Mr Juhan Parts, Minister

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Our: 10.09.2012 no 6/1248819

Dear Minister Parts,

Re: Potential misconduct by the Competition Authority and the Head of the authority

I am writing this letter to you as the Estonian Government's public official in charge of the Competition Authority (CA), and in particular of Mr Märt Ots, the Head of the Competition Authority. I do appreciate that to a degree the CA is an institution that is independent of the Ministry, however, as you are the Minister with direct responsibility for this governmental institution the matters I wish to raise with you which are of a great magnitude that that they require the attention of the Estonian Government.

Two weeks ago, the newspaper Postimees published a pertinent article written by Tuuli Koch detailing the practices used by the CA when regulating Kunda Elamu, where from 2002 until 2007 Mr Ots was one of the owners of the company. AS Tallinna Vesi (ASTV) has now researched the information published in that article as well as on the website www.kohalik.info concerning the same matter and believes that, if the points raised are proved to be correct, it demonstrates the clearest breach of the professional ethics of a regulator and regulatory function. Therefore I believe it is imperative that, as a matter of urgency, **you conduct a full an open investigation into the matters raised in this letter and if necessary take the appropriate disciplinary action.**

If proved correct, the evidence included in this letter and its appendices brings you inescapably to the conclusion, that the CA has:

1) Knowingly used inaccurate and contradictory statements and actions in allowing different regulatory methodologies to be used for local investors, whilst in the case of ASTV all the terms and conditions of the international privatisation were disallowed.

2) Knowingly forced ASTV and its shareholders into a defence of the international privatisation contract based on a set of completely inaccurate accusations.

3) Knowingly misled the Estonian Courts and the EU Commission over the status of economic regulation in Estonia.

4) Knowingly made regulatory decisions in Kunda where Mr Ots, the Head of the Competition Authority had a very clear conflict of interest.

5) Knowingly made regulatory decisions in Kunda from which the Head of the Competition Authority may have personally benefited, but were to the detriment of the citizens of Kunda.

6) Knowingly made regulatory decisions in Kunda using inaccurate information

Correspondence with ASTV shareholders

In May 2012 the shareholders of ASTV wrote to you asking what actions you are prepared to take to protect local and international investors who have invested into Estonia in good faith from the arbitrary and groundless actions of the CA. In your response to ASTV's Shareholders in your 25.06.2012 letter nr 1.15-5/12-00457/080 you stated the following:

1) *(W)e deem it necessary to stress that the purpose of the act of setting price limits for monopolies adopted by the legislator was **certainly not to breach the legitimate interests of investors.***

2) *"The purpose of the act of setting price limits for monopolies **was to protect the rights of the consumers of universal services against the abuse that the unjustified price formation may involve."***

3) *"(T)he original reason of the ongoing dispute is the fact that Tallinn City Government and AS Tallinna Vesi have signed an agreement by which the parties have agreed upon the mechanism of forming the water tariffs, which is **allegedly** not in conformity with the principles of the PWSSA and competition law."*

4) *"Certainly the Minister **cannot intervene in the activities of the Competition Authority as an independent regulator or establish administrative acts that are not in compliance with the law."***

All of which are clear assurances of respect for the investment community and legal due process.

You are fully aware that ASTV and its shareholders have been forced to defend the international privatisation contract and their legitimate expectations from this contract, primarily because the CA and the Ministry have **consistently stated in public and to the Estonian courts** that the privatisation contract cannot be fulfilled as it does not and has never complied with the law and the custom and practice for price regulation in Estonia, ""*(H)ereby the CA would like to emphasise that there are regulation **principles valid in Estonia since 2002** that are applied **uniformly** for the purpose of equal treatment in several monopolistic areas".*

From the evidence we have presented in this letter and its appendices the Minister will understand that there is now very significant and credible doubt about the correctness of this allegation and other statements, which constitute the CA's very reasons for forcing ASTV and its shareholders into court. I am sure the Minister would agree that it would be extremely damaging for Estonia if ASTV and its shareholders were forced to continue to have to defend themselves in court against what, in the light of the evidence available, may prove to be baseless and incorrect allegations that represent nothing more than the unsubstantiated opinion of Mr Ots as the Head of the CA. This is especially true, if the information provided in this letter which has already been presented to the Minister on more than one occasion, is proved to be correct, without the appropriate action being taken.

<u>Undertaking to investigate the CA's tariff setting methods, especially in Kunda and the conduct of the Head of the CA, Mr Märt Ots</u>

As the Minister himself said in January 2012 "*This (the situation in Kunda) must be definitely investigated if there is even a slightest suspicion in the CA´s impartiality.*"[1]

Given the importance of the evidence in this letter and appendices, and the Minister's own words on ensuring the impartiality of the CA, we request that the Minister commit to immediately carry out a full and public investigation into the tariff setting and business practices of the Competition Authority and Mr Ots as an independent regulator, and to make the complete results of this publicly available. The reason why we are urging you to conduct an expedient but thorough and detailed analysis into the conduct of the CA and also Mr Ots is because the evidence in this letter and its appendices points to the conclusions that such conduct could constitute multiple breaches of the Public Service Act and the Public Servants' Ethics Code (please see our analysis in the relevant section in Appendix 1). When conducting this analysis, in particular the following specific questions needs answering:

1) Does the CA have a substantial body of empirical evidence to support its claim that <u>*there are regulation principles valid in Estonia since **2002** that are applied **uniformly** for the purpose of equal treatment in several monopolistic areas"?*</u>
2) Do the statements made by the CA and Mr Ots to the Estonian Courts, the EU Commission and ASTV reflect the truth based on fact and evidence or are they only the unsubstantiated opinion of one institution or one person?
3) Why did the Head of the CA permit all the terms and conditions of the private sale in Kunda but disallowed all the terms and conditions of ASTV's international privatisation that was carried out with the full knowledge and support of the Estonian government?
4) In the case of Kunda, did Mr Ots as the Head of the Competition Authority have a conflict of interest by knowingly making tariff determinations in 2007 (less than five months after he sold the assets) and 2011 for Kunda, when he himself had previously been one of the main shareholders in Kunda Elamu and who profited from the sale of assets to Fortum, the party now making the tariff application?

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[1] Business news 26.01.2012: "Juhan Parts: doubts about the impartiality of the CA must be investigated" - http://www.e24.ee/716784/juhan-parts-kahtlusi-konkurentsiameti-erapooletuse-suhtes-tuleb-uurida/

5) Why did the Competition Authority and Mr Ots, when making its 2011 tariff determination in Kunda, deliberately not take into account the full regulatory facts, of which it was fully aware, thus making an incorrect determination which was detrimental to the customers?
6) Why did the Competition Authority and Mr Ots, when making its 2011 tariff determination in Kunda, knowingly make a tariff determination which included profits from transactions from which the Head of the Competition Authority had personally benefited?

Losses suffered by ASTV

Finally, I would like to highlight to the Minister that the company and its shareholders have to date lost approximately 30m Euros to date as a result of the breach of contract caused by the CA's refusal to take into account any of the terms and conditions of ASTV's privatisation contract. From the evidence we have accumulated to date, it appears that this loss of earnings is attributable to the deliberate actions of the Competition Authority. Therefore, in this situation ASTV and its shareholders will be forced to seek damages for this full amount from the Ministry of Economy and Communications (MoEC) and the Competition Authority for loss of earnings and reputational damage.

I appreciate that some of the points raised in this letter and appendices are technical and regulatory specific in their nature, therefore I remain at your disposal to discuss any of these points should you wish.

I look forward to a positive and cooperative discussion with you in spite of the seriousness of the topics raised in this letter.

Yours sincerely

IJAP

Annex 1

Annex 1

1. ASTV in court because of the CA and MoEC's unsubstantiated opinions

Over the past three years the Competition Authority, and especially its head Mr Mart Ots, have made repeated public statements about the "illegality" of ASTV's privatisation contract, which was signed and commenced in 2011, over 10 years ago, and the **alleged** over profitability of ASTV. As such the CA has refused to process the tariff increases that were contractually agreed in the international privatisation process that has brought considerable financial and environmental benefits to the state of Estonia, and was carried out with the full knowledge and approval of some of the most senior figures in the Estonian government, both currently and in the 2001 government at the time of the privatisation (see Appendices A and B [2]).

Since this time ASTV has made repeated attempts to demonstrate to the CA, with independently verifiable evidence, that the international privatisation contract was conducted to the highest international standards with the support of the EBRD, and that the privatisation has not led to over profitability for the initial privatising and subsequent IPO investors. The CA has refused to listen to any of these points whilst continuously repeating the mantra that its current methodology has always been the legally correct method of regulation in Estonia since 2002 and by default prior to the privatisation.

The CA has made the above allegations and refused to process ASTV's tariff application based entirely on its own opinion and without any independently verifiable evidence. The CA's main admission, which has also been supported by the Ministry in writing[3] is that the justified profitability calculation included in the PWSSA always intended to state "to operate with justified profitability on capital invested by the water undertaking[4]", even when the law did not state this (this wording was only inserted into PWSSA in 2010), and that as a consequence ASTV's tariff methodology, which was the cornerstone of the international privatisation, does not and has never complied with the law.

The CA states that this "intention" can be proven by reference to past "custom and practice" of monopoly regulation Estonia. I quote from the CA's tariff decision of 02.05.2011, "*(H)ereby the CA would like to emphasise that there are regulation principles valid in*

[2] See also Estonian Government's order of 01.08.2000nr 641k (see https://www.riigiteataja.ee/akt/83132) and Ministry of Foreign Affaris 2000 yearbook (see http://www.vm.ee/?q=en/node/4040)

[3] 06.06.2011 letter of deputy chancellor of MoEC, Mr Kuningas, nr 1.8-5/11-00596/001 and 25.06.2012 minister's response to the letter of AS Tallinna Vesi's shareholders nr 1.15-5/12-00457/080.

[4] The CA insists that captial invested by the water undertaking is the net book value of the fixed assets required to provide the service (See guidelines for calculating the price of water services at CA's webpage: http://www.konkurentsiamet.ee/?id=18324).

*Estonia since **2002** that are applied **uniformly** for the purpose of equal treatment in several monopolistic areas (energetic, communication, postal services, railway etc). (p 34 in the English version)"*. In addition the CA repeated these claims in its submission to a court of law dated 29.08.2011, "(*H)ereby the CA would like to emphasise that there are regulation principles valid in Estonia since 2002, that are applied **uniformly** for the purpose of equal treatment in several monopolistic areas (energetic, communication, postal services, railway etc)* (p 40 in the English version) and *"(T)his **harmonises** the bases for price formation of water and **heating undertakings**, and will serve to ensure regulation of prices of natural monopolies across industries (*p 20 in the English version)". In addition, in its response to shareholders dated 25.06.2012 the Minister wrote, "*(T)he bases of forming water tariffs stipulated in the Public Water Supply and Sewerage Act (hereinafter also the PWSSA) § 14 applied before and at the time of privatisation and the bases of forming water tariffs stipulated in the PWSSA applicable today have stayed unchanged in their essence since the law was enforced in 1999, including amongst other things the justified profitability component to be added to the water tariff.* ***The fact that justified profitability is calculated on the capital invested by the water company was also used when providing a meaning to the respective provision of the PWSSA that was applicable at the time of privatisation and through that when establishing the water tariff".*** Finally we would like to highlight that the Ministry of Economy and Communications and the CA have repeated these same statements to the European Commission in their response of June 2011.

As a consequence of the above you will be aware that ASTV has been forced to defend the terms and conditions of the privatisation process in the Estonian courts and the EU Commission, with the CA refusing to approve the tariffs ASTV applied for in 2011, and after having launched an investigation into current tariffs (i.e. those approved in 2009), have made a prescription to ASTV to reduce these current tariffs by 29%. This is in spite of the company only following the terms and conditions of the privatisation contract that were established by the Estonian authorities themselves more than 10 years previously.

2. Evidence to demonstrate that the CA does not have a uniform method of regulation

2.1. The CA has allowed and itself used different methodologies for calculating justified profits

For the CA to make such allegations about "custom and practice", and for the Ministry to make formal statements in writing in support of the CA, one would expect the CA to have a fully documented and substantial body of evidence to support its position that justified profitability has only ever been calculated on capital invested by the monopoly being regulated, and that the net book value of the fixed assets used to provide the service has always been used as the value of capital invested.

However when ASTV, in order to defend itself against these statements, requested information on other tariff decisions for natural monopolies the CA has refused to provide the information stating that this contains the business secrets of other companies - (APPENDIX C 29.08.2012 ASTV's letter to Tallinn District Court and the Supreme Court). In addition, to help give you a basic understanding of the lengths the CA has gone to avoid a public discussion of its methodologies, in its letter to ASTV dated 16.12.2011 the CA has claimed that the COUNTRY risk premium is a business secret (Appendix D). In summary the CA has either been unwilling or unable to provide any evidence to support its opinions, and has used completely inaccurate technical reasons as an excuse.

Two weeks ago ASTV became aware of an interesting and pertinent article in the Postimees newspaper that detailed the practices used by the CA when regulating Kunda Elamu, where from 2002 until 2007 Mr Märt Ots **(between 2001 and 2007 the Head of the Energy Market Inspectorate and since 2008 the Head of the CA),** was one of the owners of the company. To fully understand what has happened here it is necessary to look beyond the headlines and into the information published on the website www.kohalik.info. Here one can find sufficient documentation necessary to understand how Mr Ots has first engaged in transactions and thereafter regulated in Kunda, and as a result identify very clearly that the very practices that Mr Ots claims were the law and custom and practice since 2002 appear to be completely incorrect. This information casts very serious doubts upon whether such a consistent practice for economic regulation has ever existed.

When reviewing the financial accounts of Kunda Elamu (KE) from 2002 to 2007, and the tariff determinations made by the CA in October 2007 and 2011, both approved by Mr Ots, it appears that the means of regulating Kunda's heating tariffs does not correspond to the method which Mr Ots insists has always been in place since 2002, and does not correspond to the reasoning given by Mr Ots in his refusal to approve ASTV's tariff's in accordance with ASTV's privatisation. The following factual details demonstrate this inconsistency in regulation.

1) In its 21/10/11 the CA appears to have allowed the 2007 selling price received by the himself as one of the owners of Kunda Elamu, to be used as a proxy for the opening value of capital invested.. However, in the case of ASTV it stated that the multiyear price cap tariff model was not in compliance with the law and completely refused to accept that UU should be allowed to earn a return on the full amount of the capital it had paid on privatisation.
   This action in Kunda is in direct contradiction with the reasoning given by the CA and the Ministry have in its response to the EU Commission in June 2011, For example, "*(A)n approach where the value of the assets subject to regulation is derived from the value of the company agreed upon between two parties cannot be considered justified. If an incorrect principle is followed, the price of the water service for consumers will rise as a result of the privatisation transaction solely due to the fact that the value of the assets subject to regulation increases. But no changes that improve the public water supply and sewerage system take place solely through entering into a privatisation agreement (no new investments are made) and only a change of ownership takes place*". Clearly these principles were not applied in Kunda where

asset values could be increased without any money changing hands (revaluations), and asset valuations have increased based entirely upon a private agreement (asset sale from OU Wille Servcie (WE9 to Kunda ELamu (KE), and then the sale of all assets from KE to Fortum (FT) without any commitment to improve service. Whilst in the case of ASTV's privatisation the multiyear price cap tariff model was accompanied with a contractual requirement to make significant increases in the quality of service (see page 75-82 of CoT's 03.07.2000 information memorandum on ASTV's website[5]). ASTV's privatisation model protects against this risk, whilst in Kunda the CA has knowlingly permitted, and perhaps encouraged, this very risk situation to occur.

Why has the CA disallowed ASTV's privatisation contract, insisting that only the net book value of fixed assets can be used to calculate the justifed profit, whilst in this case in Kunda the CA has allowed the much higher private sale value to be used to calcualte the justifed profit?

Why, in a situation where the Head of the CA had personally gained from Kunda Elamu, did he permit the above risk situation to occur by allowing the change of ownership, without any commitment to increase service standards, to be included in the tariff calculation?

Why has the CA knowingly used the statement above to mislead the EU Commission about ASTV's privatisation contract and regulation in Estonia?
Why has the CA completely refused to accept all the evidence that proves that this risk did not occur in the case of ASTV privatisation?

2) This action in Kunda is also in direct contradiction with the reasoning given by the CA in its court application dated 29.08.2012 for rejecting ASTV's tariff application. In addition to claiming ASTV's tariff application as being not in compliance with the law the CA went on to further criticise ASTV's privatisation contract and tariff application by using some text from the World Bank Guidelines in an inaccurate and completely misleading way tariff, to quote *"(A)ccording to the World Bank guidelines (Annex 18 to the Complaint, 20.06.2011, translation 50−51, the last paragraph) the application of the method used by ASTV for calculating justified profitability entails a great danger, namely circularity in assessment, i.e. if the investors know that the price paid by them upon privatisation of the company is used for the assessment of their asset base, and thereby also for their subsequent profitability, they tend to benefit from the situation, i.e. they knowingly pay a higher price for the company, or by successively selling the company achieve a result where consumers have to pay a higher price for the service of water, while no actual changes have taken place in the public water supply and sewerage system"*. In the case of Kunda where the Head of the CA had a personal business interest the circularity danger described by the World Bank could easily have occurred, as the price appears to have been the only determinant in the private sale agreement.

[5] http://www.tallinnavesi.ee/et/investor/Regulatsioon/522-Erastamise-protsess

Of course such circularity <u>could not occur in the case of ASTV's privatisation as the main bid award criteria was the lowest increase in tariffs (worth 60%),</u> i.e. if a bidder offered the highest price for the equity but did not offer the LOWEST increases in tariffs it would lose the bid, and, as mentioned above, significant increases in quality were built into the privatisation contract. The CA was well aware of these facts when making this statement, but instead of engaging with the evidence has knowingly misled the courts. Why, did Mr Ots, the Head of the CA, calculate tariffs in Kunda based on 2007 private sale value for Kunda's assets, thus permitting the circularity danger described above to occur in this tariff determination, whilst disallowing all the terms and conditions of ASTV's international privatisation contract, which protected against such danger?

<u>**Why has the CA disallowed ASTV's privatisation contract, insisting that only the net book value of fixed assets can be used to calculate the justifed profit, whilst in this case in Kunda the CA has allowed the much higher private sale value to be used to calcualte the justifed profit?**</u>

Why has the CA knowingly accused ASTV, in a document submitted to the Estonian courts, of using a tariff methodology for calculating justified profitability *entails such a great danger, when a cursory review of the well publicised details of the international privatisation would have proved this was a completely incorrect allegation?*

3) *On 26 October 2007, less than five months after selling the assets to Fortum for 16.6m EEK, Mr Ots made a tariff decision in Kunda,* where he approved the tarif<u>f as it included "a reasonable rate of return"/justified profit.</u> However it is<u> impossible to see if this "reasonable rate of retur</u>n" was <u>earned on the capital invested by the heating company</u> into the assets required to provide the service, <u>or on the selling price received by Mr Ots</u>, as he has "blacked out" all asset values – which cannot be a business secret as these are monopoly assets.

4) If the CA has a substantial body of evidence to support its claims of custom and practice, why has Mr Ots declared the value of invested capital, which cannot be a business secret, to be declared a business secret in the case of Kunda and other tariff determinations?

5) On 21 October 2011 Mr Ots made a further tariff decision in Kunda. In this decision it can be seen that Mr Ots has allowed a significantly higher asset value than the net book value of the fixed assets required to provide the service. In fact the amount allowed for the asset value is remarkably close to the 16.6m EEK purchase price paid by Fortum for these assets. In this situation of personal gain, Mr Ots has clearly interpreted the wording of the law in Estonia to allow a range of methodologies to be used to calculate justified profit.

6) On 21 October 2011 the CA permitted tariffs to be calculated using methodologies that the CA itself has deemed illegal when applied to ASTV's international privatisation contract, hence the alleged custom and practice referred to the by the CA did not apply neither before nor after the anti-Monopoly bill.

2.2. Recent changes in the CA's regulatory methodologies

In addition, to further demonstrate that the CA's has never applied a uniform approach to price regulation it is opportune to review any recent changes to the CA's methodologies to ensure that no changes or amendments that are allegedly relevant to ASTV's case have been incorporated into the CA's methodologies or the law.

When looking at the changes to the various regulatory methodologies that been implemented in the recent past one comes across the following very pertinent change that was incorporated into the methodology for regulating heating companies and was valid only from 5.03.2012 (see explanatory note to section 6.5 in document [6]):

> *"The circumstances whereby the assets related to the heating production, distribution and selling are re-sold or re-evaluated with a considerably higher price (only the owner of the asset does change) without any extra investments to increase the value and useful lifetime of the same assets , are not considered as investments to the existing regulated assets"*

If the law or the CA's methodology had never permitted such transactions to be included in the justified profitability calculation, and only one UNIFORM methodology was permitted for setting tariffs, then why has the CA made this very specific amendment to its methodology in March 2012. **Is the CA saying that prior to this date the law and its methodologies permitted a range of different methods for calculating the regulatory asset base and tariffs?**

From this amendment and other evidence presented in this letter, it is clear that many different methods for valuing the regulatory asset base, and different tariff setting methodologies were and have been applied by the CA since 2002. This evidence presents a situation that is in complete contradiction with the CA's claims that it had "since **2002**…*applied **uniformly** for the purpose of equal treatment in several monopolistic areas".* This amendment is further evidence of the absence of a uniform practice across different sectors, and moreover is another clear demonstration of the CA's incorrect allegations that are specifically directed against ASTV's international privatisation contract.

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[6] http://www.konkurentsiamet.ee/?id=18306: 8. Soojuse piirhinna kooskõlastamise põhimõtted (kehtivad alates 05.03.2012 käskkiri nr 1.1-2/12-011)

Finally, the timing of this change (6 March 2012) and the fact it was only applied to heating sector (the story of Kunda Elamu only became public on 26 Jan), gives grounds for a certain amount of cynicism as to its reasoning.

In summary, from the empirical evidence of tariff setting presented above, and the very recent changes to the CA's own methodologies one has to cast significant doubt on the CA's allegations against ASTV's international privatisation contract for the following reasons:

1) The CA has knowingly allowed the terms and conditions of the private sale of assets from Kunda Elamu to Fortum to be the starting point for his regulatory analysis. However in the case of ASTV the CA has completely disallowed all the terms and conditions of ASTV's <u>international</u> privatisation, clearly discriminating between local investors and the international privatisation.
2) The CA has interpreted the law to allow a range of different methodologies to be used to calculate "justified profit", both prior to and after the publication and taking effect of the AMB. <u>Thus the statements made by the CA and the Ministry regarding a UNIFORM application of the law (custom and practice) that existed at the time of the privatisation and from 2002 are clearly incorrect.</u>
3) On 5 March 2012 in the heating sector the CA amended its methodology to stipulate that justified profitability could only be earned on capital invested by the heating undertaking, i.e. prior to this date it was not custom and practice in this sector, there was no uniform practice applied since 2002, and the methodology and the law and the CA methodology and application of the law permitted different tariff calculations – see section 4 below for further evidence to support this.
4) Should all or even a proportion of the above prove to be correct, then Mr Ots has knowingly made a number of <u>false representations to ASTV, the national courts of Estonia, and the EU Commission</u> when stating that there are "*regulation principles valid in Estonia since **2002** that are applied **uniformly** for the purposes of equal treatment in several monopolistic areas*" in order to force ASTV into court to defend the international privatisation contract.

3. <u>Mr Ots has acted in a clear situation of conflict of interest.</u>

From 2001 to 2007 Mr Ots was Head of the Energy Market Inspectorate, and from 2008 the Head of the Competition Authority. In both these positions he was responsible for setting tariffs. As such he should have kept a professional distance from any related party transactions where he was involved in a purchase or sale transaction in order to avoid any **<u>conflict of interest</u>**, especially so if he was looking to avoid the very situation in which he criticised ASTV.

If I could provide a definition of a conflict of interest situation to help give clarity to this point:

- ***<u>A situation that has the potential to undermine the impartiality of a person because of the possibility of a clash between the person's self-interest and professional interest or public interest. This includes when an individual's personal interests or</u>***

<u>concerns are inconsistent with the best for a customer, or when a public official's personal interests are contrary to his loyalty to public business.</u>

In fact this potential conflict of interest was recognised by Mr Ots, if I could re-quote Mr Ots' own words (CA's 29.08.2011 response to court):

"i.e. if the investors know that the price paid by them upon privatisation of the company is used for the assessment of their asset base, and thereby also for their subsequent profitability, they tend to benefit from the situation, i.e. they knowingly pay a higher price for the company, or by successively selling the company achieve a result where consumers have to pay a higher price for the service of water, while no actual changes have taken place in the public water supply and sewerage system".

However, in the situation of Kunda Mr Ots, as the public official in the position of Head of the Energy Market Inspectorate and Head of the Competition Authority, took actions that were related to his own personal business interest, and his professional/public role as a regulator, which have led to a clear conflict of interest. He was the selling party (assets of KE), and in his role as Head of the Energy Market Inspectorate he had a professional relationship, i.e. he had both, the capability to fix the value for the selling party and to set the ongoing revenues for the purchasing party. For example:

On 1 June 2007 Mr Ots, who was at this point in time Head of the Energy Market Inspectorate and wio had a professional responsibility for tariff regulation in Kunda, and his business partners sold the assets of Kunda Elamu to Fortum for 16.6m EEK (personal business). During the sale process and at the time of making the sale Mr Ots would have known that from that point onwards he would have been regulating Kunda's tariffs (professional/public role as regulator). As Mr Ots was selling the company (personal business), and knew that he was going to be the party who was able to set the revenues, cash flows and profits immediately after the sale as he would be setting tariffs - Kunda would now become part of Fortum, a group whose total sales were greater than 50GWh per annum (professional/public role as regulator). This fact is confirmed by the following sentence from the 26.10.2007 tariff determination which states:

> *"According to the 2007 version of the distant heating law, namely §9 - 1 required the approval of the Energy Market Inspectorate in the following case:*
>
> - *Company belonging to the group, if the total sales of the group to the Estonian residents not belonging to the group exceeds 50 GWh per annum."*

<u>In effect, Mr Ots, in his professional role as regulator, was able to "fix" the value for the assets he was currently selling (personal business).</u>

In addition, as a result of this transaction Mr Ots would have known he was moving the responsibility for regulation in Kunda from the Municipality to himself, as the Head of the Energy Market Inspectorate – a further conflict of interest.

1) In 2007 the company in which Mr Ots held his shares in KE, OU Klingsor received a loan of 6.9m EEK, from the cash received by Kunda Elamu from this sale, thus confirming his ongoing personal relationship with the company (see Appendix E, note 5 from OU Klingsor 2007 financial accounts).

2) On 26 October 2007, Mr Ots, in his role as the Head of the Energy Market Inspectorate (professional/public role as regulator), made a tariff determination for Fortum in Kunda (personal business). Less than five months after selling the company, Mr Ots has made a tariff determination for the company who bought the assets from him.

    For example, it is a well established fact that the value of any regulated business is driven by its cash flows. In this case the specific price paid by Fortum would be based on its understanding of future sales volumes and FUTURE tariffs. Less than five months after selling the business Mr Ots made a tariff decision, which would have had a significant effect on the value of the business. In effect Mr Ots, in his role of Head of the Energy Market Inspectorate, was able to establish the ongoing cash flows of the business and thus heavily influence its selling price. Furthermore, in this situation ,had the regulator reduced the cash flows of the business this could easily have exposed the selling company (KE), and Mr OTS to a potential liability claim from the purchasing party, which is another clear conflict of interest.

   <u>Does the Minister believe that the situation where Mr Ots had a personal business relationship (selling party), and then less than five months later sets tariffs (professional/public role as regulator) for the party that purchased the same assets from him (personal business), is NOT a conflict of interest for a public official?</u>

3) On 12 January 2008 Kunda Elamu published its 2007 financial accounts. Here one can see that the Chairman of the Supervisory Board of Kunda Elamu was Loone Ots, Mr Ots's wife, who incidentally was also the CEO of OU Klingsor, the company that received the loan that resulted from the cash received from the sale to Fortum (personal business).

4) On 21.10.2011 Mr Ots as Head of the Competition Authority made another tariff determination for Kunda (professional/public role as regulator). In this determination Mr Ots confirmed that he had allowed the price paid by the investors on the private sale (personal business) to be used as the asset base.

a. In this situation where Mr Ots had clearly benefited, he was quite prepared to knowingly permit the circularity danger referred to above to occur. Furthermore, as pointed out above, Mr Ots had INCORRECTLY accused ASTV of this danger in its tariff application, but was quite prepared to allow this risk to tariffs in another tariff determination regarding Kunda where his own personal interests were involved.

5) On 21.10.2011 Mr Ots as Head of the Competition Authority made a tariff determination regarding Kunda (professional/public role as regulator). In this determination he claimed to have no knowledge of the assets of Kunda Elamu (personal business), why?.

6) Does the Minister believe that it is acceptable business practice for the Head of the CA to have an ongoing professional/public interest relationship to set tariffs for Fortum in Kunda, when he previously had a personal business relationship with the same company when selling the assets of Kunda Elamu to Fortum in 2007?

In summary, prior to the sale transaction, during the sale transaction Mr Ots still had a serious conflict between his personal interest as the selling party, and his professional capacity to represent the public as a regulator., Before and whilst concluding the sale transaction (personal business) he knew that he would be making tariff decisions (his professional/public role as regulator) that would impact the business valuation and ongoing relationship with the purchasing party. Moreover, Mr Ots was prepared to <u>**knowingly**</u> act in this clearest situation of a conflict of interest, where he was prepared to set tariffs for a company with whom he had engaged in a direct sale transaction less than five months previously and with whom he still had ongoing business links with the selling party.

4. <u>Mr Ots has engaged in "sharp" business practice which is in conflict with his role as a public official</u>

In addition to all of the above, there are significant ethical and regulatory questions that need to be asked of the business transactions undertaken by Mr Ots in Kunda from which he has profited significantly. The following is a chronology of the main transactions:

1) In 2002, when Mr Ots bought into KE, the Net Book Value(NBV) of the company's fixed assets was 1.2m EEK
2) In 2003, Mr Ots had the assets re-valued and a corresponding increase in asset value of 8.1m EEK giving a total NBV of fixed assets of 9.6m EEK by the end of 2003. The revaluation of the assets in question was 44 times the purchase cost of those assets, in effect the assets, after a number of years of use, were now worth 44 times more than they cost at the time they were purchased (see note 5 to the 2003 financial statements).<u>Note here that this 8.1m EEK is not "capital invested" by the company or any other entity.</u>

Does the Minister believe that this asset revaluation, that increased the value of the assets to many multiples of the original purchase price should be included in the value of capital invested?

3) In 2004 Mr Ots sold assets from his own company Wille Service (WS) to KE for 4m EEK (see the cash flow statement of WS and notes 5 and 11 to the accounts of KE). These assets had a value of only circa 1m EEK in the accounts of WS at the time, hence by selling the assets to himself in KE Mr Ots was able to realise a profit of 2,9m EEK for himself (see 2004 cash flow of WS for confirmation of profit). Why would KE want to buy assets at such an inflated price when, under Mr Ots' opinion of the law, it could only make a justified profit on 1m EEK and not the 4m EEK purchase price? Why does the Minister believe that the citizens of Kunda should have to pay a higher tariff to enable Mr Ots to earn a profit on sales of his own assets? Note, according to CA's and Mr Ots' public statements of the law as applied to ASTV only the net book value of the assets of 1m EEK should be included in the "justified profitability calculation.
4) In 2007, Mr Ots and his partners sold KE to Fortum Termest for 16.6m EEK at a profit of 4.2m EEK above the re-valued net book value of the fixed assets of KE (see note 12 to the accounts for the profit on the sale value). Why would FT buy the assets from KE at such a profit when, according to Mr Ots's opinion of the law FT could only make a profit on the net book value of the fixed assets used to provide the service? Furthermore, in this situation the actual not re-valued net book value of these assets would have been at the most 4m EEK, some 12m EEK less than the purchase consideration. Note that according to the CA's and Mr Ots' view of the law as applied to ASTV none of the 4.2m EEK profit from the sale of the fixed assets should be included in the justified profitability calculation.
    a. To demonstrate this point, in Appendix E we have included a simple calculation that estimates the real value of capital invested into the assets of KE until the sale of the assets in 2007. In this analysis we have taken a very prudent view, increasing asset values where we weren't certain of the values due to the inconsistent accounting in some years, have used a zero depreciation rate and have excluded any fixed asset sales. Here, even after making such prudent assumption you will see an estimated gross value of capital invested by Kunda Elamu of 5.5m EEK – note this excludes any depreciation on new assets, when taking a depreciation rate of 4% on new assets (itself a very prudent rate) then the NBV would be at the most some 4m EEK.

In summary, included in the selling price of 16.6m EEK were amounts of 8.1m EEK (asset revaluation), 2.9m EEK (profit on the sale of the assets from WS to KE), and 4.2m EEK (profits on the sale of the assets to Kunda). Even after allowing for any depreciation on these inflated asset values it can be seen that the residual value of these inflated asset values would have to be removed from the "capital invested" by the company for future justified profit and tariff calculations.

All of the above certainly constitutes "sharp" business practice, especially from a regulator and an individual who was already in charge of regulating similar undertakings in the district heating sector (as the Head of the Energy Market Inspectorate) and therefore should have been well aware of its irregularity.

However, to better understand the impact of these transactions and the conduct of Mr Ots as a regulator it is necessary to review the 2011 tariff determination made by the CA in Kunda:

1) On 21/10/2011 the CA made a tariff determination, signed and approved by Mr Ots. In this tariff determination sent to the residents of Kunda the CA has allowed the list of the fixed assets required to provide the service to be declared a business secret – see appendix G to this document for the "blacked out" fixed asset register. In addition, in the other tariff determination dated 26.10.2007 the CA has also "blacked out" all information related to fixed assets and the value of invested capital. We fail to understand how a regulator can declare the assets used to provide the service to be a business secret. It is a well know fact that the main reason a company is declared a natural monopoly is that the cost of constructing new the assets necessary to create a market is such a significant barrier to entry as to make competition impossible, hence the company can be said to be a natural monopoly. However in this situation the CA has declared the very assets used to provide the service to be a business secret.
2) On page two of its 21.10.2011 tariff determination the CA states "*to prevent unequal treatment the methodology is applied similarly and uniformly in course of analysis of operations and approval of tariffs of all heating companies*". Therefore, the CA was making this decision in the full knowledge of how it believed the law should be applied.
3) In its 21/10/11 tariff determination, from 2007 onwards the CA allowed Fortum (FT) to earn a justified profit on 16.9m EEK (1.08m Euros) of fixed assets (see tables 12 and 13), which corresponds almost exactly to the purchase price paid (16.6m EEK or 1.06m Euros) by FT for the assets from KE of which Mr Ots was one of the owners. In his professional capacity why would Mr Ots knowingly allow FT to earn a justified profit on an asset value that was many multiples higher than the value allowed under the methodology that he himself has stated has been in use since to 2002? Especially because in this case Mr Ots as the selling party who had profited from the sale of these assets and could therefore never plead ignorance of the facts of this transaction and the knowledge of the true value of the assets when making and signing the 2011 tariff determination.
4) In its 21/10/11tariff determination, the CA states "*(I)n Table 13, the total of fixed assets of 2007 according to the CA´s decision no 217-048-07S has been acquired with an amortized depreciation norm of 4,0% per year and not knowing the fixed assets structure and age, the amortization has been calculated also from non-amortized fixed assets (on land in value of 112,85 th €), and had appointed to the technically old equipment the depreciation norm of new fixed assets (e.g. boilers Witermo have been built in 1984 and 1981, but in the fixed assets list the acquisition year is reflected as 2007, i.e. when the networking area was acquired*".

   In effect, the CA and Mr Ots are claiming that they did not know the details of the fixed assets purchased in 2007, neither the date of purchase nor from whom these assets were purchased. Of course this cannot be correct as the assets acquired by FT were purchased from KE, of which Mr Ots was one of the main owners, and had made a previous tariff determination on the same company in Kunda in October 2007. In fact, had the CA wanted to understand this information a cursory glance at the 2006 and 2007 financial statements of KE would have informed the CA of the assets in question, their age, depreciation rates and residual value. Why would the CA claim to have no knowledge of these assets when Mr Ots as Head of the CA and the signatory to the 2011 tariff determination was also the one of the main shareholders who sold these assets to FT?

5) Related to the above point, the CA states "*according to the CA´s decision no 217-048-07S has been acquired with an amortized depreciation norm of 4,0% per year*". The CA then goes on to check the asset value using this depreciation norm as if it had no other available information with which to make a more professional calculation.
Of course, as detailed above, the CA and Mr Ots were well aware of the detail of the assets that were acquired and could easily have made an improved calculation. However this decision becomes more difficult to understand when one considers the transaction detailed in point 2 above. In note 5 to the KE accounts of 2003, when revaluing the assets the Regional Energy Centre recommended the re-valued assets to have a remaining useful asset life of 12 years[7]. However in its tariff determination of 21/10/11 the CA is applying a remaining useful asset life of 25 years starting from 2007 (4% depreciation rate equates to a 25 year asset life), in spite of the fact that the Head of the CA would have known all of the details of the assets purchased and re-valued including the useful life. Why would the Head of the CA ignore the recommended asset life issued during asset revaluation in 2003 and knowingly allow a longer asset life for the period 2007 to 2010? Here it should be pointed out that this extension of the asset life more than doubles the amount of "justified profit" permitted on these asset classes in the tariff calculation, whilst reducing the amount of investment deemed necessary to ensure the assets are maintained in a stable condition.

6) Also relating to depreciation, on pages 26 to 27 of the 2011 tariff determination, the CA further compounds this inconsistency by agreeing to allow a depreciation rate of 3.975% for 2011 and 2012, allowing an average asset life of over 25 years for assets that previously has much shorter asset lives. Why would the CA knowingly enable a higher ongoing "justified profit" to be earned by making a further adjustment to ongoing valuation of the fixed assets?

In summary from the above information one has to cast significant doubt on the conduct of Mr Ots as a regulator in Kunda for the following reasons:

1) The CA has been unwilling or unable to provide any evidence to support its opinion and declared the value of the assets on which the company could earn a "justified profit" to be a business secret.

2) In the case of Kunda the CA appears to have knowingly included in the tariff calculation the following, all of which should not be included under the CA's stated methodology that it insists has been uniformly applied in Estonia since 2002:

a. The 2.9m EEK profit made by WS on the sale of its assets to KE in 2003
b. The 8.1m EEK asset revaluation made by KE on its existing assets in 2003
c. The 4.2m EEK profit made by KE when selling its assets to Fortum in 2007

[7] See note 5 from 2003 accounts for this recommendation.

3) In the case of Kunda, the CA has knowingly allowed an ongoing higher "justified profit" by knowingly increasing the useful asset lives of assets he had previously had re-valued.

5. Conduct expected of a public official

Potentially, the actions of Mr Ots as the Head of the CA qualify as disciplinary misdemeanour(s) or even indecent acts for the following reasons.

Public officials are required under §59(1) the Public Services Act (PSA) to perform their duties *"/…/ in an accurate, timely and conscientious manner, expediently and without self-interest, pursuant to the public interest. /…/ A public servant shall also perform his or her duties pursuant to the public service code of ethics /…/.*"

First, regarding ASTV as a public servant Mr Ots has not fulfilled his duties set out in § 59(1) of the Public Service Act (PSA) in a "conscientious manner" nor "expediently" nor "pursuant to public interest". By rejecting ASTV's tariff application as submitted because of relying on a mere opinion based on no verifiable evidence regarding the uniform regulation principles applicable since 2002, the CA and Mr Ots who signed the decision rejecting ASTV's tariff application have not performed their duties in a conscientious manner.

Forcing ASTV and its shareholders to defend the international privatisation contract in Estonian courts and in front of the EU Commission also means that, as referenced above in §59(1) PSA, there is no "expedience" in CA's and Mr Ots' regulatory practice. Ignoring ASTV's repeated and evidenced statements that in the public interest the lowest tariff increases had been agreed at privatisation means that, as referenced above in §59(1) PSA, the CA and Mr Ots have not acted "pursuant to public interest" when reviewing ASTV's tariff application. Considering the above, Mr Ots as Head of the CA who signed the decision rejecting ASTV's tariff application has failed to perform his duties in a conscientious manner, expediently and pursuant to public interest. Such non-performance is a disciplinary misdemeanour according to PSA § 84 sec.1.

Secondly, should the evidence regarding Kunda confirm, once again that the allegations of Mr Ots as the Head of the CA regarding the uniform regulation principles applicable since 2002 turn out to be incorrect, then the sole possible conclusion is that the CA and Mr Ots as the Head of the CA have knowingly forced ASTV and its shareholders to defend its international privatisation agreement in court and knowingly mislead the Estonian courts as well as the EU Commission about the principles of economic regulation in Estonia

Thirdly, should the investigation into the Kunda circumstances prove that Mr Ots received personal gains as a result of his activities as a regulator in Kunda when acting in a conflict of interest situation, then regarding Kunda (and not just regarding ASTV), then Mr Ots has not fulfilled his duties neither "without self-interest" nor "pursuant to the public interest", and as such has breached §59(1) PSA and committed multiple breaches of § 84 sec. 1 PSA.

Finally, by knowingly, i.e. intentionally not fulfilling his duties, regarding ASTV as a public servant Mr Ots has also breached the Public Servants' Ethics Code. Submission of knowingly untrue data to Estonian courts and (via the Ministry) to the EU Commission regarding the regulation principles applied in Estonia is a wilful, i.e. intentional act, which not only constitutes unsatisfactory performance of duties of a public official, it is also contrary to sections 5[8] and 4[9] of the Public Servant's Ethics code.

Based on information available to ASTV and based on the very different regulation principles from those stated publicly by the CA and Mr Ots having been applied in Kunda, there is now grave doubts whether such a uniform and consistent regulatory practice has ever existed in Estonia, which was the very reason for the CA to force ASTV and its shareholders into courts. The more so that the CA's representatives have, in a compellation complaint case in the Tallinn Administrative court regarding Maardu's 2011 tariff determination which Mr Ots as the Head of the CA signed, have admitted to ASTV and to the Estonian courts that the CA does not apply any regulation principles in a uniform manner and this admission has been minuted at the court hearing (Appendix H). Casting doubt on the independence and objectivity of proceedings by the Head of CA and therefore also on the CA qualifies as an additional breach of section 13 of the Public Servants' Ethics code. Such wilful acts are not only constitute unsatisfactory performance of duties of a public official and thus breaches under §59(1) PSA, but as they are knowing and wilful breaches of ethics code they are also potentially indecent acts pursuant to § 84 sec. 3 PSA.

Considering all of the above information we are requesting for you to conduct a thorough and detailed disciplinary proceeding into the activities of Mr Ots as the Head of the CA.

Annexes:

A. 20.06.2000 Letter from Ministry of Finance to the City of Tallinn

B. Excerpt of ASTV's privatsiation's 03.07.2000 Information memorandum nr 3.

C. 29.08.2012 ASTV's letter to Tallinn District Court and the Supreme Court.

D. CA's 16.12.2011 letter to ASTV where CA has claimed that the COUNTRY risk premium is a business secret.

E. Excerpt of the 2007 Klingsor accounts

F. A calculation that estimates the real value of capital invested into the assets of KE until the sale of the assets in 2007.

[8] Public authority shall always be exercised pursuant to law.

[9] Public authority shall be exercised solely in the public interest.

G. The “blacked out” fixed asset register of KE.

H. Minutes of the 18.08.2012 Tallinn Administrative court hearing in ASTV’s compellation complaint against CA regarding Maardu’s 2011 tariff determination.