

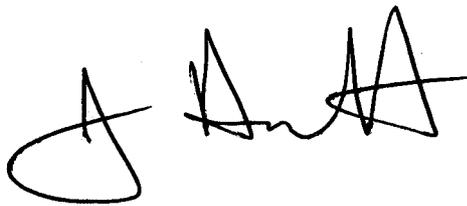
November 10th 2010

To whom it may concern

Estimating allowed revenues for ASTV

The attached report, 'Estimating allowed revenues for ASTV', was undertaken by Oxera on behalf of Tallinn Water.

Yours sincerely

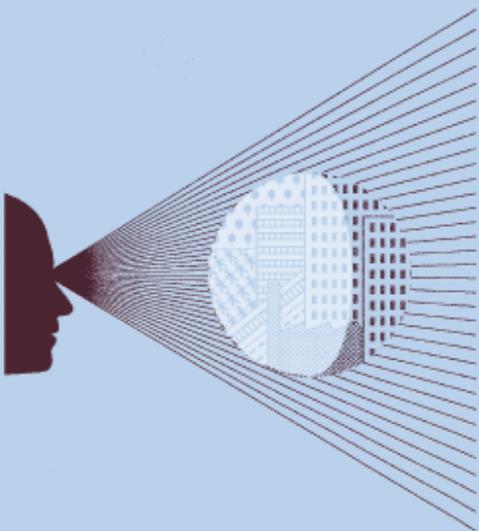


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Estimating allowed revenues for ASTV

Prepared for
Tallinn Water

November 3rd 2010



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1 Introduction and summary of main findings

In the context of its tariff application for the year 2010–11, Tallinn Water (AS Tallinna Vesi, ASTV) commissioned Oxera to estimate the level of allowed revenues that would be consistent with the methodology adopted by Ofwat, the regulator of the water sector in England and Wales.

This report presents the resulting estimate for the allowed revenues in the case of ASTV, and summarises the main assumptions behind these estimates, on the basis of principles set out by Ofwat.¹ It also presents an assessment of the historical revenues generated by ASTV in comparison with the allowed revenues that would have been determined using an Ofwat-style building-block approach.

Summary of main findings

The analysis suggests that applying Ofwat's methodology in the case of ASTV would result in allowed revenues of approximately EEK764m for 2010–11. It also appears that ASTV has under-recovered since privatisation in 2001, in that its actual revenues have been below the estimated allowed revenues in each year since then. A high-level comparison of the return on the regulatory capital value (RCV) with the vanilla weighted average cost of capital (WACC) also suggests that the company has under-recovered since privatisation.²

The report is structured as follows:

- section 2 summarises the key components of allowed revenues under the building-block approach;
- section 3 outlines the assumptions made in order to estimate the allowed revenue for next year's price control period—ie, 2010–11—as well as those allowed revenues that could have been determined historically using a similar building-block methodology;
- section 4 presents the resulting allowed revenue estimates.

2 Key components of the building-block approach

The building-block approach aims to capture the main aspects of the methodology used by Ofwat to determine the allowed revenues for water companies in England and Wales. The approach is implemented using information provided by ASTV, with certain assumptions made where insufficient information is available.

While the approach captures a number of aspects of Ofwat's financial modelling methodology, some components of the regulatory approach used by Ofwat to assess allowed costs, such as efficiency and taxes, are not modelled specifically.

¹ Allowed revenues here relate to the level of revenue that the regulated company is allowed to recover through the provision of the regulated services (water and sewerage services). Under the approach adopted by Ofwat, this revenue is estimated at the start of a price control period in order to determine the tariffs that will be charged to customers over that price control period.

² Vanilla WACC is estimated by taking a weighted average of the pre-tax cost of debt and the post-tax cost of equity.

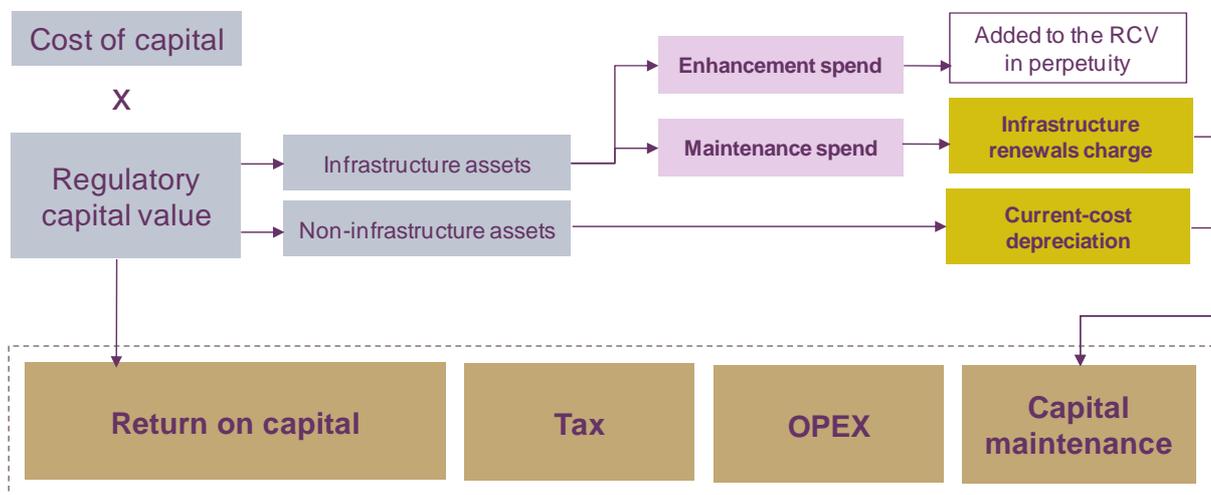
- **Efficiency.** Actual efficiency improvements achieved by ASTV are assumed to be in line with the efficiency assumptions that a regulator may have set. Under Ofwat’s approach, challenging, yet achievable, efficiency assumptions are set with an expectation that companies can outperform these targets and that, under RPI – X regulation, they have the incentives to do so. If companies outperform the efficiency assumptions, they will earn returns higher than those assumed by the regulator, while, if they underperform, they will earn returns lower than those assumed by the regulator, all else being equal. Oxera’s understanding is that ASTV’s contract, which is set relative to the CPI, does provide some incentives for it to seek efficiency improvements. However, from 2011 onwards, an efficiency assumption of around 1% of the OPEX is assumed for determining allowed revenues.³
- **Taxes.** A simplified approach is also used for taxation. While this approach is based broadly on Ofwat’s methodology for determining allowed revenues as described in publicly available documents, some discrepancies may remain due to differences in the corporate tax regimes between the UK and Estonia, or with regard to aspects of the methodology that have not been described in detail in these documents.

Under Ofwat’s approach, allowed revenues can be divided into four main building blocks:

- the return on capital;
- tax;
- operating expenditure (OPEX);
- capital maintenance—in the form of compensation for the capital invested through current-cost depreciation and an infrastructure renewals charge.

Figure 2.1 summarises the key components of allowed revenues under the building-block approach.

Figure 2.1 Summary of the key components of allowed revenues



Source: Oxera.

In contrast to OPEX and tax, which feed directly into the price control through an annual allowance, the allowance for capital expenditure (CAPEX) is determined in order to spread the compensation for it over time. This is because some categories of CAPEX are relatively large and lumpy, and cannot be fully compensated for within the year in which they are spent due to the resulting increase in prices and price volatility. Moreover, the relatively longer asset lives can create issues regarding intergenerational equity—eg, ensuring that the cost

³ This estimate is based on efficiency savings forecasted by ASTV, presented in its business plans.

of investment in fixed assets is shared adequately between current and future consumers. Therefore, to compensate for CAPEX, Ofwat adopts a different approach to those that it uses for OPEX and tax. The approach it uses for CAPEX involves varied treatments for different types of investment.⁴

The main assumptions relating to each building-block parameter are described in section 3.

3 Estimating allowed revenues

The methodology used to estimate allowed revenues for the forthcoming control period, 2010–11, is described below (section 3.1), together with details on the estimation of allowed revenues since ASTV's privatisation in 2001 that would have been consistent with Ofwat's methodology.

3.1 Allowed revenues for 2010–11

The assumptions made in order to arrive at the estimate of allowed revenues for 2010–11 are outlined below. The analysis relies on ASTV's ten-year business plan and historical financial information.⁵

- **Opening RCV.** Similar to Ofwat's approach, the opening RCV is determined on the basis of the value at privatisation and the debt held by ASTV at that time. This ensures consistency with Ofwat's Financial Capital Maintenance principles, thereby disallowing any over-compensation to the investors for their investment. Moreover, under the assumption that the replacement cost of the asset is greater than the price paid at privatisation, this is consistent with the value-to-the-owner principle.⁶
- **Accounting for inflation.** In England and Wales, the approach adopted by Ofwat ensures that companies earn a return that compensates for inflation (on the basis of a real cost of capital and indexed asset base). Conceptually, forward-looking inflation estimates are used to roll forward the RCV, thereby allowing compensation for the expected inflation during the price control period. However, due to limited information about inflation expectations since 2001, the RCV is rolled forward using realised inflation up until 2010. Thereafter, the one-year forecast inflation is used to index the RAB for 2010 and 2011.⁷
- **Depreciation.** The depreciation charge for non-infrastructure assets is calculated on the basis of the current replacement cost, consistent with the approach adopted by Ofwat.⁸ The modern equivalent asset (MEA) value could be estimated to determine the current-

⁴ For example, Ofwat allows for recovery on the maintenance expenditure on infrastructure assets using an infrastructure renewals charge, whereas enhancement expenditure on infrastructure assets is added to the RCV in perpetuity. In contrast, expenditure, both enhancement and maintenance, on non-infrastructure assets is depreciated using certain assumptions about the lives of the assets.

⁵ Financial information is based on the financial year reported by ASTV in its statutory accounts—ie, for the 12 months ending December 31st of each year.

⁶ The value-to-the-owner principle states that an asset value can be estimated as the lower of its replacement cost or economic value, where economic value is expressed as the greater of i) the net present value of future profits, and ii) the net realisable value from selling the assets. A high-level estimate of the replacement cost for ASTV (based on CAPEX figures) indicates that the modern equivalent asset (MEA) value is higher than the net present value. This would suggest that the price paid at privatisation provides the appropriate benchmark for the asset value. See Edwards, J., Kay, J. and Mayer, C. (1987), *The Economic Analysis of Accounting Profitability*, Oxford: Clarendon Press, November, and Oxera (2003), 'Assessing profitability in competition policy analysis', a report prepared for the Office of Fair Trading.

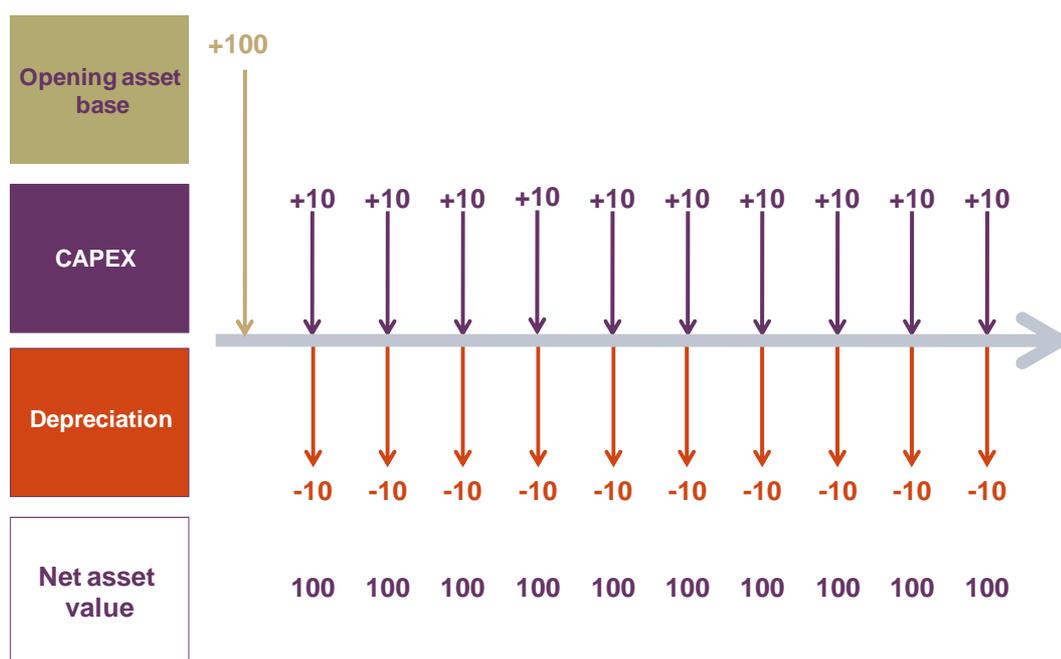
⁷ See Table 3.1 for sources of data on inflation.

⁸ Ofwat (2007), 'Regulatory Accounting Guideline 1.04: Operative: Financial Year 2006-07', February.

cost depreciation on the non-infrastructure assets. In the absence of periodic data on such revaluations, the following assumptions were adopted.

- The depreciation charge on existing assets can be based on the assumption that maintenance CAPEX on non-infrastructure assets represents a steady-state level of investment (ie, it exactly offsets depreciation taking place within the year).⁹ An example is illustrated in Figure 3.1.¹⁰ However, to the extent that ASTV’s investment in non-infrastructure assets increased over time, it is also relevant to take into account some measure of enhancement CAPEX when estimating depreciation for these assets. Further information, including an independent valuation of ASTV’s non-infrastructure assets, would be required in order to obtain a more precise estimate for the current cost depreciation of these assets.

Figure 3.1 Stylised example showing the steady-state assumption for non-infrastructure assets



Source: Oxera analysis.

- In practice, the replacement cost valuation of the existing asset base depends on the asset life of the non-infrastructure asset spend. The product of average annual maintenance CAPEX and the asset life is used to arrive at an estimate of the replacement cost value as of 2001. The resulting value is a proxy for the MEA value of a new asset base, whereas ASTV’s actual asset base would have a combination of relatively older and newer assets. The asset value is adjusted to reflect this combination of older and newer assets in order to avoid a situation in which a large proportion of the existing asset base is anticipated to become fully depreciated at the same time.
- The opening replacement cost value of the non-infrastructure assets is then rolled forward assuming that all enhancement and maintenance spend on non-infrastructure assets post-2001 is valued at the acquisition cost. Given the lack of information available for benchmarking, it is assumed that, within the modelling

⁹ CAPEX on non-infrastructure assets has been adjusted to reflect the amount attributable to ASTV’s regulated business only.

¹⁰ For example, if an asset with a ten-year life is purchased at EEK100 and is depreciated each year on a straight-line basis, a maintenance spend of EEK10 each year would be assumed to reflect the steady-state level of investment. In this example, the net asset value remains constant at EEK100 over the life of the asset.

framework, the CAPEX in ASTV's business plan is at the level that would have been allowed by a regulator.

- **Infrastructure renewals charge.** In contrast to the non-infrastructure assets, maintenance spend on infrastructure assets is remunerated through the infrastructure renewals charge.¹¹
 - Ofwat calculates the infrastructure renewals charge based on the average of forecast 15-year maintenance spend, or on the average of the historical infrastructure renewals expenditure spend in the past five years and a ten-year forward-looking infrastructure renewals expenditure estimate. The choice between the two depends on whether the company is able to demonstrate a medium- to long-term view of its infrastructure renewals expenditure.¹²
 - In the model, the infrastructure renewals charge is calculated by averaging the actual infrastructure renewal spend in the past ten years, measured in real terms, and forecast real spend on infrastructure maintenance over the next five years. This expenditure is indexed using Estonian inflation, similar to Ofwat's methodology.
 - Any difference between the infrastructure renewals charge and the actual outturn infrastructure renewals expenditure is remunerated by adjusting the RCV.
- **Rolling forward the RCV.** The opening RCV is rolled forward each year to reflect the depreciation of old assets, additional CAPEX and inflation adjustments. The following assumptions are made to arrive at an estimate of the average RCV, which is used to estimate the return on capital.
 - In each year, the opening asset base is indexed using the inflation for that year. Similar to Ofwat's approach, it is assumed that the capital spend is equally distributed over the year; therefore, on average, it is assumed that the annual CAPEX is spent in the middle of the year.¹³
 - In line with the aforementioned assumptions, indexation on new CAPEX for the year is assumed to be allowed for a period of six months in the year that it is spent. Similarly, new CAPEX for the year is depreciated on a pro-rata basis, assuming that it is spent in the middle of the year.
- **OPEX.** In the absence of benchmarking information, it is assumed that the OPEX in ASTV's business plan is at the level that would have been allowed by the regulator.
- **Tax.** Various elements of the tax regime need to be taken into account in order to estimate the tax component of allowed revenues. In the regulatory context, it may be appropriate to determine the allowance for tax based on the interest payments to be made under a notional gearing assumption. For example, this approach was adopted by the UK Competition Commission in its review of the appeal by Bristol Water in relation to Ofwat's decision in the 2009 water periodic review of prices.¹⁴ This ensures consistency with the cost of capital estimate, which is based on the notional gearing assumption. However, tax estimates are based on ASTV's approach for determining dividend payments, combined with interest payments determined consistently with the notional gearing assumption. Corporation tax expenditure for 2010–11 is estimated on that basis.

¹¹ Maintenance spend on infrastructure assets has been adjusted to reflect the amount apportioned to ASTV's regulated business.

¹² Ofwat (2008), 'Setting price limits for 2010-15: Framework and approach', March, p. 44.

¹³ ASTV's total CAPEX is apportioned in order to reflect only the amount of CAPEX attributable to ASTV's regulated business only.

¹⁴ Competition Commission (2010), 'Water Services Regulation Authority Water Industry Act 1991, Section 12 Bristol Water Plc: Appendix N', February 8th, p. 8.

- **Cost of capital.** The cost of capital is based on Ofwat’s estimate of the WACC for the 2010–15 price control review.¹⁵ Ofwat’s estimate for allowed WACC has been adjusted for gearing in order to reflect specific factors affecting ASTV’s cost of capital. Investors may also require additional compensation for investing in Estonian assets compared with similar assets in the UK.¹⁶ The post-tax cost of equity and the pre-tax cost of debt are affected by country-specific factors and are adjusted accordingly. The resulting WACC estimate would be used to derive allowed revenues for 2010–11. However, a more thorough analysis would be required to arrive at a robust estimate of the cost of capital.
- **Volume risk and tariff basket.** In practice, volume risk is borne by consumers—ie, any under- (or over-) recovery by the company due to lower (or higher) volumes is compensated for through revenue correction mechanisms in the following five-year price control period. Within the modelling framework, it is assumed that all volume risk is borne by the consumers; the ‘modelled’ allowed revenues are estimated independently of the volume risk that ASTV may in practice have borne. Furthermore, the approach does not take into account the basket of products and their respective tariffs. Any change in the composition of the tariff basket or demand is likely to affect the allowed revenues; however, in the approach adopted, it is assumed that ASTV’s tariff basket is composed of a single product, namely water and sewerage services.
- **Financeability.** Within the modelling framework, no adjustments are made for financeability. It is assumed that the cash flows arising from the forward-looking estimate of allowed revenue would be sufficient to compensate investors for the allowed cost of capital.

3.2 Historical estimates for allowed revenues

While analysing the profitability of a regulated company, it may be appropriate to compare allowed revenues with actual revenues. This exercise may provide an indication of any over- or under-recovery by the company in comparison with the ex ante allowed revenues. Typically, the allowed revenues are based on forward-looking estimates of the components of the building blocks and reflect the revenues that the regulated company should be generating. This involves estimating allowed revenues based on an approach that is fairly similar to that adopted for estimating revenues for 2010–11.

In addition, it may be appropriate to compare returns with the cost of capital at the time of the investment decision. The use of an ex ante cost of capital appropriately reflects the opportunity costs faced by investors at the time of investment. In competitive markets, companies are expected to make profits in the long run that are broadly in line with the cost of capital. Similarly, in regulated industries, the cost of capital set by the regulator often aims to reflect the minimum return demanded by investors. Thus, in ASTV’s case, over the longer term, the return on RCV should be broadly in line with the cost of capital in the absence of any efficiency under- or outperformance.¹⁷ The appropriate benchmark for the earnings before interest and after tax as a percentage of the average RCV is the vanilla WACC.

A comparison of allowed modelled revenues and actual revenues indicates an under-recovery of revenues in the first few years after privatisation. Comparing the return on RCV with the vanilla WACC yields similar results. As mentioned in section 2, these results are

¹⁵ Estonian Competition Authority (2009), ‘Analysis and Opinion on AS Tallinna Vesi’s Price Formation’.

¹⁶ See Table 3.2 for more details on the estimation of the country risk premium for Estonia.

¹⁷ However, under the RPI – X regulation commonly applied in the UK, a company would be expected to outperform a regulator’s assumptions on efficiency, and thereby earn higher returns than those expected by the regulator over the price control period. If this is the case, the regulator could then reduce prices at the next price control review in light of the revealed, more efficient, cost level (all else being equal), and thus pass on these savings to customers.

based on a number of assumptions. This section outlines the additional assumptions that were required in order to draw meaningful conclusions about historical returns.

- **Time horizon.** Under the RAB/WACC regulatory regime, the cost of capital is set for each regulatory period. Since the ex ante cost of capital is compared with the realised returns, it is important to ensure consistency of the cost of capital estimate with the appropriate time horizon. In order to be consistent with an Ofwat-style approach of periodic regulatory reviews of the cost of capital, the benchmark cost of capital is assumed to change every five years.
- **Efficiency.** Within the regulatory framework, there may be a deviation of returns from the cost of capital due to under- or outperformance, depending on the efficiency of the company. In the model it is assumed that the actual OPEX and CAPEX reflect the target levels.¹⁸
- **Tax.** In practice, the compensation for tax allowed by the regulator is based on forward-looking tax estimates. However, for the purpose of determining historical allowed revenues that would have been allowed by the regulator, it may be suitable to use actual tax paid. Therefore, in the model, actual corporation tax paid on dividends is separately added to the other components of the building blocks used to estimate allowed revenues. The estimate of corporation tax allowed in the revenues is adjusted for the tax payments attributable to earnings from the service agreements outside the scope of the agreement with the City of Tallinn. The adjustment is made based on the assumption that the effective tax rate for both the regulated and unregulated parts of the business is the same. In other words, the corporation tax paid by ASTV is adjusted downwards on the basis of the earnings before interest and tax (EBIT) of the share of the regulated business in the total EBIT of the business.
- **Actual revenues and profits.** When comparing ‘modelled’ allowed revenues with actual revenues, it is important that any comparisons are made on a like-for-like basis. Any revenues generated from services outside the scope of ASTV’s contractual agreement with the City of Tallinn should be eliminated from actual revenues when analysing the profitability of the regulated entity. Similarly, actual profits should be adjusted for the unregulated entity’s profits before comparing the actual returns with the cost of capital. In the model, the actual revenues and profits are adjusted accordingly in order to reflect the revenue and costs of ASTV’s regulated business only.

3.3 Summary

The main assumptions made while estimating the allowed revenues for 2010–11 and the historical allowed revenues are summarised in Table 3.1.

¹⁸ See discussion in section 2.

Table 3.1 Assumptions made while estimating allowed revenues

| Parameter | Assumptions | |
|------------------------|--|---|
| | Forward-looking estimates (2010–11) | Historical estimates (2001–09) |
| Opening RCV as of 2001 | Price paid at privatisation | Price paid at privatisation |
| Inflation | Forecast from the Ministry of Finance of Estonia | Observed inflation in Estonia taken from Statistics Estonia |
| Depreciation | Based on replacement cost | Based on replacement cost |
| Tax | Taxes on dividends paid out, which are estimated at 90% of the previous year's net profit adjusted to reflect notional gearing | Actual tax paid adjusted to reflect notional gearing |
| Efficiency | The actual OPEX/CAPEX level reflects the level allowed by the regulator adjusted for efficiency | The actual OPEX/CAPEX level reflects the level allowed by the regulator |

Note: The components of the building blocks model are adjusted to reflect financials of ASTV's regulated business only. Source: Oxera analysis.

The cost of capital estimate for ASTV is based on Ofwat's price control review determinations. The underlying parameters used by Ofwat to estimate the cost of capital for the water companies in England and Wales are adjusted to reflect factors that may affect ASTV specifically—ie, country risk premium and gearing. Table 3.2 summarises the parameters used to estimate the cost of capital.

Table 3.2 Assumption for parameters used to estimate ASTV's cost of capital

| | 2001 | 2005 | 2011 |
|---|------------|------------|------------|
| Cost of capital for water companies in England and Wales | | | |
| Risk-free rate (%) | 2.8 | 2.8 | 2.0 |
| Debt premium (%) | 1.8 | 1.1 | 1.6 |
| Gearing (%) | 47.5 | 55.0 | 57.5 |
| Equity beta | 1.0 | 1.0 | 0.9 |
| Asset beta | 0.5 | 0.5 | 0.4 |
| Equity risk premium (%) | 3.5 | 4.5 | 5.4 |
| Cost of debt (pre-tax) (%) | 4.5 | 3.9 | 3.6 |
| Cost of equity (post-tax) (%) | 6.1 | 7.3 | 7.1 |
| Vanilla WACC (%) | 5.3 | 5.4 | 5.1 |
| Cost of capital for ASTV | | | |
| Gearing (%) | 50 | 50 | 50 |
| Country risk premium ¹ (%) | 2.5 | 2.0 | 1.5 |
| Equity beta | 1.0 | 0.9 | 0.8 |
| Cost of debt (pre-tax) (%) | 7.0 | 5.9 | 5.1 |
| Cost of equity (post-tax) (%) | 8.7 | 8.8 | 7.8 |
| Vanilla WACC (%) | 7.9 | 7.3 | 6.5 |

Note: Figures might not exactly match due to rounding or assumptions around using a point estimate rather than a range. The underlying parameters for ASTV's cost of capital as at 2001, 2005 and 2011 are based on Ofwat's determinations in 1999, 2004 and 2009 respectively. ¹ In the absence of traded Estonian government bonds, credit default swap (CDS) spreads for the Republic of Estonia are used to estimate the country risk premium: over the last year (ie, 2009–2010), the ten-year Estonian CDS exceeded the German CDS (May 2009–May 2010) by approximately 150 basis points on average. In the absence of similar data for earlier periods, the country risk premium for Estonia is assumed to decrease by 50 basis points every five years. Furthermore, it is conceivable that the country-risk premium for Estonia will decrease following the introduction of the Euro currency in 2011, although it is difficult to estimate the effect precisely.

Source: ASTV, Estonian Competition Authority, Ofwat price control review determinations, and Oxera's analysis.

4 Results

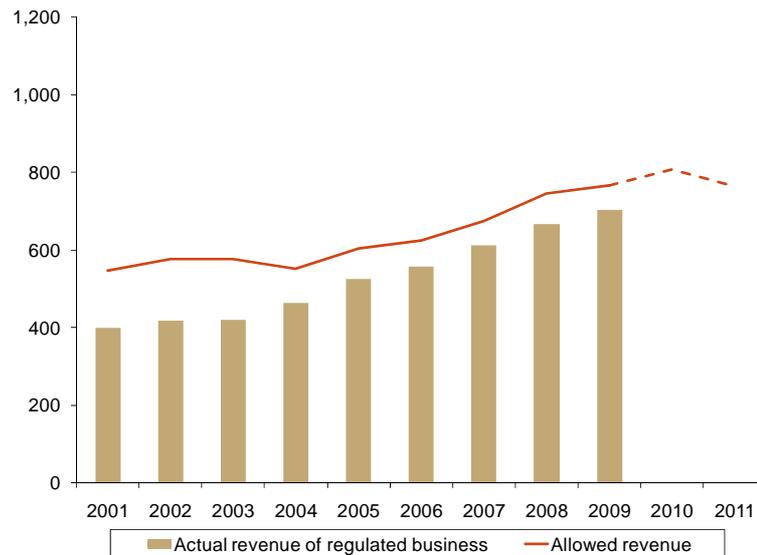
The resulting allowed revenues estimated using the building-block approach are presented below.

For 2010–11, the allowed revenues are estimated to be EEK764m. This result is highly sensitive to a number of assumptions described in section 3, and in particular the opening RCV. As described in the earlier sections, the opening RCV relies on the assumption that the replacement cost of ASTV's assets was greater than the value inferred from the price paid at the time of privatisation.¹⁹ An alternative could be to use the net book value of assets at the time of privatisation, but this would be out of line with the real Financial Capital Maintenance approach adopted by Ofwat.

The allowed revenues—estimated using the building-block approach—are presented in Figure 4.1.

¹⁹ In the absence of any independent valuation of the assets at replacement cost, the CAPEX estimates could be used to estimate the MEA value. A high-level analysis based on this approach indicates that the MEA value is higher than the net present value. For further details on asset valuation methodologies, see Edwards, J., Kay, J. and Mayer, C. (1987), *The Economic Analysis of Accounting Profitability*, Oxford: Clarendon Press, November, and Oxera (2003), 'Assessing profitability in competition policy analysis', a report prepared for the Office of Fair Trading.

Figure 4.1 Allowed revenues (EEK millions)

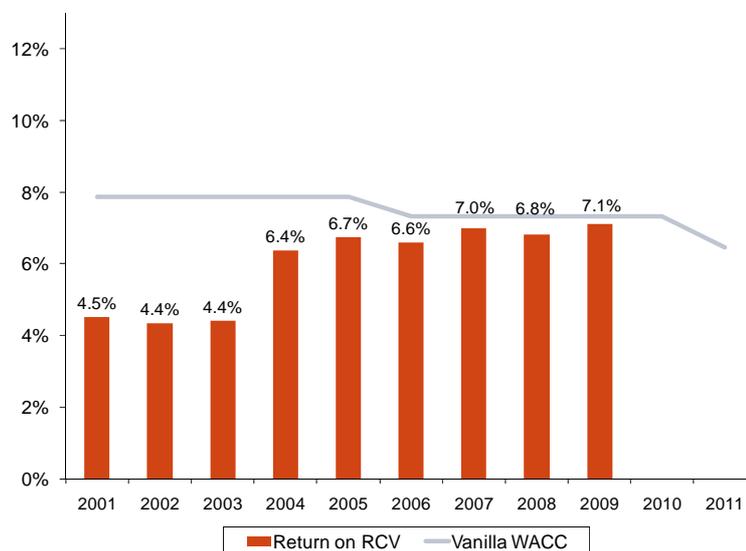


Note: The country risk premium is assumed to decrease by 50 basis points every five years, starting in 2001. However, given the lack of evidence on the evolution of country risk premium over time, it could be assumed that it has remained constant, although this would not change the overall conclusion from the analysis.

Source: ASTV, Statistics Estonia, the Ministry of Finance of Estonia, Statistics Estonia, Estonian Competition Authority, Ofwat's price review determinations, Datastream, and Oxera analysis.

This suggests that the actual revenues are below the revenues that could have been allowed by a regulator for the regulated business under the building-block approach. In addition, a comparison of the return on the RCV with the vanilla WACC yields results that are consistent with the comparison of revenues. These results are summarised in Figure 4.2.

Figure 4.2 Comparison of return on RCV and vanilla WACC



Source: ASTV, Statistics Estonia, the Ministry of Finance of Estonia, Statistics Estonia, Estonian Competition Authority, Ofwat's price review determinations, Datastream, and Oxera analysis.