Märt Ots
Competition Authority
Auna 6
10317 Tallinn

Your ref 01.04.11 No 9.1-2/10-0448-044
Our ref 05.04.2011 No 6/1073392-5

Dear Mister Ots

As a response to your letter of 01.04.2011 we must unfortunately state that the Competition Authority (CA) has not practically responded to any of our questions submitted in the letter of 28.12.2010 or specified in the letter of 02.03.2011.

It is incomprehensible for us that in all responses without adding any explanations the CA refers to the Public Water Supply Act (PWSSA) and/or the document prepared by the CA "Guidelines for calculating the WACC (2001)" (WACC guidelines) in a situation in which **neither of the documents do not even on a smaller scale treat the issues raised by AS Tallinna Vesi (ASTV) nor include even the terms related to these issues like 'inflation' (or its alternative of price index) and 'income tax on dividends'**.

Hereby we repeat once again all the questions from the letters of 28.12.10 and 02.03.11 to which the CA has not provided a substantial response. We have left the text of the questions as identical to the initial question as possible, however, for simplifying we have only specified the references. We have not repeated all explanations from previous letters and in the following list we shall point out the questions without answers, by highlighting with underlining the parts of the questions regarding which we have considered repeating the context to be explanatory to the question:

1. <u>Please explain how the CA envisages that the principle of real financial capital maintenance shall be implemented</u>. 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.
    a. <u>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?</u>
    b. <u>What is the level of inflation that is included in the 8.26% WACC rate in the calculation of 2010?</u>

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 <u>how the CA plans to compensate the water companies or the customers for any under or over estimation of inflation?</u>

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. <u>From which component, according to the CA, the undertaking must earn the company's income tax compensation in calculating the allowed revenue base?</u>

5. Firstly, we kindly ask the CA to explain how the use of a nominal WACC with un-indexed assets provides an adequate compensation for inflation. In this context, it would be helpful to consider how possible alternative approaches would compare. For instance, how does the CA's method compare to the method adopted by other water regulators. What does the CA believe are the advantages of compensating for inflation through the WACC rather than by indexing the asset base, as Ofwat does in its regulation of privatised utilities?

6. I would also like the CA to explain how its methodology would ensure that the company is compensated for inflation risk, that is, the effects of inflation fluctuations within a price control (this relates to the first question). I would like some clarity on whether i) inflation risk is transferred toward consumers? or ii) whether the inflation risk would remain with the company (this relates to my third question)? For instance, inflation risk could be allocated towards consumers if the allowed WACC each year was updated to account for changes in inflation, or by indexing tariffs by an appropriate inflation index each year. Alternatively, inflation risk could be allocated towards the company if a constant nominal WACC is assumed for a longer price control period. As indicated by the CA's WACC determinations for 2007, 2008 and 2010 (8.31%, 8.31% and 8.26%, respectively), the CA appears to have assumed broadly the same inflation rate for all periods, despite considerable changes in Estonian inflation across those years (see the table with OECD data attached to the letter of 02.03.11).

7. In your letter you state *"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)"*. This statement is not only unfounded, but its meaning is also unclear; is the CA implying that inflation does not need to be considered given that there are other factors?

8. To assist with the transparency/openness of the new regulatory regime, could the Competition Authority provide more details on its methodology and any additional analysis and calculations of the various investment circumstances (risk level, phase of economic cycle, money supply, inflation etc) it may have undertaken?

9. Secondly, it would be helpful if the CA clearly stipulated the reasons for using a particular inflation measure. In particular, I would like clarity on the exact level of inflation assumed by the CA when estimating the allowed returns for recent years (this relates to my second question). The CA states that it uses "*the average rate of return of the last five years of German bonds*", but without justifying why the use of German inflation is appropriate in the context of Estonian assets. I note that over the past five years German inflation has been considerably lower than Estonian inflation, with Estonian inflation 3.3% per annum higher than German inflation over the period to 2006 to 20010 (see the table with OECD data attached to the letter of 02.03.11).

10. As explained in our recent tariff application, a compensation for the Estonian country risk also needs to be included in the allowed returns for ASTV in addition to the compensation for inflation (which is discussed above). In that respect, it is important that the CA clearly explains how it measures the country risk premium and also that it outlines the reasons why using this measure is appropriate? In the letter of 9 February 2011 the CA to some extent explains the calculation of the country risk: "*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%."* However, the CA does not provide a justification of why it considers Euribor/Talibor to be an appropriate measure of country risk premium. The Talibor quotation is based on a local only, not widely used market, and is primarily made up of short term quotations (ranging from overnight borrowings to a period of 12 months). As explained in our recent tariff submission, a measure of country risk would need to be based on longer

term instruments in order to be consistent with the maturity of instruments used for the other WACC parameters. In the absence of long-term Estonian government bonds, credit default swaps (CDS) for the Republic of Estonia could be a useful guide. For example ten year Estonian CDS exceeded German CDS by approximately 1.5% over the past year. It should be noted however that this measure does not include an inflation differential, which would need to be taken into account separately. Finally, it is important to clearly distinguish the elements of compensation that relate to country risk from those that relate to inflation, as some measures encompass both. For example, the difference between yields on German and Estonian government bonds would capture both inflation differentials and country risk, while the difference between CDS for the same countries would only capture a country risk element. The CA should ensure that the compensation it allows for country risk is consistent with its approach to compensate for inflation. In summary, it would be helpful if the CA could provide more details on the reasons why it considers its country risk estimate appropriate and preferable to other alternative measures?

11. Unless the company is compensated for taxes it is liable to pay, equity investors would be under-compensated, and this would be inconsistent with the Act. A parallel can be drawn to the treatment of interest payments: those are included in the allowed return (through the WACC) even though they also "occur after operating profit". In other words, the fact that tax payments "occur after operating profits" is not in itself a reason for not allowing a compensation for taxes. As a consequence of the above, how does the CA's methodology ensure equity investors will not be treated more unfavourably than debt investors?

12. In your second statement, you state that dividend payment is "voluntary". Whilst paying out dividends is voluntary it is not rational to believe that anyone would invest in long run assets such as those in the water sector without ever receiving any form of cash return/dividends. In fact by using such treatment it could be said that the regulation in its current format is discriminatory against those investors who would like to receive an annual return on their invested capital. Utility companies are generally known to be dividend investments rather than growth investments. By their very nature they are considered to be stable long term investments that require large amounts of capital to be invested over long periods of time. In this situation investors will require an appropriate level of dividends to retain their investment or attract new investors should they choose to exit. By insisting that equity investors can only make a return on pre-tax earnings, the CA is effectively asking these investors to fully take governmental tax policy risk. For example, should the government increase or decrease the rate of tax then the rate of return will automatically change, which could completely overturn the basis for the original investment decision. In this case companies that wish to attract external equity investment will find it much harder to attract new investors. As a consequence how will the CA protect equity investors from government tax policy risk/gain?

13. In summary, I do not agree with the reasons put forward by the CA to justify not allowing a compensation for corporate taxes in the allowed returns. As noted above, the proposed approach is inconsistent with economic principles and with regulatory precedents. Furthermore, this approach would result in an under-recovery for equity investors and be inconsistent with the Public Water Supply and Sewerage Act's requirement that prices should allow companies to earn "justified profitability". Given the statements above, in the interests of open dialogue, it would be very helpful if the CA could demonstrate how its methodology does not prejudice equity investors?

We kindly ask from the CA for specific substantial responses for all the questions presented above and underlined, taking into account in the interpretation of the content of the question both the previously submitted as well as currently repeated background information.

I am certain that the CA recognises the importance of this discussion for the customers, investors and ASTV itself. It is of fundamental importance that all the above stakeholder groups clearly understand the points and questions raised above as well as previously. With clear and well communicated explanations all parties will know their rights and responsibilities within the current regulation, which I'm sure is the intention of the law and the regulation developed by the CA.

We kindly ask the CA when responding not to hide behind vague references to law, because as pointed out previously, we have thoroughly examined the regulatory legislation and we are aware that neither PWSSA nor any other law makes prescriptions or established restrictions to the CA regarding the application of inflation nor income tax on dividends when calculating the return on invested capital.

I would be gladly prepared to explain additionally the content of all questions asked, if any of the aspects of the questions should be incomprehensible in written form. We are aware that it is a complicated topic, which is why before making final decisions regarding the application of WACC it could be necessary to involve recognised consultants of the specific area. We kindly ask the CA to inform us if as a result of these circumstances you would require additional time or assistance in involving international consultants. As the largest water company in Estonia we would gladly be prepared to contribute to the development of international best practice regulation.

I am hoping for an open dialogue with the CA and shall be looking forward to a constructive and positive response.

Sincerely,

Ian Plenderleith
Chairman of the Management Board