipulates preconditions stemming from the actions or inaction of the water undertaking, which, if they occur cumulatively, give rise to the CA's discretionary right to decide to establish a price. Decree § 4 specifies the conditions based on which the CA establishes temporary price for water services. Establishing a temporary price for water services presumes considerably more detailed rules than the general basis for the price regulation of § 14 of the PWSSA. On the basis of § 14(9) of the PWSSA the CA established and publishes the recommended principles for calculating the price of water services. When establishing the temporary price for water services it must be clear in which part and with which differences the general methodological bases of establishing the price of water services are applicable when establishing the temporary price for water services. Therefore, the conditions of establishing the price should be specified on the level of a methodology. As per the legal provision giving rise to this right and, considering the general provisions of establishing prices, the methodological bases of establishing the temporary price for water services shall be stipulated in the guidance material, which has been formulated as an Appendix to this Decree. The guidance material has an equal legal standing with the Decree and is mandatory to all addressees of the legal norms when establishing a temporary price for water services. Neither the Decree nor the guidance material contains conditions that are not stipulated in the law, they only modify the general basis of establishing prices to the intricacies of establishing a temporary price for water services.

Annex to the Decree sets out an instruction for establishing temporary price for water service

Instruction for establishing temporary price for water service sets out the methodical bases of establishing temporary price for water service and differences compared to the recommended method for approving the water service.

Annex to the Decree Section 1 – Differentiation of expenses

The objective of § 1 of the Annex of the draft Decree is to ensure the transparency of price formation and a reasonable relation of the product or service of the water undertaking with the value of the product or service and to avoid cross-subsidization of the fields. Pursuant to § 7² of the PWSSA a water undertaking has additional commitments in the accounting for keeping separate accounting on the costs and revenues related to each product or service in order to make the price formation of the water undertaking as transparent as possible and to enable an efficient price regulation. § 1 of the Annex of the draft Decree specifies how the CA proceeds from the mentioned accounting differences in establishing a temporary price for water service. In addition, it has been stipulated that if necessary, the CA shall be entitled to request additional information from the water undertaking within a reasonable term for the completing the information request and the annexes thereto with the data mentioned in this section (from § 14² (7) and (9) of the PWSSA) if this proves to be necessary when establishing temporary prices for water service. In order to prevent a situation in which a breach of law continues and the water undertaking does not submit the required information to the CA, the CA is entitled to establish a temporary price for water service, proceeding from the information that it is aware of.

CA's right to request and collect information necessary for checking the legality of the price and the respective obligations of the water undertaking have been set out in § 14² (7-9) and § 15⁴ (3) of the PWSSA. Establishing a temporary price for water service must be possible also in case the water undertaking refuses all cooperation and withholds its documents. In such case the CA has the right to proceed from the information that it is aware of when establishing the price.

Annex to the Decree Section 2 – Operating expenses to be included in the temporary price for water service

The objective of § 2 of the Annex of the draft Decree is to specify the operating expenses that are considered to be justified in establishing temporary price for water service.

Identifying the justified costs to be included in the temporary price for water service takes place by the party establishing the prices on the basis of the instruction presented in Annex and discretionary power.

When establishing temporary price for water service the justified costs of the financial year preceding the year of issuing a prescription to the water undertaking (hereinafter the accounting period) and the justified rate of return valid at the time of establishing the price. When establishing the price the valid price structure of the water undertaking shall be taken as the basis. Resulting from law the CA cannot establish a temporary price for water service on the basis of the costs of the accounting period and the received operating profit, but must beforehand analyse the costs of the accounting period, identifying which costs reflected by the water undertaking are directly related to the price to be established and whether the costs correspond to the volume of services provided.

§ 2 of the Annex lists the costs that are not considered justified and that are not to be included in the prices (e.g. financial costs, costs related to non-core activity, etc). These costs are not included in the price because these are not connected to the main activity of the water undertaking or the occurrence of these costs can be avoided. It is important to emphasise that the operating expenses that the CA considers to be justified when analysing the price of the accounting period are included in the temporary price for water service. When assessing the justifiability of the costs, the costs necessary for servicing the existing customers of the water undertaking shall be taken as the basis, not for servicing the consumers to be connected in the future from the forecasts, etc. Thereby also the costs aimed at servicing the consumers to connect in the future shall not be taken into account (e.g. construction of new pipeline without any new consumers connecting).

The CA analyses the justifiability of the operating expenses of the accounting period and includes into the temporary price for water service only the justified costs in the extent that ensures the provision of water service. In case the operating expenses of the accounting period are not justified, the CA shall use its discretionary power and shall analyse the justified costs of the accounting period by using various methods for analysing costs, which are: observing the dynamics of costs in time, in-depth analysis of the justifiability of various cost components (incl. expert opinions) and comparison of the statistical data of similar water undertakings.

Annex to the Decree Section 3 – Regulatory asset base and capital expenditure

The objective of § 3 of the Annex of the draft Decree is to specify how the calculation of assets and capital expenditure proceeds.

Regulatory asset base is the fixed assets and working capital used in the regulatory activity. In addition to the abovementioned definition of regulatory asset base also the list of assets not to be included in regulatory asset base is also presented. The regulatory asset base shall not include fixed assets

- that are not used in the provision of water service (assets used in non-core activity, financial investments into subsidiaries, stranded assets, etc);

- the acquisition of which did not bring about costs for the water undertaking (pricing up the fixed assets);
- the acquisition of which is covered from EU Cohesion Fund resources (assets acquired by government grant, assets acquired from connection fees);
- the useful lifetime of which is of an unspecified length in case during the predictable future the completion of money generation by the given asset object is not foreseen (intangible fixed assets: goodwill).

5% of the allowed sales revenue of water services provided at the accounting period shall be considered as the working capital, however, thereby shall not take into account the internal turnover of other companies belonging to a vertically integrated group.

In order to ensure the transparency of the temporary price for water service, the book residual value of the asset as at the end of the accounting period is used for calculating the value of regulatory asset base. An exception is a situation where after 31.12.2009 revaluations of fixed assets reflected in the accounting of the undertaking have been performed and/or the depreciation rates of fixed assets have been changed considerably or if the depreciation rates of the fixed assets do not comply with the useful lifetime thereof, then a calculation of regulatory asset base and capital expenditure shall be performed as stipulated in clause 13 of § 3.

In such case the calculation of regulatory asset base is performed (adjustment in the value of fixed asset) and a justified depreciation rate for calculating the capital expenditure shall be set as per clause 13 of § 3. In the course of the calculation of regulatory asset base in the abovementioned case the fixed assets shall be divided into fixed assets acquired before 31.12.2009 or fixed assets acquired before the margin year and new assets or fixed assets acquired since the margin year. In case it becomes evident that the fixed assets acquired either before or after the margin year include assets that the undertaking is not actually employing for carrying out its economic activity or in case it becomes evident that the capital expenditure rates are not justified, adjustments to the cost of fixed assets and capital expenditure rates shall be made. This means that the fixed assets shall be valued and justified rate of depreciation shall be set for calculating capital expenditure. Capital expenditure on fixed assets acquired before the margin year shall be reported at its residual value, capital expenditure on fixed assets acquired after the margin year shall be reported at its acquisition value. Thereby capital expenditure rate(s) shall be established for the fixed assets, based on which the calculation of capital expenditures to be included in the prices shall take place. When determining the capital expenditure rates for fixed assets acquired after the margin year, the useful life of assets included in clause 10 in Annex 2 of the Minister of Environment Regulation No 34 of 01.07.2009 “Guidelines for preparing the feasibility study, the financial and economic analysis and provisional assessment of environmental impacts for the project in case the project’s co-financing application is submitted to the Cohesion Fund of the European Union “ shall be taken as the basis.

Capital expenditure is calculated only from the depreciable fixed assets included in the regulatory asset base.

Annex to the Decree Section 4 – Justified return

The objective of § 4 of the Annex of the draft Decree is to specify the calculation of justified return.

Justified return is calculated on the entire RAB (also including the non-depreciated fixed assets, which is land) by applying a justified rate of return in line with the formula set out in the Annex § 5. Similar to the rate of return of the companies owning essential facilities operating under regulation of other European countries, the regulation also sets a limit to the company’s rate of return. Limit is necessary

for protecting the market participants against unreasonable profit targets of a water company owning essential facilities.

Justified rate of return equates with (WACC), the calculation of which takes into account the cost of equity and cost of debt and proportions in line with the presented formula. The determined debt/equity ratio has been established with the target to direct the water companies to use more of the inexpensive debt capital. However, the overly extensive involvement of debt has been limited, because too high a proportion of debt jeopardises the financial stability of a company. In the lack of state bonds, the cost of debt is based on more long-term periodic interest rates of money market, country risk and company's risk premium. Cost of equity is calculated based on CAPM (*capital asset pricing model*) taking into account the risk-free rate of return of the water company, country risk premium and market risk premium and beta coefficient. Those are calculated by taking into account the average indicators of the regulated companies in Europe and/or USA. (More specific instructions about the calculation of a justified rate of return together with additional explanations are published each year by the CA on its webpage.)

Annex to the Decree Section 5 – Calculation of the allowed sales revenue and price

The objective of § 5 of the Annex of the draft Decree is to specify how the calculation of allowed sales revenue and the temporary price for water service takes place on the basis of justified costs and return.

The allowed sales revenue serves as the basis for establishing temporary price for water service. Allowed sales revenue is calculated as the sum of operating expenses, capital expenditure and justified return. In order to calculate the fee for each different water service provided by the water undertaking, the allowed sales revenue is divided between the fees included in the price for water service (price for water services as defined in § 14 (1) of the PWSSA) based on the proportion of the fees for water service received during the accounting period in the turnover of the total water service provided. Temporary fees for water service are calculated by dividing the allowed sales revenue of the price for the respective water service with the sales volume of the fee for the respective water service provided during the accounting period.

Accordance of the draft Decree with EU law

The draft Decree has no immediate contact with EU law.

Impact of the Decree

Upon the enforcement of the Decree, the CA shall have a possibility to establish a temporary price for the water services, which shall be mandatory for the water undertaking to follow. Establishing a temporary price for the water services is an extreme measure envisaged in the implementing provisions of the PWSSA taking effect on 01.11.2010 and it is meant to be implemented in a case where other measures foreseen in the law do not prove successful to make a water undertaking fulfil its legal obligations to establish a price that is in accordance with the law.

Establishing a temporary price brings about an intensive limitation of the freedom of establishment of the water undertaking. A temporary price is establishing without a tariff application by the water undertaking and based on the reasonable costs of the economic year preceding to CA's prescription (so-called accounting period) According to the law, the temporary water price may not, therefore, always cover all actual costs of the water undertaking, although they might be considered reasonable at the time of establishing the price, but they were not included in the costs of the accounting period and are, therefore, not considered as reasonable costs of the accounting period. Therefore, in

accordance with the law, the temporary water service price may cause damages to the water undertaking.

Costs required and benefits expected of implementing the Decree

The state shall not incur additional costs or benefits from the implementation of the Decree. The costs of implementation of the Decree have been planned for in the Anti-Monopoly Bill.

Taking effect

The Decree shall take effect on 1st November 2010.

Consultation round of the Decree

The draft Decree shall be submitted to other ministries for consultation via e-õigus (http://eoigus.just.ee/?act=6&subact=1&OTSIDOC_W=305870).

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