

Mr Märt Ots
Competition Authority
Auna 6
10317 Tallinn

Our ref 28.12.2010 No

Dear Mr Ots,

As you know, within the discussions of the last year, AS Tallinna Vesi (ASTV) and the Competition Authority (CA) have, among other issues, also discussed the issue of implementing the weighted average cost capital (WACC) in calculating the allowed return. ASTV has considered it to be a key question whether it is nominal or real and pre-tax or post-tax WACC.

We have noticed that in November 2010 you have supplemented the document published on the website of the CA 'Instruction for calculating the weighted average cost capital (WACC)' by adding the WACC rated to be applied to water undertakings as per the CA. Also the CA has commented the respective questions submitted by ASTV, Tallinn City Government and Eesti Vee-ettevõtete Liit in the document published at the website of the CA 'Explanations/responses by the Competition Authority regarding the instruction "Recommended principles for calculating prices for water services"' (Explanations).

Taking into account the content of the abovementioned documents, we ask for the comments of the CA to the following questions:

1. Please explain how the CA envisages that the principle of real financial capital maintenance shall be implemented. Whether and how the CA ensures during the processing of the tariff applications that the value of invested capital is fully protected from the effects of Estonian inflation? If the intention is not to fully protect invested capital from Estonian inflation could you please state what level of inflation protection you will give and what level of inflation risk must remain with the investor?
2. In your Explanations you repeatedly emphasise that the allowed return rate (WACC) has been calculated by the CA in nominal value. When building the nominal WACC could you please state, what was the level of inflation that was used by the CA in the calculation of WACC (8.31%) in the analyses of the results of ASTV in 2007 and 2008? Also what is the level of inflation that is included in the 8.26% WACC rate in the calculation of 2010?
3. Related to the above two questions, should the inflation estimates by the CA prove to be different from the actual inflation in the regulatory period can you please say how the CA plans to compensate the water companies or the customers for any under or over estimation of inflation?
4. In clause 63 of the Explanations you list the reasons based on which the CA thinks that the WACC methodology should not take into account the income tax on dividends. As you know, investors receive post-tax, not pre-tax revenue, as the income tax calculated from the payment of dividends is subject to tax to be paid to Estonia. From which component, according to the CA, the undertaking must earn the company's income tax compensation in calculating the allowed revenue base?

The outcomes to questions 1 to 3 are particularly important for customers, water companies, owners of water companies and the regulator to fully understand. Within the PWSSA *it states that the Water undertakings should notify the CA when any of circumstances could impact the tariffs by more than 5%*. As inflation is one of the largest input costs (often the largest) in the nominal WACC, and as such the tariff, then any estimating error can have a significant impact on the final price and the real returns made by the company. Therefore I am sure you would agree that a transparent and clearly communicated policy for treating inflation is a fundamental part of any tariff setting mechanism.

Sincerely,

Ian John Alexander Plenderleith
Chairman of the Management Board