For the first Contract Year W_d=50%, W_{fo}=50% and W_{fd}=0%;

For the subsequent Contract Years;

W_d = D/(D+FO+FD)
W_{fo} = FO/(D+FO+FD)
W_{fd} = 1-W_d - W_{fo}

D = Operating expenditure related to goods and services, less any non-cash items, that are incurred in EEK (excluding expenditures incurred in EEK but priced in foreign currency), plus interest paid on EEK floating-rate debt, as shown in the audited financial statements for the Contract Year prior to year y;

FO = Operating expenditure related goods and services less any non-cash items as shown in the audited financial statements for the previous Contract Year, that are incurred in foreign currency, or incurred in EEK but priced in foreign currency, for the Contract Year prior to year y;

FD = Principal and interest paid on foreign debt and foreign subordinated debt during the Contract Year prior to year y;

A.4.2 Reasonable Costs

Reasonable costs, as will be proposed by the Company and approved by the MMU/Regulator, will include the items defined under "Reasonable Costs" in Section 9.4.3, above.

A.4.3 Justifiable Profit

Comparison will be made with Estonian companies in business areas such as waste disposal, electricity production, and other utility type businesses. The minimum return to the Company will always be in line with these proxies.

The Regulator/MMU/City shall select five international proxy companies to determine a likely Justified Profitability, adjusted for Estonian conditions. The calculation will be made by the Company in its tariff adjustment submission. In terms of the most recent financial year (1999 – 2000) this would be calculated as follows:

Proxy Company	Profit (Return on Equity, nominal)
United Utilities (UK)	19.9%
Thames Water (UK)	16.4%
Vivendi (France)	18.3%

Lyonnaise des Eaux (France)	16.2%
RWE (Germany)	24.8%

The average year-on-year return on equity is therefore 19.2% for a utility in a AAA rated Western European country. The rating for the country environment can be adjusted (from AAA to BBB+, which is the Estonian credit rating), using 10 year German Bunds as a benchmark (UK bonds are a –0.18% spread, French bonds are +0.14% spread), so relative to one another, the German Bund will be a proxy for the mix of UK, French and German companies.

As a proxy for Estonian 10 year debt, we have used Poland (BBB), Slovenia (A), and Hungary (BBB+), which respectively have a spread over US treasuries of +0.28, +0.29, and +0.42. In practice ideal proxies would be at BBB+, the same rating as Estonia. Therefore it is reasonable to take an average of +0.33 against US Treasuries. US Treasuries have a premium of +0.60 against Bunds, therefore an all-in debt spread for Estonia is taken as +0.93%. Other political risk factors may be taken into account in the setting of the country premium, particularly as Estonia is not presently an active issuer in the international debt markets.

In addition a spread to sovereign risk should be included to compensate for the added risk to equity capital. Using the spread of US utilities to the US Treasury (from the Financial Times, World Bond Prices index) provides a spread of +0.93% (AA- range), +2.40% (A+ range) and +1.84% (A- range), i.e. an average of 1.72%. Assuming this spread is a sufficient proxy for our purposes, the Justified Profitability for the year would be:

19.2% (+ 0.93% + 1.72%) = 21.85%

The proxies will be chosen by the Company taking into account the fact that they must be public companies who have a substantial part of their business in public utilities, and that they should have been involved in that business as a publicly listed company for at least 10 years. The proxy companies will have a suitable risk profile in comparison with the Company, and the initial proxy universe shall consist of suitable companies in the United States of America, United Kingdom, France, and Germany. The parties can agree on the inclusion of other suitable companies as they consider necessary.