

Lühendid:

SL – Siiri Lahe

KSL – Klarika Siegel-Lorvi

RN – Raili Niine

IN – Ilona Nurmela

Tartu – Tartu Veevärk, Toomas Kapp

VK – Veiko Kaufmann

ME – Marko Err – kui Phare abi omavalitsus

Discussion on the CA's methodology

04.10.2010 at 13-15.09

Minutes

RN – Introduction.

M. Ots - Presentation:

- 1h review of the methodology in the initially proposed form, followed by a discussion.

Summary of the submitted proposals and questions together with the CA's comments:

- To apply a long-term **5-year indexed price regulation**
 - M. Ots: good idea – the old price will be applicable as long as the company does not apply for an approval to the new price. When granting the tariff approval, a local government or the CA may add a recommendation on the future tariffs in 3-5 year perspective – it has worked well in case of electricity, however, in the beginning it is planned to stick to the 12-months methodology level and extend it later.
 - KSL – if tariffs are approved for 3-5years, the company should still turn to the CA once a year for a tariff approval, in order to review the main indicators, just the approval process once a year is simpler and shorter.
 - Külli Haab – in the future it will be CPI minus x regulation.
 - Comments made by KSL and KH did not constitute a binding promise to amend the methodology, simply an opinion of the officials in the discussion at that moment.
- The book value of assets has to be accounted for as **the RAB**.
 - The principle proposed by the CA serves as the basis, but if accounting does not reflect the actual situation, it may happen that regulated value is accounted for e.g. if the city has given the PWSS network to the company for OEEK, but those are exceptional cases. It is necessary to allow the re-evaluation of assets in case the book value does not reflect the actual value. Also, if a regulatory accounting for cost of

capital was applied, 2011 would be established as the margin year in the methodology.

- **Assets acquired with grant aid** are not included in the estimation of RAB, cost of capital should cover the loan commitment is necessary for getting the aid, but those that have been paid for with the aid, do not belong to the regulatory assets.
- EL konsult – in the EVEL letter we referred to the cost of invested capital and connections to the regulatory assets?
 - M. Ots – we take the NBV of the fixed assets, it does not matter whether we add interests to the calculations of debt and equity, because the books should reflect the accurate value of the company
- SL – you kept the opportunity to estimate the value of RAB using other methods – would it be possible to use the methods referred to by KMPG and Ofwat – to take into account the value of invested capital, which has been used as an example of good practice regulation for privatised companies in other European countries
 - M. Ots – the principle of NBV would mainly be used, using exception would mean a thorough analysis and consideration.
 - SL repeated the question whether it is feasible to calculate the value of RAB based on the invested capital as an exception.
 - M. Ots – we still assume that the NBV is correct and use the NBV.
- SL – Is **inflation** going to be applied to the value of RAB?
 - M. Ots – No, because the CA assumes that the book value is correct and reflects the value of RAB. We assume that the value of RAB is nominal and there is no need to correct it.
- SL – Water companies are in different positions what regards to the book value of assets. E.g. the fixed assets of Tartu Vesi were marked up in 2007, which has to our knowledge not been done by many other water companies – what would be the CA’s recommendation to ensure a similar and equal treatment of water companies, in order for all water companies to be in the same starting point?
 - M. Ots if the value of assets does not correspond to the book value, it needs to be ensured that it did and necessary corrections would need to be made in the books.
 - SL – re-evaluation is an exceptional treatment in accounting – it is not possible or allowed to be done each time there are significant changes in construction prices
 - M. Ots: it is an endless discussion about what is the fair value of assets, it is absurd to take the replacement value of the assets built at the time of Aleksander (II) or Katariina (Peter I) as the basis, because it is unthinkable, the CA assumes that the books reflect the adequate value of assets.
- EL Konsult: If the aid has been accounted for as a non-monetary payment into equity (i.e. before the assets acquired by local governments within 2000 PHARE projects, with which the non-monetary payments to the equity were made)? Is such kind of aid included in the RAB?
 - M. Ots – methodology needs to be reviewed based on today’s discussion and then talk it through again.
- SL: Please tell us if we have understood the CA’s approach to the RAB correctly - does the CA think that investors investing into any company are entitled to earn returns only from the nominal price of share and the CA does not deem right earning returns from the part of investment exceeding the nominal value?

- M. Ots – the CA’s estimation of RAB is based on the NBV of the assets.
- *SL repeated the question by mentioning the premium:* M. Ots: I didn’t understand the question.
- SL – ASTV has addressed the issues of sums paid for the privatisation and estimation of RAB in its commentaries regarding the methodology.
- M. Ots – we will give our comments to all proposals.
- **Calculation of WACC**
 - The CA will publish the WACC calculation on its webpage
 - In the absence of Estonian government bonds, the CA has taken the returns of the last 5 years of the German 10-year bonds as a basis.
 - Market risk premium is the long-term risk premium of EL and USA, based on McKinsey User Guide 5.0%, although EU has 4.8%, 5.0% is used as a rule.
 - Estonian country risk premium = 1.85 is currently the average indicator of Euribor and Talibor. Upon joining the EURO-zone this coefficient will considerably decrease and in 2011 it makes sense to use a country with an analogous level of risk to Estonia as a comparison for estimating the country risk.
 - Proposal to calculate a different WACC for big and small companies is considered disputable by M. Ots, because the CA would like to treat everybody equally, otherwise the companies operating in a low density and high density areas would be in different positions and big companies would immediately challenge the situation asking why they are being discriminated.
 - Proposal to take the effect of the income tax on equity into account in the WACC calculation – M. Ots thinks that considering the Estonian income tax system, there is no need to include the effect of income tax in the estimation and there is no need to apply a tax shield.
 - WACC does not need to be linked to the payment of loans, because elsewhere in the world WACC takes into account the cost of both equity and debt, estimation of return stops at operating profit.
 - WACC is nominal and includes inflation.
 - SL – Would you please explain how can WACC be nominal, if its formula does not include inflation coefficient?
 - M. Ots, all coefficients include inflation – the part of German bonds as well as the country risk premium.
 - SL – these are different things. German bonds can indirectly reflect the inflation in Germany, but surely not the one in Estonia – statistics show that during the period under observation German inflation exceeded Estonian by more than 3%. It is unclear in the referred table, where it has been taken into account.
 - M. Ots– it has been estimated in German bonds and country risk premium.
 - SL – have you consulted with any experts to confirm that the CA’s calculation of WACC includes inflation?
 - M. Ots – yes, consultations have been kept with experts, the CA is the expert in this matter.
 - SL – when looking at the calculation of WACC as an investor, it is difficult to see how the Estonian inflation has been included – is the CA’s message to

the investors that the investor has to bear the inflation risk when making investments in Estonia?

- M. Ots – Estonia is in the Euro-zone, it should be a good place to invest in, plus the CA's methodology of WACC calculation is a common, wide-spread methodology; if we take the bonds of seriously risky countries from e.g. PIGS, then they also have 5.5% return on bond, before it was raised to 17%, before it turned sour. In Europe this indicator is 5.5-6%. This figure will most likely drop more after Euro, because it is a better investment environment here than e.g. in Greece. Therefore it makes sense to use a country risk of one with a similar risk level to Estonia as the country risk factor or the average of Euribor and Talibor. Hopefully we can make WACC more accurate, when Estonia issues its own bonds in 2011. Perhaps the Check bond is comparable today.
 - SL: coming back to the fact that based on the last 5 years Estonian inflation has exceeded German inflation by more than 3% and investor cannot see inflation to have been considered in WACC. What should we say to the investors about inflation today – that hopefully the approach will change in 2011? How would you feel as an investor?
 - M. Ots – the company with 8% return in a dominant position, as an investor I would feel well.
- Methodology should take into account the **obligations involved in servicing the loans** and the cash flow resulting therefrom
 - M. Ots: the CA does not agree with this, because if the company has taken far too many loans or taken a loan with inefficient interests, the operating profit stems from the level of assets.
 - VK and ME: The requirement of PWSSA to follow the terms and conditions of fund applications is not possible with the current methodology, neither does the methodology take into account loan repayments if a material part of the assets is acquired with government grants (loan repayments in a maximum of 10 years, incoming cash-flow on the account of depreciation of the same assets during 4-5 times longer time period; as there is practically no cash flow, it is not possible to finance the loan repayments). VK – in fact only the signature of one official of the MoE approving the subsidies in KIK is behind the extremely high gearing of the companies, i.e. it is not the fault of water companies.
 - M. Ots – I was not aware of such problems before. The CA based its analysis on the classical debt and equity model of 50/50, but it can be established in the methodology that the part of debt cannot exceed 60%.
 - VK – unfortunately the gearing of some companies is 90%.
 - Based on the information learned today, the methodology needs to separately address the different and also high gearing level of companies and other problems discussed today. EVEL members with a high gearing level, could propose couple of models and hold a separate meeting to discuss the subject.
 - **How is the service quality taken into consideration when applying price regulation?**
 - M. Ots – Today quite detailed standards are in place for water and wastewater, but there are no service standards on a national level on how quickly should the interruptions be eliminated, the level of pressure, for how long may the consumer be

without water. In energy sector it has been established, what is the number of allowed total annual interruptions and the number of consumers left without power, how quickly they need to answer the complaints. Currently these are not established in the laws regulating water industry and therefore there are 2 options – to incorporate those when the PWSSA will be changed one day, the other option – to develop a voluntary standard in cooperation with EVEL and MoE next year.

- SL – for each regulation it is important to define the **objective of the regulation**, which has been recommended by KPMG in their advice to EVEL, and as it has been set out in the electricity and gas regulatory methodologies. As EVEL’s representatives and bigger water companies as well as the CA are present today, it would be a good opportunity to discuss the purpose of the regulation and agree upon the more important general principles as the importance of price and quality for consumers, financial viability of companies, ensuring sensible return to the investors etc., because if the objective is in place, it is easier to agree upon technical details later and amend those if needed.
 - M. Ots – the law states that the price must be cost-based
 - SL – if the law does not address quality, then is our understanding correct that in the methodology the CA proceeds only from the cost-based principle? (*reference again to the electricity and gas regulations*)
 - M. Ots – What do we have in the objectives of electricity and gas?
 - KSL- She (SL) refers to the general principles.
 - M. Ots – general principles may sure be incorporated into the methodology

Other important positions expressed by the CA:

- SL – will all questions, proposals and comments given to the CA get an answer?
 - M. Ots – As there are *ca* 150 questions, then today we only address the more important ones, otherwise we will put them together in a table, who submitted, the proposal and answer all of them, whether the CA considered the proposal fully or partly and thereafter we will publish it for everybody to read.
 - IN – are you going to publish the table, after which there will be another discussion and thereafter the methodology will be established or the methodology gets established and the table with comments is to be circulated on the same day?
 - M. Ots – the first option is undoubtedly sensible, but it is not certain, whether there is time for it, methodology is recommendatory.
 - KSL – Comments have been received from 10 different institutions and companies, it is the third day a person enters the questions and proposals into the table, there are thousands of those, responses to all of them can be given only in spring.
 - **M. Ots – the methodology is most likely to be announced on 01.11.2010 amended as per the important issues discussed today.**
 - SL – will the CA also apply any other principles in addition to the recommendatory methodology?
 - M. Ots – certainly not.
- Selling services to the surrounding municipalities
 - M. Ots – all tariffs that are valid today, will be valid until they are amended i.e. on 01.11.2010 you will continue selling the service with the same price until it is not sufficient any more, life has to go on. BUT if another water company complains

saying that they think that the price is too high, the CA is entitled to issue a prescription stating that the tariff is unjustifiedly high. One day an approval should be given, but one should not rush with it.

- Question: Does the price formation for the services sold to the other water companies have to be based on the methodology
 - M. Ots: Yes, in case of water and wastewater services, because it goes under the general article of price regulation.
- Tartu – what will happen if Tallinna Vesi would not come and seek an approval to a tariff application in November? But if a citizen turns to the CA, would the CA start the proceedings then?
 - Yes, the CA is obliged to start the proceedings, if someone states that the price is not cost-based.
- The company is free to choose on what tariff structure it wishes to establish (a basic fee or not and how many tariff groups based on sales volume), the law allows and does not prescribe, equalising would clearly be an over-regulation. KSL – for each service its own sales revenue and sales volume need to be estimated, if we wish to differentiate between big, medium and small customers, then its own sales volume needs to be estimated for each customer group, to spread the costs and different groups will then have a different price. M. Ots: the CA sets forth the allowed sales revenue and then it is for the company to decide, how to divide it internally, company may also create a complicated tariff structure, a very differentiated one or just a tariff for drinking water and a tariff for wastewater. The objective is to ensure that the sales revenue stays within the allowed limit. Equalising the domestic and commercial tariffs was not the CA's recommendation in developing the law, now probably each company has to see, when obtaining an approval to the tariffs, how they are able to fulfil the legal requirement to equalise the tariffs in 15 years.
- Cross-subsidisation – water, wastewater, storm water – Tartu: reality is that storm water is cross-subsidised today, the law allows to charge a separate fee for storm water, however does not obligate to do that.
 - RN – different services should still be treated separately right in the beginning, a methodology of its own has to be developed for storm water, law allows to sign a contract for storm water, if an agreement is reached that the local government pays 100% for storm water, but if not, a separate methodology should be developed and it needs to be decided, whom the storm water fee should be charged from; then separate the wastewater tariff proportionally from the storm water tariff.
 - M. Ots – if a local government does not pay for the storm water from its budget, a separate tariff component should be established and an approval to which needs to be applied for.
 - Tartu – in order to set the methodology up, all properties need to be measured, the bases need to be developed on which the storm water fee can be charged etc., that takes at least 1 year
 - M. Ots – sales revenue will be prescribed to the company and it is for the company to decide on how they collect that revenue, whether it is better to sign a contract with the city or arrange a basic fee for storm water or a fee for a m³.

- Tartu – If the state unexpectedly changes pollution fees and the company needs to submit a tariff application in order to increase tariffs, then is it acceptable that the storm water fee is part of the wastewater fee?
 - M. Ots – each company has to find the best manner of earning the allowed sales revenue
 - RN – if you wish to make investments, it should be separated
 - Tartu – we probably need to submit the application soon, but the storm water methodology has not been established yet
 - M. Ots – transition period, storm water does not need to be separated
 - RN – instructions for storm water could be developed by the next year in cooperation with the MoE and EVEL, but this cannot be an obstacle, if companies wish to differentiate the storm water fee for application already now.
- Environmental fines should be included in the allowed costs and revenues
 - MoE – 10X pollution fee is meant to be a fine, 1x paid on nitrogen is not a fine, this can be written into the tariff
 - M. Ots – to develop instructions in cooperation between the CA, EVEL and MoE on what is treated as justified cost and what is treated as fine
- It should be defined, what happens if a company earns less or more profit than what has been taken as the basis for calculating the tariff
 - M. Ots: If it earns more profit, the company can keep it, if less than forecasted, then it is a loss for the company or it can apply for an approval to new tariffs from the CA, but we would not want to define it explicitly in the methodology.
- The role of local government in price approval process
 - It certainly needs to be approved in terms of the development plan, but the CA cannot predict when the local government would respond and presumably the local government first considers the investment plan, whether the investments are reflected in the tariff or not.
- A good proposal to make the average cost indicators of companies public as is done with energetics – operating costs/m³, electricity consumption, number of staff – if a database is created, it will be made public.
- Accounting for water leakages – it will be incorporated in the methodology and statistics will be collected and the dynamics of leakages of water companies will be analysed. The same with making the average cost indicators of companies public, the average indicators of companies can be made public for comparison, BUT it is only indicative, it is not reflected in tariff.
- Proposal to develop the instruction for dividing costs between different areas of activity and services
 - M. Ots: Also proposed in energy sector, but companies are against it, costs are divided in line with the internal accounting rules of companies – the CA would recommend the same.
- Proposal to include the cost of bad debt in the tariffs
 - M. Ots: the CA cannot allow that, because those consumers, who have paid their bills, would be punished, and also because water supply service is a risk free service and any risks are also included in the estimation of WACC.
- Proposal to set up a list of uncontrollable costs:

- M. Ots: Good proposal, as many uncontrollable costs that are known are added to the methodology as possible.
- Proposal to develop the instruction for the submission of tariff applications
 - M. Ots – such instruction will come.
- Proposal to establish precise rules for correcting the asset value
 - M. Ots: there will probably be such an instruction.
- Proposal to review the inclusion of the cost of unfinished constructions to the RAB
 - M. Ots: I agree, this will probably be left out from the methodology, to be given for the internal accounting rules of a company to define.
- The immediate inclusion of connection charges paid to the other companies in the tariffs is not justified, those charges should be added to the assets and thereafter through depreciation proportionally to the water tariff of all consumers, probably the amount of immaterial assets should be specified in this respect.
- Concerning the construction price index, which was extremely high in the meantime, the depreciation might not cover the cost of investments necessary to be made today.
 - M. Ots – this might be a problem, we will review this in the future in the process of applying the regulation.