Mr Juhan Parts
Minister
Ministry of Economic Affairs and Communications
Harju 11
15072 Tallinn

Our ref: 28.10.2010 No

Dear Mr Parts,

On 22nd October, 2010 in the electronic forum of e-õigus the Ministry of Economy issued its draft Decree "Terms and conditions and procedure for establishing a price for water service" (herein draft Decree - http://eoigus.just.ee/?act=6&subact=1&OTSIDOC_W=305870). The purpose of this draft Decree was to establish the basis, which the Competition Authority (CA) needs to rely on, should it decide to use the right given to it in the PWSSA and establish a temporary water price for a water undertaking.

Although AS Tallinna Vesi (ASTV) was not copied or asked for comment on this draft Decree, I am writing to you to ensure that ASTV's comments and concerns on this decree become a matter of public record. As this draft Decree has important ramifications for the water industry in Estonia, AS Tallinna Vesi, the citizens of Tallinn, as well as for the future investment environment of Estonia, then it would be negligent of ASTV not to make a public and professional response.

On reading the draft Decree, there are a large number of areas of concern, however, in this response I will concentrate on the principal issues that need discussion and professional resolution to enable this draft Decree to protect the long-term interests of the water industry and allow a price setting regime that is based on economic reasoning, avoiding a regime moulded to fit the political and election cycle.

Our key areas of concern relate to:

- **the lack of respect for due process;**
- **the implementation of a simple copy of the Competition Authority's regulatory methodology that is still under discussion;**
- **the absence of independent verification of methods and decision-making when analysing tariffs and issuing notices and setting temporary tariffs; and**
- **the ability of government agencies to make random decisions without having the obligation to explain their decisions to those impacted by those decisions.**

Firstly, the regulation is exhibiting several instances of breach of due process. The regulation is aimed at being enforced from Monday, 01.11.2010, while the deadline for comments is Friday, 29.10.2010. There is no time left for analysis or incorporation of any potential material comments. A best practice regulation that is not pre-determined and allows time for discussion and debate of key principles would be enacted at a later date, e.g. 01.01.2011. **Giving only 2 days and a weekend at that for discussion and analysis of the draft Decree will not allow any professional discussion and is a grave breach of due process (*vacatio legis*).**

Moreover, the draft Decree was sent for consultation only to the ministries, not to EVEL or any(!) water undertakings. This is against good industry and administrative practice not to involve industry participants in a topic, which has a huge impact on public health and the environment. Best practice regulation ensures all stakeholders are fully consulted, water companies, ministries, municipalities and

consumer groups. We fail to understand why an open and public discussion with all stakeholders has not taken place. ASTV recommends a longer time frame for discussion and analysis to ensure all comments can be properly considered and included. This will only serve to strengthen and improve the draft Decree, which is surely the main objective of this consultation round.

Secondly, the draft Decree repeats in essentially a copy-and-paste manner the draft methodology being developed by the Competition Authority (CA), which is still in its draft form. While the draft Decree has certainly more weight than the CA's methodology, it incorporates most of the CA's version 2 methodology. It would be logical to assume that should the CA's methodology change, the Decree should be amended accordingly. However, the CA's currently still draft methodology does not yet reflect international best principles of regulation nor has it incorporated any suggestions for betterment sent by the water companies with the assistance of recognised international regulation and corporate finance experts (KPMG/Oxera/PWC). The CA's methodology is still being drafted – ASTV has been asked to provide further comments by 27 October 2010 and EVEL was required to issue comments by 26 October. If this draft Decree that incorporates the current draft of the CA's methodology and is passed on 29.10.2010 and enforced from 01.11.2010, as envisaged, then this would imply that there is no point in the industry responding to the CA's methodology as any comments will simply not be taken into account as the decision appears to have already been predetermined. To give some understanding of the professional regulatory comments, principles and questions we raised I have appended the correspondence we and EVEL have sent to the CA regarding their draft methodology.

Many of these problems would disappear if the decree and CA's methodology were not implemented until all the points raised by those that have been requested to comment, especially the important principles raised by the industry have been answered. By taking into account the views of different stakeholders the methodology in the draft Decree would be strengthened, which would only save time, effort and money later as the potential for disputes would be considerably reduced. ASTV recommends that the implementation of the Decree is delayed until all material points raised by the industry have been discussed and answered. Furthermore, by delaying the implementation to improve the quality, say, until after the elections, one would reduce the likelihood of a methodology being implanted for short term political advantage.

Thirdly, the draft Decree enables temporary prices to be set without independent verification of economic facts and decisions. For example, § 3(1) does not list failure to submit a tariff application as a required pre-condition to establishing temporary prices. Draft Decree §3(1) read together with § 3(7) would therefore seemingly allow for a situation, whereby the water company submits a tariff application to the CA and the CA can still issue the company a prescription, then a notice and then still impose temporary prices. This would amount to bad faith and improper administrative practices not to mention an undue burden on the state to unnecessarily conduct such temporary price proceedings in parallel with the tariff review. The explanatory note to the draft Decree states that temporary prices are an **extreme measure of last resort** after all else has failed to make the water company comply with the law. If the company applies for tariffs with the CA, then it is complying with the law and there is no need for temporary pricing because under § 16(6) of the PWSSA the prices valid as at 31.10.2010 would apply until the tariff application is being processed. Therefore, the draft Decree should expressly state in its preconditions that temporary prices may only be imposed, if a company does not submit a tariff application.

Additionally draft Decree's § 3(4) and (5) read together mean that **if the CA, at its discretion, decides that no consultation is necessary or that the company's explanations are invalid or if the CA has already reached its decision on temporary pricing, it may end the consultation and proceed to decide on a temporary price.** This effectively means that if the CA instigates the temporary pricing procedure and is already convinced of what the tariff should be, it can forego all

consultation with the company. As temporary prices would be effective until the final court judgment is enforced (procedures take 1-3 years), then such rights of the CA are very much against due process. The company should be properly consulted especially since temporary prices would be a severe limitation of the right of establishment, one of the principal rights under EU law. The CA should not have such decision-making powers to simply cancel consultations at its discretion.

Fourthly, the draft Decree promulgates disputes that can and will lead to damages claims, which will incur a cost to the state. The explanatory note of the draft Decree openly admits that establishing a temporary price for water services will be disputed by the water undertaking. More seriously, the explanatory note admits that establishing temporary prices for water services may cause damages to the water undertaking. This effectively means that the Minister and via him the state has accepted the future possibility that companies will be suing the state for damages more often than not. The explanatory note assures that the state shall not incur additional costs from the implementation of the Decree. If damages are incurred and the state is at fault, then the state shall be liable to compensate those damages, unless the drafters have foreseen that any such damages shall be somehow agreed to be built into the tariff and the customer will end up paying for the CA's mistakes. Conscientious regulators do not expect to be taken to court, they expect to regulate the industry properly so that there is no need for unilateral extreme measures like temporary prices even to safeguard transition to a new regulatory framework.

Effectively, the draft Decree disregards any presumption of innocence. May we point out that under general price regulation, the CA does not have the function of establishing prices, it has the function of checking costs and profits of applications made to them for approval. It is the water companies who set the tariffs, the CA's function is to keep them in check. Thus, the CA is not even envisaged to act as a proper regulator (indeed, perhaps for this reason the law nor the CA's methodology does not factor in the link between setting tariffs and achieving quality performance standards, which is different from what regulators, e.g. Ofwat, do). In the draft Decree it is presumed that whatever the CA decides is presumed to be right. ("*Until the final judgment is enforced, one should generally be guided by a presumption that the decision to establish the price is legal.*") Logic dictates that by inference the company would be presumed wrong in every single case. If the presumption is that the CA and/or the state is always right, litigation and potential damages claims against the state, are already accepted beforehand, this raises serious concerns about the legality of this Decree as well as the principles the ministry and via it the Estonian state is operating under.

Considering disputes over tariffs will mainly be about economics and not law, then all of the above could be avoided by implementing an independent arbitration panel. ASTV recommends that the Ministry establishes an independent arbitration panel made up of respected finance and economics experts to rule on disputes that are not able to be resolved between the CA and the water company/industry. This would avoid the need for unnecessary court cases, which would reduce the legal costs for all parties, would give greater confidence to the CA, water companies and the customers that the decisions were fair and independent, and would strengthen the principles in the CA's as well as the minister's methodologies by reducing the opportunity for individual interference in tariff setting. This would ensure that the court system is only used as a last resort, which I am sure is the intention of any state operating justly with the long term interests of their citizens in mind.

Fifthly, the draft Decree enables the CA to take decisions without having the obligation to publicly explain their decisions on those impacted by those decisions. Draft Decree § 3(9) gives the CA the right, to publish the temporary price decision but does not have the obligation to publish the reasoning and analysis of why it felt temporary prices were necessary. Draft Decree § 3(6) does not even obligate the CA to issue reasoning to the water company, just the decision. This means that the CA can take an arbitrary decision to change prices and publish its reasoning later or not at all. ASTV recommends that the CA issues its decisions to the water company together with the reasoning and

publicises all this information on its website This would safeguard water companies against the CA making temporary price decisions lightly, and would also ensure that all other stakeholders (Ministry of Environment, Ministry of Social Affairs, municipalities, customers, other water companies) are aware of the reasons for the price change and its impact on the ongoing service that will be provided.

Sixthly, looking at the draft Decree from a practical perspective, the default rule of enforcement from the date of decision of temporary pricing would be difficult and costly to adhere to. Draft Decree § 3(8) states that the application of temporary prices is mandatory from the date of CA's decision unless a different date is foreseen. The lack of consultation with the industry can clearly be seen here, as most customers are on a quarterly billing cycle. Implementing a change in the middle of the quarter would require companies to re-design their billing systems in order to invoice customers on two tariffs. – ASTV recommends that the draft Decree be amended to make the default date for temporary prices to be the month or quarter end following the CA's decision. This would provide more legal certainty to customers as well as companies.

In order to help the Ministry to understand the points we have raised we have appended the questions we sent to the CA. The main principles included in our analysis are as follows:

1) Within the Electricity and Gas regulatory methodologies the CA clearly states the objectives of its regulation. ASTV recommends that these same objectives are included to the regulatory methodology for the water sector. Agreement in objectives is crucial and critical to facilitate the solutions regarding the potential discussions and disputes about the technical details.

2) The value of invested capital for privatised utilities (i.e where private participation has been actively sought and premium payment was required) is calculated using the privatisation value of the company and not the accounting net book value of the fixed assets. ASTV recommends that the CA use this in their methodology, or used independent experts or engage in open and professional dialogue with the investors impacted to resolve thee differences.
3) Most regulatory regimes protect the value of invested capital from the effects of inflation – the principle of financial capital maintenance. The current methodology is not clear on how and to what degree invested capital will be protected from inflation. This will discourage investments into the sector in the long term. ASTV recommends the decree and methodology include a clear regulatory principle on how inflation will be treated.
4) 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. ASTV recommends to include income tax component to the allowed revenue calculation either via WACC or as a separate component included to the allowed revenue.

5) Other issues and ASTV's and EVEL's recommendations are thoroughly described in the attached documents sent to the CA on 27 September 2010 already.

In summary it appears that this draft Decree is being rushed through an approvals process without the necessary checks and balances being carried out to ensure the draft Decree is fit for purpose. Under the current draft Decree, its methodology in Appendix 1 and also in the CA's draft general price setting methodology there is a complete absence of regulatory principles, guidelines and objectives. Should this be allowed to continue then the ability to establish tariffs will be given to individual officials rather than creating an objective process, based on firmly established regulatory model with clearly defined principles and objectives. For example the current electricity market regulation has an objective that reads "*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."* This type of

sensible objective is completely absent from the draft Decree's as well as CA's draft methodology. Such objectives however, are the cornerstone of any regulatory regime and need to be included.

ASTV and its investors have repeatedly stated their willingness to work within a regulatory regime that uses best practice internationally accepted regulatory principles. It is for this reason we have made a number of positive suggestions throughout this letter and other correspondence with various authorities.

However, should a regime be implemented for short term political gain and without any form of professional consultation or dialogue, then ASTV and its investors will take all necessary steps to ensure their rights as investors are not violated, especially as to date the company has always met all the contractual obligations it signed up to on privatisation in 2001.

Sincerely yours,

Ian Plenderleith
CEO AS Tallinna Vesi