The WindAcre Partnership

2200 Post Oak Boulevard
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1 September 2017

Re: Public Consultation 01/2017 (SABESP)

ARSESP
Avenida Paulista, 2313
CEP 01311-300
Sao Paulo-SP

To: ARSESP

We appreciate ARSESP's desire for transparency and to have an open process. We are writing to you as one of the largest minority shareholders of Sabesp. We have been a long-term shareholder, and are very familiar with regulated utilities in Brazil. In addition to our current investment in Sabesp, over the past 12 years I have been responsible for over US$1 billion of investments in Brazilian utilities, including in Cemig, CESP, Transmissao Paulista, and AES Tiete.

We believe the rate reset process is the single most important event for a regulated utility. It sets the return and asset base, and many of the conditions that will determine whether the company will actually achieve that return or not. This is why we are writing to you now.

Based on ARSESP's Preliminary Technical Note, we are very concerned that several matters are not being appropriately addressed or calculated, and if they are not remedied Sabesp will have no chance to earn its fair return on its fair capital base. This is damaging not only to its shareholders, but also more broadly as investors will become increasingly reluctant to invest more capital in this sector. After all, why would investors choose to invest fresh capital if the odds to achieve a fair return are low, or zero? That path is one we all seek to avoid, but we fear it might be the path we are on.

We understand that in any process this complex there will be differences in calculations and perspectives, and ARSESP must balance various objectives, including protection of water and sanitation consumers. But as we detail below, the risks posed to Sabesp from this rate reset are extraordinary in size. By our estimate these matters accumulate to <u>*over R$2 billion per year in lost net income*</u> from Sabesp. These are profits the company needs to earn so it can achieve economic equilibrium (i.e. earn its cost of capital). Economic equilibrium is required for the sustainable development of Sabesp's water and sanitation services, which is also an ARSESP objective. While ARSESP's aim, rightfully, is to be extremely technical, in the end we would argue what is most important is to be "right". A technical and analytical approach certainly increases the chances of being right, but it doesn't guarantee it. We believe it is critical for any regulator to occasionally step back from the process and question whether the results of the process are truly fair. We believe Sabesp is particularly deserving of this because of its successful navigation through the extreme drought years. Sabesp avoided rationing and it did so largely at the expense of its shareholders (as it effectively paid consumers to reduce their consumption). Given this backdrop, we think it is reasonable that all efforts be made to treat the company fairly in this rate review, and in matters that are subjective and where there is simply no definitely right answer, Sabesp be afforded more benefit of doubt. To be clear, we are not asking for anything over and above allowing Sabesp to earn its fair return on its fair capital base. We are not seeking to be compensated for risks we as shareholders rightfully bear. But investing in a regulated utility comes with certain protections, and we are asking that those protections be wholly fulfilled.

Following are the matters we are most concerned about based on ARSESP's Preliminary Technical Note:

1. **Tariff increase**. We note ARSESP has indicated a preliminary P0 of R$3.63 and noted this is a 4.4% tariff increase off of a base tariff of R$3.47. However, Sabesp does not actually achieve a tariff of R$3.47. In fact, over the past 4 quarters the average tariff has been R$3.20, and in the most recent quarter it was even lower, R$3.16. ARSESP has not provided the basis for its R$3.47 figure, but if we start with the 2012 P0 and apply the tariff adjustments since 2012, we arrive to R$3.47; we assume this was ARSESP's methodology. This methodology however does not reflect the reality of Sabesp's situation today. Because Sabesp does not charge a strict price per cubic meter and instead charges by buckets of consumption, and because consumption patterns have changed meaningfully since 2012, a large difference has emerged between the actual tariff Sabesp achieves today and the tariff it would have achieved based on the 2012 P0 and 2012 consumption pattern. It is exactly because changes like this occur and need to be reflected in the tariffs that the periodic rate review process is necessary. Quite simply, reality changes and the tariffs need to reflect that. Of course if consumption reverts back to the 2012 pattern, ARSESP can and should incorporate that in the 2021 rate reset. But given the drought conditions have passed, and the "bonus pricing" has ceased, the best assumption we can have for the consumption pattern over the next four years is the consumption pattern we see today, and that consumption pattern causes Sabesp to actually achieve an average tariff of only R$3.20. Therefore even to achieve only the preliminary P0 of R$3.63 that ARSESP has preliminarily noted, the tariff increase needs to be 13.4%. *The estimated damage to Sabesp from not incorporating Sabesp's actual base tariff in the tariff increase percentage is a loss of revenue of over R$900 million per year.*

   Putting the details of calculations aside, fundamentally Sabesp should be allowed to earn the revenue that is required to achieve its mandated return. Any discrepancies between how ARSESP and Sabesp calculate volumes or tariffs should not interfere with Sabesp's ability to achieve this required revenue. In other words, whether by one calculation Sabesp is currently charging a tariff of R$3.47 and by another calculation it is charging a tariff of R$3.20, does not change the fact that even per ARSESP's initial note Sabesp should generate a Direct Regulatory Revenue in 2017 of R$13.1 billion to earn its return; thus Sabesp should be allowed to charge the tariff required to achieve this revenue based on the regulated volume scenario. We believe the most logical regulatory framework would therefore be for ARSESP to empower Sabesp to earn its allowed regulatory revenue, and charge the tariff necessary to do so based on the agreed volume scenario, and not prescribe a % tariff increase where discrepancies in the *calculation of the base tariff interfere with the appropriate result. Regulated revenue is the key objective, the % increase in tariffs is only a calculation to achieve that goal, but it shouldn't supersede the goal (or in this case make the goal unachievable).*

2. **R$6bn disputed RAB from 1st rate review**. We are not in a position to discuss the technical merits of Sabesp's argument to include this in the RAB. And we do understand that ARSESP must protect consumers from paying unfairly high tariffs, as would be the case if Sabesp wasted money on assets that were not required (and thus tried to artificially inflate its RAB). From the perspective of a shareholder, we can say minority shareholders of Sabesp have no interest in Sabesp spending money just to increase its RAB. At best the regulated return would be fair and anytime a company spends money and earns just a fair return, it does not add value to the company. Add to this the risk the assets purchased will not be added to the RAB, or that the regulated WACC may be below the true cost of capital, and the economic incentive to spend capital to grow the RAB diminishes even further. We also do not see why the controlling shareholder would have an interest in Sabesp wasting its money on un-needed assets, particularly when there is so much needed investment in the sector. So we question – who is it that had the incentive to spend R$6bn on assets that are not needed? In doing this we are asking ARSESP to question whether its criteria in allowing this disputed amount into the RAB is overly strict. If the company spent the money with the proper intention, it should be compensated. If ARSESP believes the company knowingly and willingly wasted this money, those within the company who did so (and who oversaw) should be prosecuted. But it seems an unfair balance to ask the shareholders to pay R$6bn for assets and then not allow them to earn a return on those assets because of technical matters, which is our understanding of the issue today. This is particularly harsh treatment of minority shareholders, who have no control in this case to implement investment discipline. Again, we cannot opine on the technical details of this matter, but we ask ARSESP to consider – if the money was actually spent, and was spent on a reasonable basis and without intent to inflate the RAB in a malicious way, shouldn't those assets be compensated? The amount in dispute, brought forward to today by inflation, is around R$8 billion; this is an enormous amount for shareholders to bear on the basis of technicalities, and in light of a regulator's duty to balance the economic needs of the business with the protection of the customers. *The estimated damage to Sabesp from not including this R$8 billion in RAB is a loss of net income of over R$600 million per year.*

3. **7.5% Sao Paulo Infrastructure Fund Fee.** Sabesp cannot achieve its required return unless this fee is passed through to consumers in some form, or Sabesp stops paying the fee. We understand there are many parties in this dispute, but as an impartial regulator we ask ARSESP to use its authority to facilitate the right economic outcome on this matter. This has already cost the Sabesp shareholders nearly R$3 billion, and will continue to cost them c. R$500m per year. Frankly, it makes no economic sense for Sabesp to agree or service a concession in which it has no chance to earn a fair economic return, especially when it owns the underlying assets. Yet this is the situation Sabesp faces today, and has for 6 years now. Far greater things have been accomplished in far less time than resolving this issue. *The*

estimated damage to Sabesp from not passing this fee through to customers is a loss of net income of over R$350 million per year.

4. **WACC.** Sabesp's nominal cost of equity simply is not 12.5%; we know of no investor who has or would invest in Sabesp to earn a 12.5% nominal return. We, for example, use a 16% equity discount rate in our valuation of Sabesp. A 12.5% equity return is insufficient versus the long-term equity return of circa 10% we believe is achievable in the U.S. (this is the actual total return the U.S. equity market has provided over multi-decade periods, mid-cycle to mid-cycle). The 2.5% premium above this 10% return does not adequately compensate for the risks of Brazil vs the U.S., and the risks inherent in owning a business that is government owned and where the regulatory process itself is a source of significant risk, as we highlight in this letter. U.S. sanitation peers, for example, do not provide services to municipalities that haven't paid them for years, they pass through all the fees and costs they should pass through, they wouldn't pay customers to reduce demand, and they aren't subject to regulatory risks on the scale we see now in Sabesp. We understand that maintaining a private sector WACC provides an incentive for Sabesp to operate like a private sector enterprise, and this incentive is valuable and needed. But this incentive also needs to be balanced with what investors will consider realistically achievable, because investors will not invest based on assumptions that are unachievable or a scenario that is unrealistic. Assuming Sabesp will operate like a private sector U.S. sanitation business throughout this next rate cycle is unrealistic (although we hope it will be true some day). Instead we would suggest observing what the market is truly communicating at its cost of equity specifically for Sabesp. Over US$40 billion of Sabesp stock has been bought and sold since the last rate reset, at an average P/E (price-to-earnings ratio) of around 9x (excluding the drought period where the P/E was artificially inflated due to the depressed earnings). This is equivalent to an 11% earnings yield (E/P). This is effectively the *real* return equity investors were seeking, because if Sabesp were to dividend 100% of net income it would not be able to grow its RAB, so its earnings growth would come only from inflation adjustment over time. So Sabesp's observed real cost of equity seems to have been around 11% and therefore its nominal cost of equity would be around 16%, assuming 5% normalized inflation. This is also consistent with our own estimate of cost of equity, as mentioned above. While simpler than ARSESP's technical methodology, we believe this figure is a more representative estimate of Sabesp's cost of equity, and it has the advantage of being observed from Sabesp's investors directly versus via a comparison to companies that are meaningfully different from Sabesp (in country, business mix, regulation, ownership, corporate governance). Again, over US$40bn has spoken on exactly the question ARSESP is trying to answer, and it is providing a very different answer. We believe this calls into question the assumptions in ARSESP's cost of equity calculation. *The estimated damage to Sabesp from not reflecting a 16% cost of equity is a loss of net income of over R$500 million per year.*

5. **Operating costs.** It seems to us that ARSESP is using the 2016 operating expense base as appropriate for 2017 and onwards. We believe this makes sense in principal, but we are concerned that some of the cost cuts that Sabesp implemented during the drought years are

not permanent. Our understanding is Sabesp was very aggressive about cutting costs to protect its financial position, which was appropriate given the circumstances. We share ARSESP's objective of having Sabesp be as efficient an operator as possible, but we also know from experience that many cost savings that are achieved in times of severe stress are not sustainable. We are not in a position to provide an opinion on how much of the cost savings are permanent versus temporary, but we simply ask that ARSESP take this distinction into account when it is evaluating the appropriate cost base for Sabesp going forward.

We would note that it is totally inconsistent to use the actual 2016 cost base in this rate reset process, but not use the actual 2016 consumption patterns (and thus the actual 2016 achieved tariff). It is not logical to mix and match years in this way. If 2016 is the appropriate base for the 2017-2021 operating costs, why wouldn't it also be the appropriate year for the base tariff and consumption pattern? If there are items within the 2016 base that can be identified as extraordinary or unsustainable, of course it is reasonable to make those adjustments (whether in costs or revenues/tariffs), but we struggle to see how 2012 provides a better base on any of these matters than 2016.

6. **Drought extraordinary tariff fulfilment**. In 2015 ARSESP granted Sabesp an extraordinary tariff of 15% but that was short of the 22% that Sabesp requested. Our understanding at the time was ARSESP would evaluate the actual volumes in the 2015-2017 years, and then make the appropriate adjustment in the 2017 rate review. The actual volumes were meaningfully below those ARSESP assumed in the 15% extraordinary tariff, and thus we request ARSESP allow Sabesp to now make up this shortfall in revenue in the 2017-2021 rate review period.

7. **Compensation for delay.** The delay in implementing the rate reset has a real economic cost to Sabesp and its shareholders. Sabesp should be compensated for this delay, so that there will be no net-present-value (NPV) loss from the difference between when the tariff increases are actually implemented, and the scenario where the tariff increases were implemented on time in April 2017.

We appreciate ARSESP's time in reading this letter, and in allowing parties to submit their views into the rate reset process. We hope our thoughts are clear, and that ARSESP agrees that these matters must be resolved in a way that will allow Sabesp to earn its fair return on its fair asset base. We are always available to discuss these matters further.

Sincerely,

Snehal Amin
Managing Partner, The WindAcre Partnership