AS TALLINNA VESI COMMENTARIES to the

RECOMMENDED PRINCIPLES FOR CALCULATING THE PRICE FOR WATER SERVICE

We would first like to draw your attention to our key concerns of the proposed methodology **Error! Not a valid bookmark self-reference.** and later on to **Detail questions and commentaries by sections** and paragraphs.

Executive Summary

The role of the Regulator
With the regulation for Electricity the CA list their main objectives as:

- protection of electricity users;
- application of regulatory measures that allow companies to remain viable economically and financially, i.e. to recover operating costs and to finance necessary investments out of own and external funds;
- creation of sufficient incentives for companies to carry on their activity more efficiently;
- guarantee of acceptable return on invested capital for investors, i.e. at least equivalent return that they would obtain on investments with the same degree of risk.

These are high quality objectives that accord with international norms. Does the CA believe that the same/very similar objectives should be included within the regulatory methodology of the water sector?

Furthermore, an appeals process should be clearly defined. Under the current legislation any appeal against a decision for the Competition Authority needs to be made to the Competition Authority. This is clearly not in accordance with any best practice governance principles.

Opening RAB
Section 7.7 states that the "calculation of assets is usually based on the residual book value of the assets invested by the owner. In the case of AS Tallinna Vesi the value invested by the owner on privatisation is much higher than the residual book value of the assets. In this case will the CA include the privatisation value of the company within the calculation of the opening RAB?
To do so would be consistent the RAB calculation methodologies used in other countries when state owned utilities have been privatised.

Inflation and WACC or RAB – Financial capital maintenance principle
The treatment of inflation within the CA's WACC calculation is not clear. It is not stated whether it is a nominal or real WACC. If it is a nominal cost of capital then it is not clear why the CA feels that German inflation is a good proxy for Estonian inflation – this is especially the case as the annual difference in the last five years has been over 3% per annum and over 2.7% per annum since 2001. If the CA uses German inflation within their calculation will they be expecting the investors to take the gain or loss on the difference between German and Estonian inflation? Moreover, if this is the case then the CA should publish their view of German and Estonian inflation before each regulatory review in order for investors to understand the degree of risk they are taking. In the CA's methodology is it

the intention to use the principle of financial capital maintenance and protect the purchasing power of invested capital from the effects of inflation?

Regulatory period
At only one year the regulatory period is too short for the company to make asset planning and financing decisions. The water industry has long life assets that require long term financing and planning decisions. With only a single year time horizon it will be impossible to plan with certainty, which will make it harder to attract financing and will also not allow a long enough time period to understand whether any investments made have fulfilled their investment objectives. In Europe the most common regulatory period is 5 years.

Taxation
The CA does not include an allowance for tax anywhere within its revenues calculation. All equity investors will only invest on the basis that they will be able to earn a cash return on their investment. Within the CA's current methodology the returns to equity shareholders would need be reduced further to take account of tax that would have to be paid when making a dividend payment.

Other
Within the methodology there are a number of details that require agreement and transparent communication before finalisation. Such as

- the list and rationale behind controllable and uncontrollable costs
- the procedure for ensuring experts used are independently chosen
- How the CA intends to consider and compensate for the effects of inflation each year. Cost justification without a clear reference to an index, incentive regime and comparative analysis lacks transparency and also carries a significant cost and administrative burden.
- the circumstances under which the CA will change/correct an asset value and the RAB how this will be evaluated and agreed. This is especially important as arbitrary adjustments that can be made in a non-transparent way will seriously compromise the integrity of the methodology!
- What will be the principles for choosing the risk free rate, beta coefficient, market risk premiums? Within the draft methodology we have only statements.

Detail questions and commentaries by sections and paragraphs

1. Foreword

- Is the **energy sector** the best proxy for the water regulation? We believe that that the international best practice of water sector regulation should be considered when developing the methodology.
- It is surprising that only **price regulation** elements have been considered and all quality aspects are ignored which is not in accordance with the best regulatory practices.
- It is difficult to understand how anybody could implement **the methodology in a similar and uniform manner in order to avoid unequal treatment** when any outputs, i.e. quality and service standards, are not identified.
- As the draft methodology ignores all key principles of best practice regulation we are strongly against of using **AS Tallinna Vesi** reference within the list of parties involved in the development of the methodology.
- CA should establish the range of services regulated by the methodology, i.e. is the regulation applicable only for the tariffs of water and sewerage services for the nominated water

company in area or does CA intend to regulate also the ‘water services’ between the water companies. If the last has been meant then also the definition of the ‘water services’ has to be introduced (i.e. is it the treatment of water and waste water). It is important to understand that the CA would not intend to regulate non-regulated business.

2. Definitions

2.10. Justified return – the definitions and the methodology should be developed including the terms of real return and nominal return or either the regulatory asset base has to be indexed using the inflation.

2.11. Regulator – the role of the regulator is much wider than to calculate the tariffs.

2.12. Regulation period –12-month regulatory period. Such a short time period is inconsistent with best practice and is completely different from that used in the electricity and gas sectors. Investment planning, the achievement of investment objectives and financing require a time horizon that is longer than one year. Would the CA consider extending this to match the length of the regulatory period in the electricity sector?

2.13. Regulatory asset base (*RAB*) – the definition should match with RAB description in Section 7.

3. Objectives and general principles of the economic regulation of the activities of undertakings dealing with the sale of PWSS services

As a general comment to the whole paragraph 3 we have to say that the objective of the regulation and the role and duties of the regulator have been described using a really limited and impartial approach. The best practice regulatory objectives and the duties of the regulator are much wider than only to regulate the tariffs as we have described below. And moreover, to ensure the sustainable development of the water sector it would be essential to establish the principles of the regulatory regime constantly and independently. The regulatory regime has to be transparent, stable and predictable to allow the companies to make any long term investment decisions to increase the service standards or to improve the quality.

With the regulation for Electricity the CA list their main objectives as:

- protection of electricity users;
- application of regulatory measures that allow companies to remain viable economically and financially, i.e. to recover operating costs and to finance necessary investments out of own and external funds;
- creation of sufficient incentives for companies to carry on their activity more efficiently;
- guarantee of acceptable return on invested capital for investors, i.e. at least equivalent return that they would obtain on investments with the same degree of risk.

These are high quality objectives that accord with international norms. Does the CA believe that the same/very similar objectives should be included within the regulatory methodology of the water sector?

3.2. It is positive, that you recognise that **‘**The activities of infrastructure companies have an important impact on the whole society and economy’, but it is regrettable that ‘to protect customers against the arbitrary action of monopolies’ you have considered only the price sensitivity of the customers and ignored fully their expectations regarding the product & service quality.

There is no need to invent the wheel as looking at the best regulatory practice in European water sector the similar service standards could be applied as well here in Estonia with appropriate adjustments only. We would recommend seeing the Ofwat’s (i.e. the UK regulator) quality assessment for example, it may be the easiest as all documents are available in English and as we have notices the Competition authority has earlier used Ofwat as positive reference regarding the return's analysis. Just briefly, Ofwat is assessing the companies' quality in the following areas:

- Water supply (drinking water quality, pressure, interruptions, restrictions, etc)
- Sewerage service (flooding risk and incidents, etc)
- Customer service (customer complaints and satisfaction, response time to solve the issues)
- Environmental impact (compliance with statutory environmental regulation).

3.3. As discussed above the best practice regulation is wider than purely tariff regulation and **therefore** it is needed to expand what the regulation really means. Any recognised best practice regulation considers the interests of the customers (incl tariffs, service standards and quality aspects), but via establishing the tariff mechanism the Regulator should ensure financial viability of the water companies, to find the measures to increase the efficiency and to ensure the acceptable return to the shareholders.

The proposed methodology for water undertakings could even be considered discriminatory from this aspect compared to the electricity regulation[1] and gas regulation that both have included the respective objectives.

4. Differentiation of expenses

4.5 If the regulator takes the responsibility to evaluate the differentiation of the expenses it should also introduce the range of acceptable differentiation methods otherwise it may be the sole discretion of the regulator to decide about the justification on individual cases. It would be significantly add to the strength and transparency of the regulation if the CA were to publish its methodologies for justifying expenses. For example, how the CA will establish a benchmark cost base and relative efficiency? How it will use historical and future data? How it will use detailed "bottom up" assessment of costs? How it will use "top" down assessments such as intercompany comparisons?

5. Sales volumes, operating costs to be included in the prices, the analysis and justification thereof

Overall comment to the whole paragraph 5: Any modern regulatory regime should motivate the companies to achieve efficiency gains. We understand that it may be difficult if not impossible to introduce any efficiency objectives if no outputs are prescribed. Still ignoring the key regulatory objectives may lead to subjective cost analysis and evaluation and it can be questioned how anyone can evaluate the inputs when the outputs are not identified.

5.1. It needs to be specified how the long term plans are considered in course of the analysis of the next regulatory period revenues and costs and capex. If the sales volumes and revenue forecasts are inaccurate will the CA expect the companies to take all such revenue risk or gain or will it introduce some form of under/over recovery compensation mechanism?

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[1] This methodology is intended for use by EMI to regulate the activities of power network operators (hereinafter companies) considering the following main objectives:

- protection of electricity users;
- application of regulatory measures that allow companies to remain viable economically and financially, i.e. to recover operating costs and to finance necessary investments out of own and external funds;
- creation of sufficient incentives for companies to carry on their activity more efficiently;
- guarantee of acceptable return on invested capital for investors, i.e. at least equivalent return that they would obtain on investments with the same degree of risk.

5.2 With regard to costs, many costs in the industry are influenced by the weather (wastewater treatment, leakages, interruptions, maintenance) and ground conditions. How will the CA take account of weather and ground conditions when establishing justified costs on an annual basis?

5.3 A complete list of controllable and uncontrollable costs should be established with a clear rationale of why each cost type was categorised as controllable or uncontrollable. Also see point 5.2 re the weather impact.

5.4 Just the reference to the companies' ability to operate in an effective manner is not sufficient to understand how the regulator intends to evaluate the efficiency and justification of the costs. Without established quality requirements the cost control exercise may lead the regulator to require the company to simply cut costs that may have adverse impact to the service standards.

5.7.1. Despite of the fact that the payment discipline is relatively high in Estonia none of the water companies is capable to collect 100% of the bills issued due to the uncontrollable factors. Therefore we disagree that the cost of bad debt is fully excluded from the allowed expenses. We recommend revising the clause like this: 'Bad debt allowance exceeding 2% of the sales'.

5.7.3 The reference to the 'other activity' is unclear. We believe that you have meant under 'other activity' the costs related to the non-regulatory services and revenues. If this is the case, please specify respectively or otherwise the clause needs clarification. The regulator has to be clear also that the Companies are not prohibited to earn unregulated profits from other activities and that these profits are not considered within the allowed returns.

5.7.6 If it is not agreed what quality, safety and environmental requirements have to be fulfilled, then how can anyone assess if the cost input is sufficient or excessive for these outputs?

5.9.1 This is very broad and does not give the industry any understanding of how CPI will be considered. From the way the regulation is written it appears that each and every cost item and change will need to be justified each and every year with the companies having no/little idea of what they will be benchmarked against or how their costs will be benched against the dynamics of CPI. Without any clear understanding of the tools and benchmarks to be used by the CA it will be impossible to have a professional two way discussion. Before implementation it is essential that the CA publishes and agrees its CPI incentive mechanisms, and cost comparison benchmarks.

5.9.2. Without identification of the outputs it is impossible to understand how the Regulator is going to evaluate the justifiability of various cost components, including opex (5.9.2) capital expenditures (5.9.4) and investments (5.9.5). It would be significantly add to the strength and transparency of the regulation if the CA were to publish its methodologies for justifying expenses. For example, how the CA will establish a benchmark cost base and relative efficiency? How it will use historical and future data? How It will use detailed "bottom up" assessment of costs? How it will use "top" down assessments such as intercompany comparisons?

Also how will the experts who will give expert opinion be chosen. In any dispute situation it would only be fair and transparent if both parties had an opportunity to present/choose an expert to give advice. Furthermore, if an appeal against a regulatory judgement needs to be heard them who will the company appeal to? To accord with best practice governance procedures this cannot be the Competition Authority, and going to court will be costly and the court may lack the necessary competence to rule on technical or economic matters!

5.9.3. Once again without identified outputs the comparison of the operating costs and the statistical indicators (so-called *benchmarking)* is meaningless and may be discriminatory between different water companies. It also has to be established how the presented data have to be validated to ensure the consistency of data.

6. Capital expenditure

It needs to be specified how the capital expenditures and investments will be analysed. Is it intended to use any standard cost for the assets, etc. Are there any type of capital expenditures the regulator may not allow to be included to the tariff, etc.

6.2 Will the CA establish and publish regulatory accounting standards and guidelines, especially with regard to accounting for fixed assets? In the UK Ofwat has established detailed regulatory accounting guidelines to ensure consistent application across all companies and from accounting year to accounting year. By implementing such standards it will enable the CA to carry out better benchmarking of companies and annual performance.

6.3 What is the margin year? What is the objective of the margin year? How has it been established? This needs a much more detailed explanation.

6.7 Under what circumstances would the CA make changes to the cost of assets/capex rules etc? These rules/principles should be agreed and clearly communicated before any regulation methodology is implemented.

6.10 Under what circumstances would the CA disallow/make changes to the cost of assets/capex rules etc? These rules/principles should be agreed and clearly communicated before any regulation methodology is implemented.

7. Regulatory Asset Base

None of the paragraphs currently regulates the assets ownership issue. It should be noted that all assets used to provide the water and sewerage services will be included to the asset base despite of the ownership structure. (Comment: assets may be in the ownership of the municipality and the water company may not own any assets or may own only part of the assets, but all investments into assets should be considered when calculating the return). As stated in the previous sentence, in the water industry in Estonia the structure of asset ownership is occasionally complicated. In this case how would the CA expect the tariff application to be made for these municipalities?

7.4. The term of ‘net external turnover’ is not clear and needs to be specified.

7.7 Proposed treatment to value the assets based on their NBV refers to the usage of historical nominal prices, respectively. Provided that new CAPEX is incurred each year, NBV is a mix of historical costs in various years, and therefore does not reflect either the real or nominal value of the assets. It would be appropriate to index asset value by a measure of inflation. Under what circumstances would the CA disallow/make changes to the cost of assets/capex rules etc? These rules/principles should be agreed and clearly communicated before any regulation methodology is implemented

To ensure that the investors are remunerated for the acquisition price that they paid, and to prevent any windfall gains or losses to the investors the opening regulatory capital value (RAB) has to be the sum of the market value of equity and the book value of debt, provided that it does not exceed the replacement value of the assets. Thereafter the opening RAB calculated as above has to be indexed annually with CPI to ensure the purchase power of the invested capital. Indexing the RAB and not including the inflation to the WACC calculation would at the same time ensure the consideration of the inflation, but also avoid double counting of the inflation.

If you do not include our proposals to the methodology, we would kindly ask for your comment to the following questions:

- If an investor has been encouraged to pay more for the assets than the NBV, i.e. has invested a larger amount of money than the NBV, would you automatically expect that investor to lose the entire value of the premium?
- Would you expect the investors to take the risk of CPI when making the investments into infrastructure companies?

7.10 When the constructions in progress have been allowed for the regulatory purposes these have to be included to the assets base calculation either within existing assets or within investments. As the company has paid for the assets already it would be unfair not to allow any return on work in progress compared to the intended investments for the next regulatory period.

7.13 In table 2 in section 7.13 the calculation of justified return is inconsistent with the methodology used in section 7.3. In the table the justified return in calculated on the closing RAB and not the average RAB. Please advise which is the correct method?

7.17 Under what circumstances would the CA amend the value of the RAB? These rules/principles should be agreed and clearly communicated before any regulation methodology is implemented.

8. Calculation of justified return

8.1 To reflect the ownership structure of the regulated water companies we would propose to include the reference to the municipal ownership also to the clause if such a clause is needed at all. In practice it may be still wise to consider that the risk levels of different water undertakings may vary more depending on their size rather than the ownership structure of the companies.

8.8 We fully appreciate that ‘in the conditions of market regulation, the regulator may intervene in the financing decisions of undertakings and dictate a certain capital structure or calculate the prices of services with a certain capital structure’. We only would like to insist here that the regulator should also clearly recognise its responsibilities for the financial viability of the companies and should state it clearly in the objectives of the regulation as mentioned above.

8.9 The formula for determining the cost of debt has to be introduced to understand precisely how the average of 5 last years of German 10 year bonds has been fitted to the Estonian country risk etc. Is this a nominal or real risk free rate? If nominal then, given that German inflation has been significantly different from Estonian inflation (over 2.7% per annum or the last nine years) does the CA expect investors to take the gain or loss on the difference between German and Estonian inflation?

To ensure even and transparent implementation of the methodology the sources and principles for identification of the following factors have to be specified:

- Company risk and state risk (clause **8.9)**
- Beta coefficient (clause **8.12)**
- The market risk premium (clause **8.13)**

8.11 See 8.9

8.13 As all equity investors will only invest on the basis that they will be able to earn a cash return on their investment and as equity investors require compensation from post tax earnings then the country risk premium should be added to the pot tax cost of equity. Within the CA's current methodology the returns to equity shareholders would need be reduced further to take account of tax that would have to be paid when making a dividend payment.

Dividends income tax impact should be added to the methodology. Or tax has to be accounted for separately in the allowed revenues (see comment to 9.2 and 9.3).

9. Calculation of the allowed sales revenue and prices of public water supply and sewerage services

Overall comment: the revenue requirement has a clear link to the achievement of output service and quality levels. In simple terms – input values should ensure the delivery of the output values.

9.2 The list has to be extended with the income tax applicable to the dividends as this is payable to the state and cannot be distributed to the investors. Respectively the formula presented in clause **9.3** has to be revised. If not the post tax returns made to investors will be reduced.

9.5 As the regulatory revenue may consist of revenue from domestic and commercial customers then the formula for price calculation should be as indicative reference and not as prescription unless the tariffs are promptly equalised. It is also unclear how CA intends to equalise the tariffs to follow the requirement of the law, i.e. whether the intention is to increase domestic tariffs only or is it a combination of higher increase in domestic tariffs and reduction in commercial tariffs?