

AS TALLINNA VESI

*Annual report
for the financial year ended
31 December 2010
(Translation of the Estonian original)*

AS TALLINNA VESI

ANNUAL REPORT FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2010

(thousand EEK)

Beginning of the financial year	1 January 2010
End of the financial year	31 December 2010
Name of the Company	AS TALLINNA VESI
Legal form of the Company	Public limited company
Commercial register number	10257326
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Field of activity	Production, treatment and distribution of water; storm and wastewater disposal and treatment
Auditors	AS PricewaterhouseCoopers
Documents attached to the Annual Report	Independent auditor's report

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MANAGEMENT REPORT

CHAIRMAN'S STATEMENT

2010 has been an extremely challenging year for AS Tallinna Vesi. Our company, our performance, our financial results and our business model have all been criticised by various politicians, political groups and state institutions. All of these criticisms have been made without any prior discussion with our company, or without making any attempt to understand our services agreement or our financial model. In addition we have been faced with some of the most extreme weather conditions, in both winter and summer, seen in Estonia in decades, which has contributed to the most difficult operating conditions we have faced.

Therefore it gives me great pleasure to say that our operating performance across most business areas has continued to improve. This improvement is a testimony to the attitude and commitment of our staff who have worked tirelessly to provide a better service for our clients in spite of the adverse weather conditions and the difficult political environment. For this, on behalf of the Board and owners of the company, I would like to say thank you.

It is also very pleasing to see that our efforts have been recognised externally. At the NASDAQ OMX Baltic Stock Exchange awards for 2010 we once again won the award for the company with the best Investor Relations in Estonia. In addition the Ministry of Environment presented the Company with the "Environmental Player of the Year Award" for our operational performance and our customer awareness campaigns during the year. These awards are clear demonstrations of the company's commitment to improving environmental awareness and of course transparent reporting and high quality corporate governance, both of which are pre-requisites for any responsible utility company.

Operations & Customer Service – best ever water quality at western European levels

We have continued to ensure we meet or exceed the services contract we have with the City of Tallinn. This services contract requires us to maintain a high standard of service to our customers across a range of over 90 levels of service, ensuring that we deliver a service to our customers that is second to none.

We invested almost 275 mln kroons in 2010, in our networks, treatment plants and catchment area to help deliver an improved service for the people of Tallinn. In 2010, the highlight of our operational performance was the quality of tap water with drinking water quality compliance at the customer's tap improving to almost 99.6%, which is well above the EU standard and close to the highest standards in Western Europe.

Network access for everyone

In November 2007 we agreed a partnership with the City of Tallinn to finance and deliver over 3,500 new sewerage connections by the end of 2010 and to finalise the construction program fully by end of 2012. We are pleased to report that all the connections promised by the end of 2010 were delivered and this important environmental programme was completed on time. As a result of the efforts of our teams and our contract partners we have constructed 170 km of water, wastewater and storm water networks and 3,779 connection points in the past three years. These constructions bring

significant environmental benefits and cost savings to all the households that have been given the opportunity to connect. Furthermore, fulfilling this programme on time enables the City of Tallinn to fulfil its EU obligation regarding network accessibility. We are rightly proud of our contribution in this extremely important project.

Customers recognise our quality

I was delighted to see that our customer satisfaction rating improved in 2010. After a disappointing fall in 2009 our performance rating in 2010 for domestic customers increased to 78 points on the TRIM Index, an increase of 11% year on year and brings our customer satisfaction back to 2007 levels. It is extremely positive that, in spite of the negative media comment about the company our customers recognise the quality of our products and services. We fully understand the responsibility we have before our customers and are determined to provide an even better service.

Our People and teams

In 2010 the commitment of our workers was exemplary. The severest of winters and the dries of summers placed additional stresses on our teams and our resources. However it comes as no surprise for me to say that our people rose to these challenges and once again delivered an excellent service that is without comparison across the Baltic's. During the year we made some structural changes in our customer facing departments in order to make our working processes and internal communications even more customer focussed. We expect our customers to see the full benefits of these changes in 2011.

In AS Tallinna Vesi we strive to develop our talented members of staff. In 2010 we saw a number of our talented young people rise into management positions. This is something I very much welcome and hope that giving opportunities for personal and professional development will make the company an attractive employer for the brightest and the best.

Stable Revenues, returns in accordance with other privatised utilities

Our financial performance continues to be robust. Our turnover from our main business activity, sales of water and wastewater decreased by 0.1% to 706.7 mln kroons (45.2 mln Euros) and our operating profit from these activities increased by 10.1% to 377.9 mln kroons (24.2 mln Euros). The real return (net of inflation) on invested capital in our main business was 5.5% in 2010 and 6.3% over the five year period from 2006 to 2010, which is in accordance with the rates of return made by other privatised water utilities.

Uncertain growth potential

Our excellent operational performance leaves us well placed to expand our service offering across the Baltic's. We already provide a very high quality service and we should be able to utilize this operational strength to increase revenues from activities outside of the City of Tallinn whilst bringing a better quality service to other municipalities at a lower cost. In 2010 we created our subsidiary Watercom to offer our world class services across the country. Unfortunately the new regulatory regime implemented in late 2010 lacks clarity and may mean that our growth opportunities within Estonia are limited. We will however continue to work with the various ministries and regulatory authorities to demonstrate the benefits that outsourcing in the water sector can bring for both customers and the environment.

Change of law and new regulator

It is impossible to review 2010 performance without commenting on the potential impact on the company of the changes in the way the water sector will be regulated from 2011 onwards.

In August 2010 the Act on Establishing Price Limits on Monopolies was passed by Parliament, which gave the power to set tariffs to the Estonian Competition Authority. On 10 November the Competition Authority also published their recommended methodology which they will use as the basis to regulate prices in the water industry.

This act and methodology fundamentally changed the contract that we have with the City of Tallinn. In previous years our tariffs were approved by the City of Tallinn in accordance with the tariff mechanism agreed on privatisation, and the 'K' factors agreed when the contract was amended in 2007. This was a simple and effective tariff mechanism that gave little room for dispute and, as 'K' factors were agreed until 2020, gave excellent transparency to all stakeholders.

From 1 November 2011 we have had to apply to the Competition Authority for our tariff increase due from 1 January 2011. In order to ensure our application was as professional as possible we worked with Oxera, the UK economic consulting group, to analyse our current contract and ensure that the returns made by the company were in accordance with those made by other privatised utilities. This analysis proved that this was correct and that our real rates of return were not excessive. Therefore, as per the terms and conditions of our contract, on 9 November 2010 we applied to the Competition Authority for a 3.5% tariff increase from 1 January 2011. To date however the Competition Authority has not processed our tariff application or taken the opportunity to engage in meaningful discussion on the merits of the application. Therefore, at present our tariffs remain frozen at 2010 levels.

Uncertain outlook and a request to respect the contract

The change in regulatory environment leaves the company in a very uncertain position. At present we have no clarity of revenues, do not know the policies and levels of risk we may have to take when purchasing supplies which are absolutely necessary but where the prices are extremely difficult to predict, such as energy and chemicals, and are unsure of the quality standards we must achieve on behalf of our customers, nor the investments we need to make to protect our services and the environment. In summary we are currently unable to fully manage our business and will be unable to do so until the authorities engage in meaningful discussion about our current contract. However I would like all our stakeholders to know that we are doing everything in our power to ensure this contract is fully respected as we believe it has brought and will continue to bring significant benefits to the citizens of Tallinn. In this uncertain interim period we are 100% committed to bringing the same high level of service to all our direct customers and service users.

Finally, I would like to thank my colleagues in Tallinna Vesi and Watercom, and all our suppliers and business partners for all their energy, commitment, and support in serving our customers in this challenging and uncertain year. It is because of all your efforts that we are once again able to report a level of operating and service performance that is second to none.

RESULTS OF OPERATIONS - FOR THE YEAR 2010

Main economic indicators

million kroons	2010	2009	2008	2007	2006
Sales	777,3	772,4	719,9	648,3	589,2
Gross profit	453,7	488,4	447,2	431,7	368,6
Gross profit margin %	58,4	63,2	62,1	66,6	62,6
Operating profit	429,7	461,9	405,4	377,4	337,9
Operating profit - main business	377,9	420,6	377,4	363,1	331,0
Operating profit margin %	55,3	59,8	56,3	58,2	48,7
Profit before taxes	389,6	401,1	362,2	333,1	294,9
Profit before taxes margin %	50,1	51,9	50,3	51,4	42,5
Net profit	256,7	339,9	296,0	277,8	248,0
Net profit margin %	33,0	44,0	41,1	42,9	42,1
ROA %	8,9	12,3	11,6	10,9	10,0
Debt to total capital employed	60,1	49,7	49,9	51,8	53,4
ROE%	22,4	24,4	23,1	22,5	21,5
Current ratio	2,1	4,2	1,8	1,9	2,2
Number of employees	319	336	327	312	318
Share capital	200	200	200	200	200

Gross profit margin – Gross profit / Net sales

Operating profit margin – Operating profit / Net sales

Profit before taxes margin – Profit before taxes / Net sales

Net profit margin – Net profit / Net sales

ROA – Net profit / Total assets

Debt to Total capital employed – Total liabilities / Total capital employed

ROE – Net profit / Shareholders' equity

Current ratio – Current assets / Current liabilities

Profit and loss statement*Sales*

In 2010 the Group's total sales increased, year on year, by 0.6% to 777.3 mln EEK. Included within this is a contribution of 24.7 mln EEK from Maardu, a contract which commenced only in the 3rd quarter of 2009. Sales in the main operating activity principally comprise of sales of water and treatment of wastewater to domestic and commercial customers within and outside of the service area, and fees received from the City of Tallinn for operating and maintaining the storm water system. There is no considerable seasonality in the Group's operation.

Sales of water and wastewater services were 706.7 mln EEK, a 0.1% decrease compared to 2009, resulting from the 0.9% decrease in tariffs from 1st January 2010 for the Group's residential and commercial customers combined with the factors described below.

Within the service area, sales to residential customers decreased by 1.8% to 372.3 mln EEK. Sales to commercial customers decreased by 2.1% to 267.7 mln EEK. Sales to customers outside of the service area increased by 33.6% to 53.4 mln EEK, which includes the Maardu operating contract that commenced from 1st July 2009. Over pollution fees received were 13.3 mln EEK, a 10.1% decrease compared to 2009.

In 2010, the volumes sold to residential customers dropped 0.9%, year on year. Still the decrease in volumes sold has lowered during the course of the year.

The volumes sold to commercial customers inside the service area decreased by 1.2% compared to the respective period in 2009. Total sales volumes to the industrial sector decreased due to leave of one key customer from the Group's service area. Despite the fall in respective consumption some increase can be noticed in the industrial sector as a whole. Better economic conditions are contributing also to leisure sector volumes starting to pick up.

Excluding Maardu volumes, then outside service area volumes were 9.8% higher than in 2009, compared to 21.5% increase with Maardu volumes. The main factor in this increase was higher storm water volumes during the first two quarters of 2010 compared to 2009.

Compared to last year, sales from operation and maintenance of storm water and fire-hydrants systems increased by 8.8% to 54.4 mln EEK in 2010. This increase is driven by the terms and conditions of the contract whereby the storm water and fire hydrant costs are invoiced based on actual costs and volumes treated.

Cost of goods sold and gross margin

The cost of goods sold for the main operating activity was 323.6 mln EEK in 2010, an increase of 39.6 mln EEK or 13.9% from the equivalent period in 2009, of which Maardu added 18.9 mln EEK compared to 10.9 mln EEK in 2009.

In 2010 the Group achieved the beneficial 0.5 coefficient for pollution tax only in 1st quarter whereby in 2009 the Group had received the beneficial 0.5 coefficient in quarters 1, 3 and 4. Due to the combination of high nitrogen concentration, low wastewater volumes and low temperature during the second half of 2010 the amount of pollution tax payable was 35.8 mln EEK compared to 16.9 mln EEK in 2009. In addition to the coefficient used compared to 2009, the higher pollution tax payable in 2010 is generated by the increase in tax rates year on year by 19%. The results of the nitrogen treatment are highly dependant on temperature, concentration and volume of incoming sewage. To mitigate the nitrogen treatment and tax risk the Group has started with the investments into an additional stage of wastewater treatment and according to the construction schedule the works should be completed in the beginning of the 3rd quarter of 2011.

Chemical costs were 22.4 mln EEK, representing an 11.7% increase compared to 2009. Although lower volumes were treated the main contributor to higher chemical costs was dosed methanol and other chemicals quantities related to the need to treat the increased pollution concentration in incoming sewerage. Also the increase in prices added some unfavorable impact to the cost of chemicals.

Electricity costs increased by 8.9 mln EEK or 26.6% in 2010 compared to 2009 due to higher electricity prices as a result of three sites buying electricity from the open market having an extra 0.8 mln EEK adverse impact from the extra half-year implementation of the Maardu's contract.