

Mr Märt Ots
Competition Authority
Auna 6
10317 Tallinn

Cc: Mrs Eha Võrk, Deputy Mayor, Tallinn City Government
Mr Deniss Boroditš, Deputy Mayor, Tallinn City Government

09.11.2010 No

Dear Mr Ots,

Pursuant to § 14² section 1 of the Public Water and Sewerage System Act (herein PWSSA) the attached documents and files contain AS Tallinna Vesi's (herein ASTV) initial proposal for the prices of water and waste water services (as our principal services) offered in Tallinn City and Saue City for the five year period from 1 January 2011 until 31 December 2015 (herein tariff application – Appendix 1). In accordance with ASTV's articles of Association and best practice corporate governance principles, prior to submission, this application has been approved by ASTV's Supervisory Council. As a result of changes in the applicable law (PWSSA) that took effect on 01.11.2010, the City of Tallinn no longer price regulates ASTV, and this function will now be undertaken by the Competition Authority who will price regulate for all water undertakings that serve more than 2,000 human equivalent. We are therefore submitting our tariff application with supporting documentation for your consideration and review.

The tariff application is structured in 3 parts:

1. Business overview
2. Tariffs and Review of Contract Performance 2001-2010
3. Tariff application 2011-2015.

The 1st and 2nd parts of the application provide necessary information that will enable you to assess the outputs required to be provided by the company, and, consequently, the inputs into the tariff mechanism.

To date, the Competition Authority has not yet established the regulatory principles and methodology it will apply to the sector. Under the terms and conditions of our Services Agreement with the City of Tallinn signed in 2001 ASTV has a contractual right to a tariff change from 1 January 2011. In order to ensure compliance with this Services Agreement, we are making our tariff application for 2011 and the following four years.

ASTV takes this tariff application extremely seriously. It is the company's intention, with the support of the CA and external independent experts, that only regulatory principles that accord with international best practice for privatised water utilities are used and implemented, and to avoid the application of tariff setting methodologies that are subjective and politicised. It is for this reason that the company has had the principles used in this application verified by the international economic consulting group Oxera, as well in the previous regulatory period from 2001 to 2010. Oxera are recognised internationally as the leading advisors on the application of best practice economic regulation to both new and existing regulatory regimes.

As stated above, we are committed to ensuring that only principles that accord with international best practice for privatised water utilities are used as we believe this will best serve the long term interests

of our customers and the environment. One of these principles is that a regulator would conduct a thorough review of the company's performance in the previous regulatory period before finalising the forthcoming price determination. In the case of ASTV we have deemed this period to be the period between privatisation in 2001 and the end of 2010. To ensure this review was conducted independently, we commissioned Oxera to make a complete review of our contract since privatisation using Ofwat principles (see Appendix 4 of the Tariff application (Appendix 1 of this letter) for their complete report). We chose the Ofwat methodology as it is a very mature and internationally respected regulatory regime that regulates water companies, which have been privatised. Also, Ofwat has often been quoted by the Competition Authority in its correspondence with ASTV and other state institutions. Therefore, it is appropriate that the Ofwat methodology should be used as a means of comparison and verification.

From this independent analysis using the Ofwat principles, it can clearly be seen that the returns made by the company to date are well below those that would have been allowed under the regulatory regime for privatised water utilities elsewhere in the world. This report is appended to this tariff application and will be made available for public analysis and discussion (see Appendix 1 to this letter Tariff application – Appendix 4).

We would expect the Competition Authority to produce something similar regarding the Company's performance in the previous regulatory period, and that this will be made publicly available for challenge and discussion before any regulatory price determination is finalised. Having such a public discussion will ensure the key stakeholder group, the citizens of Tallinn, fully understand the mechanisms and assumptions used in setting the tariffs. This will ensure that they are protected from monopolies or the state abusing their positions for unreasonable gain.

Within this tariff application there are certain key principles that underpin any international best practice and transparent methodology. These are:

1. Adherence to the **value to the owner principle** by respecting the privatisation value of the company;
2. Implementing **real financial capital maintenance**. Ensuring that the value of invested capital is fully protected from the impact of inflation;
3. Recognising that investors require **returns from post tax earnings** and not pre tax earnings;
4. **Independent verification of key assumptions and cost targets.**

ASTV has built its tariff application (see section 3 of our tariff application) around these key principles. With respect to point 4, our key assumptions regarding costs and the cost of capital are clearly stated. By communicating in such a transparent manner, we expect to be able to have a full and frank discussion with the Competition Authority on the detail of our initial application based upon these assumptions.

In addition, we have made a multi-year application, which accords with international norms for privatised water utility regulation and recognises that the water industry has long planning horizons. Having multi-year certainty on the regulatory principles being applied will make it much easier for ASTV to effectively manage its capital programme, and will incentivise the company to reduce costs with these efficiency gains being passed onto customers at the end of this regulatory period. and by providing an acceptable view of the medium term to banks, will lower the company's borrowing costs.

Over the next five years we estimate that our costs will increase by considerably more than the current estimates for CPI. For example, based upon our current information, we estimate that uncontrollable costs such as pollution taxes, water extraction taxes, energy and chemical costs will increase by on average 10m EEK (over 9%) per annum in the next five years. Under best practice regulation such cost increases will be borne by customers in future years. In fact, our initial estimates show that using

international best practice regulation for privatised water utilities could lead to a nominal tariff increase of 6% in 2011 (see section 3 of our application for more details).

However, we recognise that an immediate transfer of above CPI cost risk from the company to our customers needs more detailed discussion and analysis. Immediately passing above inflation uncontrollable costs through to the tariff will lead to tariff increases that customers do not understand. On the other hand, automatically burdening the companies with the costs they cannot control will inevitably lead to reductions in the quality of service. The drivers for these costs need further discussion in order to determine a clear and systematic approach to including them in the tariff methodology.

Regarding quality standards, this application is built upon the requirements of the law and the additional standards that go well beyond the law that are part of our Services Agreement. One of the key reasons for privatising ASTV was to ensure that significant improvements in the water and wastewater service were delivered to the citizens of Tallinn. Each and every year since privatisation ASTV has delivered all standards required by the Services Agreement and the law - in many cases the company has delivered a much higher level of service than that required by the Services Agreement. Moreover, this service performance is independently verified each year by an MMU – the Supervisory Foundation for the Water Companies in Tallinn. Having an independent organisation to audit service performance is a key component of any good system of regulation for utilities.

Therefore, after making a professional building block analysis of our estimated costs for the next five years, which demonstrates a level of tariff increase higher than our existing Services Agreement, but respecting the terms and conditions of our current contract, ASTV's initial tariff application proposes the following nominal tariff increases over the five year period from 1 Jan 2011 to 31 Dec 2015:

1 Jan 2011 – 3.5%

1 Jan 2012 – 2.5%

1 Jan 2013 – 2.6%

1 Jan 2014 – 2.7%

1 Jan 2015 – 2.7%

However, the company recognises that none of its tariffs should increase by more than the contracted amount as a consequence of Estonia joining the Euro zone. Therefore, in order to ensure responsible corporate citizenship all tariffs will be rounded down to the nearest cent in 2011. This will reduce the company's proposed revenue by over 3m EEK and the proposed increase for 2011 will be **below 3%**. Making the reduction due to the adoption of the Euro will mean a below CPI tariff increase meaning that in real terms, the tariffs will be reducing.

In summary, the company has repeatedly stated its willingness to work within a best practice regulatory system. Furthermore, given that the Government of Estonia has supported the exclusive long-term concession of water and sewerage operations in Tallinn (see Appendix 2 - Government order of 01.08.2000), we believe that the current contract that runs until 2020 provides returns to investors that are in accordance with international norms whilst protecting customers from any future cost increases above the level of general inflation. Moreover, as required by the privatisation, the quality of the water and wastewater service and the level of environmental protection have improved enormously over the past ten years. It is for these reasons that the company has decided not to apply for the full cost increases that would be allowed under a methodology that complies with international best practice for privatised water utilities, but will limit its initial tariff application to only those increases that are contractually permitted under our current Services Agreement (after ensuring that we eliminate any inflationary rounding impact from Euro adoption), whilst continuing to deliver the highest quality service that the Services Agreement demands.

We are aware that currently we have not applied for an incremented 1/15 convergence between domestic and commercial prices since the law is not clear on how this convergence should happen – whether only one tariff should be increased and the other decreased or whether both can incrementally change at the same time. Although your draft methodology version 2 does not give guidance on this, I am sure you have contemplated this issue already and are able to instruct us within a very short time of how to proceed here. We therefore expect your recommendation promptly, perhaps within a week, and can then adjust our current tariff proposal and any relevant calculations accordingly and resubmit our application within a few days from receiving your relevant instruction on this matter. Alternatively, as this calculation does not impact the financial or quality of service aspects of our calculation nor discussions thereof, you may prefer to leave this recommendation until the very end of the application process.

As we need to publish the prices 30 days prior enacting them, and, according to the current Services Agreement, the next tariff period begins on 01.01.2011, then we kindly request for you to review our tariff application within the 30-days deadline stipulated in § 14² section 4 of the PWSSA, i.e. by 10.12.2010 at the latest. Until we are able to apply new prices, we will be applying the current price list valid as at 31.10.2010 as per § 16 sec 6 of the PWSSA. Should you require further data or additional explanations from us or an extension in reviewing our application, please kindly let us know at your earliest convenience.

We look forward to this tariff application being the first step towards a professional discussion on best practice economic regulation that fully takes into account the privatisation contract that is fully compliant with all laws and was entered into in good faith by ASTV and its investors.

However, should this application not be dealt with **solely on its economic and quality of service merits**, the company and its investors will have no choice but to use all available options under Estonian and European law, and international treaties to protect their rights under the original privatisation contract and the Services Agreement.

Sincerely yours,

Ian John Alexander Plenderleith

Chairman of the Management Board of AS Tallinna Vesi

Appendices:

1. Tariff application
2. 01.08.2000 order of the Government of the Republic of Estonia