

Märt Ots
Competition Authority
Auna 6
10317 Tallinn

Your ref 01.04.11 No 9.1-2/10-0448-044
Our ref 07.04.2011 nr 6/1073392-6
(Sequel to our letter of 05.04.2011 No 6/1073392-5)

Dear Mr Ots

Referring to our correspondence regarding the treatment of inflation and income tax on dividends in the calculation of weighted average cost of capital (WACC), we are asking the Competition Authority (CA) in addition to the questions presented in our letter of 05.04.11 to respond to the following question.

In order to explain the question we would like to point out an extract from your letter of 01.04.11 (page 4):

„ASTV’s question: How and to what extent is inflation reflected in WACC.

CA’s response: Pursuant to the explanations provided in the previous item, the CA has prepared and published on its website a document “Juhend kaalutud keskmise kapitali hinna WACC leidmiseks (2011)” (“Instruction for calculating the WACC (2001)”, and the WACC components calculated on the basis thereof are inflation-sensitive. If the inflation increases, the components that serve as the basis for calculating the WACC also increase and thereby also WACC, from which it is possible to conclude that the inflation is included in WACC.“

We kindly ask the CA to specifically point out and prove how in case of an increase (change) in inflation the components that serve as the basis for calculating the WACC has increased (changed) and thereby also the WACC calculated by the CA for the water companies in 2007-2011.

In order to elaborate the question, we would like to point out that the CA has used the following WACCs in the analyses carried out with regard to AS Tallinna Vesi as the water company and later in the WACC instructions prepared by the CA for the water companies (more detailed WACC calculations made by the CA are introduced in Annex 1):

	2007	2008	2009	2010	2011
WACC	8,31%	8,31%	8,31%	8,26%	8,18%

Inflation in Estonia in 2006-2010 has been the following:

	2006	2007	2008	2009	2010
Inflation (Estonia)	4,4%	6,6%	10,4%	-0,1%	3,0%

From the presented data it should be clear that without submitting an additional analysis by the CA it is not possible to understand how the CA has come to the conclusion that Estonian inflation is included in the WACC calculated by the CA and to which extent the CA has included the Estonian inflation in the WACC calculation? Responses to these questions are especially of great interest in a situation in which the CA has started to refer to the WACC to be calculated as the nominal WACC in the calculation process, without differentiating real and nominal WACC and without referring in the WACC instruction in which component Estonian inflation is included.

We have previously repeatedly explained from regulatory purposes the importance of the principles of WACC and the related invested capital in calculating the justified return, which is why I am still hoping for an open dialogue with the Competition Authority and shall be looking forward to your constructive response.

Sincerely,

Ian Plenderleith
Chairman of the Management Board