

Disclosure of the Competition Authority's decision re Tallinna Vesi's tariff application

Contract and Tariff application

ASTV believes it is the responsibility of government authorities in any EU member state to ensure that any changes in law, or implementation of such laws must be done in such a way as to ensure that complies with EU legislation and basic legal principles. This is especially the case when an investor has signed a long term contract in good faith, and in return for the increase in quality of services and capital it has invested, has a justified expectation of the returns permitted over the period of the contract

Shareholders of AS Tallinna Vesi (ASTV) have written to the Competition Authority (CA) requesting the publication of the CA's decision to reject ASTV's tariff application. The Competition Authority has asked AS Tallinna Vesi if it is willing to disclose their decision as they are constrained by the law from doing this without ASTV's permission. As a fully responsible utility company ASTV believes that all utilities that are natural monopolies should fully disclose the key aspects of their tariff application that are material to their customers, investors, but also are important from environmental perspectives. Such disclosure should include the price, the detailed reasoning for the increase, the quality standards that customers should expect to receive for the tariff, and as importantly an audited review of the company's past performance against those standards.

Customers expect high standards of service from utilities as it does the buyer no good to pay a lower price if the quality or quantity he/she gets for his/her money is lowered in the same proportion. It is for these reasons ASTV has already publicised all aspects of the service in its 2011 tariff application, including proposed tariffs, reasons for the increase, the quality standards customers can expect from the company, and an independent audited report of company's operational performance in the previous year.

AS Tallinna Vesi hereby reiterates that the Company applied for a contractual 3.5% tariff increase for 2011, submitting all necessary documents in accordance with the law, including a cost-based analysis in order to comply with the Public Water Supply and Sewerage Act. All agreements contained within our contract were in accordance with Estonian and EU law at the time of privatisation and have been ever since. At the time of the privatisation the contractual terms were agreed for a period of 15 years.

The objective of the 2001 privatisation was the rapid improvement of the quality of water services. The Company was privatised according to the terms and conditions of a market led tender to the investor who offered the lowest real tariff increases to achieve the significant improvement in standards and the highest price for the shares. In the privatisation process documentation it is clearly stated that the quickest and most efficient way to achieve these improved standards was via a privatisation process that offered a long term contract. Before the privatisation went ahead, the national government of Estonia granted a 15-year concession. To date the company and its owners have fulfilled *all* their contractual obligations.

The Competition Authorities Analysis of ASTV's tariff application

The Competition Authority did not perform an actual analysis of the agreements signed during the privatisation and claimed that "agreements between any party and ASTV do not have greater legal strength than the PWSSA". In addition, the Estonian Authorities have not made an economic analysis of the ASTV's financial performance since 2001. Such an analysis would demonstrate that the average real rate of return made by ASTV for the period 2001 to 2010 is 6.5%.

Furthermore, the CA has not analysed nor commented on the independent confirmation given by Oxera to the return the investors have had since privatisation despite of the fact that such analysis was part of the tariff application submitted to the CA together with the full set of the privatization documents on 9 November 2011. It should also be pointed out that this analysis was made using the methodologies recommended by the World Bank in their guidelines for tariff setting for privatised utilities. To take such an approach is to make *a unilateral decision which is unproven, unsupported and ignores the contractual agreements in place for the last 10 years* thus overturning the legal and economic framework of the privatisation.

Tallinna Vesi welcomes the opportunity to once again disclose its tariff application together with the key discussion documents the company has sent to CA as response to their preliminary analysis.

The company has disclosed the following set of documents on its web-page:

- 09.11.2010 contractual tariff application appended with a company review, cost analysis, the privatization contract and an independent analyses by Oxera
- 28.02.2011 CA's preliminary analysis of ASTV's tariff application
- 29.03.2011 ASTV's response, insisting that the contract should be applied, appended with the commentaries to the CA's statements
- 02.05.2011 CA's decision re tariffs

In extra we have disclosed the correspondence about the WACC debate held in parallel to the discussion of the tariff application.

Points of Dispute with the Competition Authorities Methodology

Whilst ASTV believes in total transparency the company does not believe that disagreements on technical issues should be discussed in public. However on this occasion the CA announced that it would not consider any aspect of our privatisation contract and had made an analysis and publicly rejected the 2011 tariff application using only its own internally developed **recommended** methodology, comparing this to the supplementary information sent by ASTV. Throughout the process ASTV has always cooperated with the CA commenting on the problems it sees in the CA's recommended methodology and its application, using examples and references to present our questions as professionally as possible. ASTV believes technical disputes such as these raised below should be resolved through open dialogue with expert analysis used when and where necessary, with publication made only once all points raised have been thoroughly analysed. Therefore it is with some reluctance that we make the comments below, however in the interests of balance and fairness for our customers and investors we detail the following points.

AS Tallinna Vesi would like to explain the key flaws of the analyses made by the Competition Authority:

- The methodology applied by the Competition Authority makes no reference whatsoever to service aspects of the PWSSA (water quality etc). This omission is completely inconsistent with regulatory practice across the world.
- The methodology applied by the Competition Authority does not allow the investor to earn returns on capital paid by the investor for the shares sold by the City of Tallinn at the time of the privatisation. Thereby assigning no value to the premium paid for the equity or the improvements in service made since privatisation.
- The CA's methodology for the treatment of inflation is entirely unclear. The CA declares that their WACC is nominal. However the risk free rate is based on German inflation and thus does not include Estonian inflation or a factor to clearly reflect the variance between Estonian and German inflations into WACC calculation. This is inconsistent with best regulatory practice and fundamental finance principles.
- According to the CA equity investors should receive returns from post tax earnings whilst debt investors should receive returns from pre tax earnings.. Such an approach clearly prejudices

equity investors and is inconsistent with the CA's own regulatory objectives (see No 4 below), and regulatory best practice (see World Bank guidelines). According to the CA 's logic dividend payments are voluntary however in reality would anyone invest in a stable utility business without the opportunity to earn dividends.

- The CA's analysis of pollution tax does not include any attempt to understand the most efficient balance from a customer and environmental perspective. The CA does not recognise that in order to be 100% certain of avoiding pollution taxes it would require the company to make a huge investment which would be charged to the tariffs, and could be many times higher than the disallowed pollution tax dependant on exceptional weather conditions. To illustrate the question, should the company construct an asset to avoid a 1 in 20 year weather event?
- The CA prohibits the inclusion of any minimum provision for bad debts costs. As an alternative for an allowance for bad debts the CA proposes that the water companies ask the customers to prepay for water services. Such a proposal is unheard of for utility services in Estonia, both from a business and cultural perspective. Moreover, such an approach is not in accordance with the payment term recommended by the PWS prescription of the City of Tallinn. A more sensible approach would be to understand the collection rates of all companies and then motivate the companies to improve by setting stretching collection targets.

The company would like to point out that it did not include pollution tax penalties or bad debt costs separately in its application. Under the terms of the current contract all pollution tax and debt collection risks are taken by the company.

Regulatory Objectives and Legal Obligations

In their 2009 analysis of ASTV's tariffs the CA has indicated the following objectives of the regulation that have also been included to the regulatory methodologies of other sectors:

1. Protecting the consumers;
2. Using the regulation methods, which enable the company to remain economically and financially viable, i.e. to cover current business expenses and finance the required investments from equity capital and loan capital;
3. Establishing sufficient motivation for the company for a more efficient organisation of its activity;
4. Ensuring an revenue acceptable for investors from the assets invested by them or at least revenue of equal value, which they could get from other investments with the same risk level.

Unfortunately in practice the CA has completely ignored their own regulatory objectives and the only objective of the CA's analysis seems to be "to limit the profitability" by unilaterally breaking the privatisation contract, and without any evidence to suggest that this long term contract was inefficient. For example, despite the CA's regulatory objective to guarantee a justified return to the investors the CA has decided that they do not need to include the capital paid by the investor during the privatization into the calculation of the justified return.

Finally all good regulation takes time to develop and evolve and takes account of best practice elsewhere. It should recognise existing contractual obligations, differentiate between privatised and non-privatised entities and provide a balance between price, investor return and service provided. In this manner a regulatory regime fit for purpose and respected by all parties can be put in place. Unfortunately the CA has not allowed this to take place. In this case the CA wants to impose its **recommended methodology** on AS Tallinna Vesi and the rest of the water industry without being able to **prove** its statements or methods are correct. In spite of the thoroughness and challenge contained in ASTV's responses the CA has either been unwilling to answer our questions or provide independent examples to demonstrate that the practices it uses are sound.

The Company would like to reiterate that ASTV is fully committed to honour the Contract to continuously offer high quality services to the Citizens of Tallinn and having the achievement of these

standards independently verified in accordance with good regulatory practice. In a situation where these standards have been attained, the company will strive to ensure that its owners receive an acceptable return on invested capital that corresponds to at least the equivalent return that they would obtain on investments with the same degree of risk, over the lifetime of the contract.