



Mr Ian Plenderleith  
AS Tallinna Vesi  
Ädala 10  
10614, Tallinn

Your ref 28.12.2010 No 6/1073392

Our ref 09.02.11 No 9.1-1/10-0111-003

**Response to the request for information by AS  
Tallinna Vesi**

Your letter No 6/1073392 of 28.12.2010 was registered in the Competition Authority on 03.01.2010. The questions raised in this letter have been explained previously in the explanations/responses by the Competition Authority to the methodology "Recommended principles for calculating the price of water service" as well as at the several meetings with the representatives of AS Tallinna Vesi. The CA shall submit its explanations to the questions presented in the letter as follows.

Inflation has been taken into account in the weighted average cost of capital (WACC). As WACC is nominal then inflation cannot be calculated for fixed assets, because in such a case it would be taken into account twice.

The amount of the revenue required by the investors depends on very many various circumstances – risk level of the investments, the phase of the economic cycle, money supply, inflation, etc. Connection between inflation and the required rate of return is characteristic to all investment opportunities, let it be then investment e.g. to the German state bonds or development of the water economy of the City of Tallinn. The change in inflation and the required rate of return are certainly not in correlation (when one of the factors changes then the other factor will not change immediately). For example, when the inflation indicator increases by one percentage point, then this does not mean that the required rate of return should also increase by one percentage point. As explained above, the amount of the required rate of return depends on very many various circumstances and the impact of inflation on that is not always the most important.

On its website [www.konkurentsiamet.ee](http://www.konkurentsiamet.ee) the CA has published the methodology "Instruction for calculating the weighted average cost of capital (WACC)" (hereinafter the Instruction) both for 2010 as well as for 2011. Pursuant to the Instructions, in the referred years WACC has been calculated in its nominal value. As the cost of debt and cost of equity are variable in time, then also WACC is variable in time. The WACC calculated by the Competition Authority shows how much revenue can be earned from an investment by investing either to AS Tallinna Vesi or some other monopoly. One of the basis for calculating both debt and equity is risk-free rate of return, one of the basis of which is the average rate of return of the 5 last years of German 10 year bonds. Pursuant to the Instruction the referred risk-free rate of return is increased with country risk and by the difference of the arithmetic average of the 5 last years of Euribor and Talibor quotations, which in 2010 was 1.8% and in 2011 it was 1.9%.

The income tax on dividends is not reflected in WACC for the following reasons:

- 1) Pursuant to § 14 (2) of the Public Water Supply and Sewerage Act justified return is calculated as operating profit, however, the income tax on dividends occurs after the operating profit;
- 2) Compliance with the principle of equal treatment (paying out dividends is voluntary, there are companies that do not pay dividends at all, but invest the entire profit);
- 3) Pursuant to the Income Tax Act valid in Estonia, profit is not taxable, income tax is charged only on the payment of dividends (most of the countries do not take the payment of dividends into account in the WACC for regulated activity);
- 4) Clause 4.6 of the methodology "Recommended principles for calculating the price of water service" reflects cost items that are not included into the prices of water services, incl. water undertaking's income tax cost (e.g. cost for income tax paid on dividends).

Sincerely

Küllli Haab

Head of Division of Energy and Water Regulation Division – Deputy to the Director General