

Mr Märt Ots  
Competition Authority  
Auna 6  
10317 Tallinn

Your ref: 07.09.2010  
Our ref: 27.09.2010 No 6/1052315

Cc with an email: Klarika Siegel-Lorvi, Competition Authority

Cover letter to accompany the comments made to the Competition Authority's proposed methodology.

Dear Märt Ots,

Thank you for the opportunity to participate in the development of a model of price regulation for the water and wastewater industry in Estonia. AS Tallinna Vesi recognises the importance of high quality regulation and believes that the implementation of regulation that meets with international best practice standards will bring considerable benefits to the customers and the industry as a whole.

AS Tallinna Vesi welcomes the fact that you have publicised and asked for comment on your methodology. We recognise that regulation must be fully open, transparent and involve all stakeholder groups if it is to be successful. We sincerely hope that this is but a first step in a thoroughly professional dialogue between the Competition Authority, the various ministries and municipalities who we believe will carry out the roles of quality regulators, the water industry, and of course representatives of customer groups. However should this merely be a means of gathering comments from the industry without a full and frank discussion of the implications of those comments it is possible that the methodology will not achieve efficient, sustainable improvements in the quality of service offered to our customers, which we believe is the intention of this methodology.

Furthermore, as the Competition Authority is now in the initial steps of developing a methodology for the water industry, we expect that the Competition Authority will publicly retract the previous public statements it has made about the profits and tariffs of AS Tallinna Vesi. As a consequence of this process, and the fact that AS Tallinna Vesi is now being asked to comment on a draft methodology, it is apparent that the Competition Authority had not conducted a thorough analysis based upon best practice regulatory principles agreed with the water industry. Therefore one would have to assume the previous statements were based more on opinion rather than verified regulatory evidence. Moreover, a public statement of this kind would demonstrate the independence of the regulator, and its belief that this is a professional and open consultation process that does not already have a predetermined outcome.

Based upon the legislation passed by parliament the Competition Authority's methodology it is stated that the new methodology will come into force from 1 November 2010. AS Tallinna Vesi and its owners have a long experience of working within a regulated environment and as such have a good understanding of the fundamental principles that should be included. One of those is that regulatory decisions must be based on high quality information. It is a well documented fact that one of the biggest challenges that any regulator faces is the inconsistency and poor quality information on which to base its decisions. Clear consistent analysing and reporting guidelines for, but not limited to, the following must be established.

1. Information on key levels of service indicators – water quality and pressure, interruptions to supply, sewer blockages etc

2. Financial measures – asset additions, maintenance and depreciation by asset type and asset life, expenditure by purpose
3. Non financial measures – such as population served, new connections, volume of water produced, lost and delivered, length of water mains, sewers inspected repaired and renewed.
4. Regulated business accounts information – profit and loss accounts, balance sheets, cash flow statements, opex and capex by services.

All of the above needs to be provided in a clear and consistent manner to enable the regulator to make informed decisions that do not prejudice one company or one customer group over another. As a consequence of the above points, and the fact that this exchange of correspondence is the first serious dialogue between the industry participants, AS Tallinna Vesi believes it is impossible to implement a transparent and high quality regulatory regime by 1 November 2010. AS Tallinna Vesi recognises that the Competition Authority is driven by the current legislation but hopes, that as an independent regulator, the Competition Authority will appreciate that without having clearly defined objectives and high quality information it will face extreme difficulties in implementing a regulatory methodology that is fair for all stakeholders. The very fact that the information levels of information required, data quality standards, accounting standards etc have not yet been defined and agreed make the consistent application of high quality regulation nigh on impossible. AS Tallinna Vesi recommends that the Competition Authority engage in a full and open discussion with all industry participants to understand, agree and define all these issues and the long term objectives of the regulation before any methodology is implemented.

Before addressing the main points in the methodology I feel it is extremely important to describe to you the status of AS Tallinna Vesi and the contract it has with the City of Tallinn. AS Tallinna Vesi and its owners believe that before any regulatory methodology is implemented the terms and conditions of the original privatisation must at least be discussed with the company and its investors. Whilst we appreciate that national regulation may supersede the privatisation contract we believe that to unilaterally breach this contract without any form of prior discussion, or without any thorough analysis of the performance of the contract to date would be unprofessional, unhelpful to the investment environment and not accord with internationally accepted principles of utility regulation.

Below I have outlined in more detail the main conditions of the privatisation contract. It is however important to highlight the two main bid award criteria and understand how the Competition Authority will be taking these criteria into account when discussing and establishing its price regulation.

### **AS Tallinna Vesi – Privatisation Overview**

On 24/01/01 the City of Tallinn sold 50.4% of the shares in AS Tallinna Vesi (ASTV) to UUTBV (formerly UUIWL). ASTV owned almost all the above and below ground assets required to provide water and wastewater services to approximately 400,000 people in Tallinn. The City of Tallinn had a clear intention to make the tender attractive to international experts; therefore they obtained national government permission to award a 15 year licence to operate to ASTV prior to organising the tender – normal Estonian procurement rules permitted a maximum 5 year contract award. By organising the tender in such a way the City of Tallinn would guarantee a higher degree of international interest and a higher price for the shares. The tender for the share sale was organised via international procurement rules. There were two main bid criteria used to judge the tender and award the share sale. These were:

- 1) Tariff increases for the first five years of the contract, 'K' factors. Worth 60%. The City of Tallinn decided it needed international expertise to bring the quality of water, wastewater, networks and service standards up to and beyond those required by the EU as quickly and at

the lowest cost possible to consumers. Involving international expertise was felt to be the most efficient way to achieve these twin aims. In 2000 water quality was only 60% compliant, wastewater treatment did not meet EU standards and network performance was poor. The winning bidder UUTBV offered to 15% 'K' factors in years 4 and 5, in effect a "real" tariff increase of 30%. Furthermore it was fully in accordance with the Estonian law.

- 2) The price offered for 50.4% of the equity. Worth 40%. The City of Tallinn wanted to raise additional funds to pay for other city projects. This judging criteria encouraged investors to calculate the real value of the investment and to pay more than the accounting NBV of the assets. Furthermore, the accounting value was much lower than the replacement cost of the assets.

In addition all bidders had to be able to demonstrate international experience and expertise through multiple references and to present a business plan reflecting the tariff & revenue projections but also the real return expectations after the privatisation. By organising the procurement in such a way the City of Tallinn was placing all investment risk to achieve the pre-determined quality standards on to the investor. In effect it was felt to be the most efficient way to deliver the required quality standards.

In summary, the City wanted investment, a high quality operator, to pass environmental risk onto a skilled operator, and to raise quality standards as quickly as possible. It was felt that the most effective and efficient way to do this was by privatising and selling shares in ASTV. To date, all of these conditions have been met, however none of these conditions have been considered in the drafting of the Anti Monopoly Bill and the Competition Authority's methodology.

On privatisation the bidders could only be successful if they bid a much higher price for the company than the accounting book value of the assets. Not taking this into account would mean that investors would automatically lose any premium paid for the assets. *How will the Competition Authority consider this premium? Will the Competition Authority automatically expect the investors to lose write off that premium?*

The winning bidder was awarded the contract on the basis of the lowest 'K' factors bid for the first five years of the contract – 'K' factors reflected the change in necessary expenses to achieve the set levels of service (pre-agreed quality standards) and justified profitability. It did not include costs included in the change of CPI. In effect, after a competitive international public procurement these were the lowest "real" tariff increases bid to achieve quality standards and make a reasonable return on the capital invested. *How will the Competition Authority take these factors into account? Will it retrospectively analyse the past and deem that this was not the most efficient way to achieve quality standards? Will it retrospectively review the rates of return considered by investors on privatisation and deem that the 'K' factors bid and bid process was not competitive?*

*If the Competition Authority chooses to disregard these questions, then in order to professionally provide proof why, we would expect that the Competition Authority would have conducted a profitability analysis over the lifetime of the contract to fairly evaluate these questions. These returns could then be compared to the ex ante cost of capital when the investment decision was made in 2000/01. The Competition Authority will of course fully understand that the ex ante cost of capital appropriately reflects the opportunity costs faced by the investors at the time when they commit capital to the investment. Will the Competition Authority be willing to undertake an analysis to compare actual returns to the ex ante cost of capital? And, to be even more professional, make their detailed analysis of this comparison publicly available for professional challenge and scrutiny?*

Finally, within the foreword that accompanied the methodology the Competition Authority has mentioned AS Tallinna Vesi as one of companies involved in developing the methodology. As we have stated above we are pleased to have this initial opportunity to comment on the methodology. However, we feel it necessary to emphasise that we have not had any involvement in the draft methodology sent on 7 September 2010. We will only permit the name of AS Tallinna Vesi to be used as a reference in any future methodology if you amend the draft methodology as per our comments and you publicly respond to all our questions and positions, clearly stating the reasons why you disagree, should you disagree. I feel certain you would appreciate that such public disclosures will only strengthen the methodology and will improve transparency between ourselves and our key stakeholder group, the customers of the water industry.

Sincerely,

Ian Plenderleith  
Chairman of the Management Board

Annex: AS Tallinna Vesi commentaries to the Recommended Principles for Calculating the Price for Water Service