

Dŵr Cymru Cyfyngedig

Regulatory accounts
for the year ended 31 March 2010

Registered office:
Pentwyn Road
Nelson
Treharris
Mid Glamorgan
CF46 6LY

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Directors and advisors

Directors

| | |
|-----------------------|--|
| Lord Burns | Chairman |
| Nigel Annett | Managing Director |
| Chris Jones | Finance Director |
| Peter Perry | Operations Director |
| John Bryant | Non-executive Director |
| Geraint Talfan Davies | Non-executive Director |
| Dame Deidre Hine | Non-executive Director |
| Tony Hobson | Non-executive Director |
| James Strachan | Non-executive Director |
| Bob Ayling | Non-executive Director |
| Stephen Palmer | Non-executive Director (appointed 26 October 2009) |

Company Secretary

Richard Curtis

Auditors

PricewaterhouseCoopers LLP
Cardiff

Solicitors

Linklaters LLP
London

Geldards LLP
Cardiff

Principal bankers

National Westminster Bank plc
Brecon

Directors' report

Introduction

Dŵr Cymru Cyfyngedig ('Welsh Water') is the company appointed by the Secretary of State for Wales as a water and sewerage undertaker under the Water Industry Act 1991 and is required to comply with the conditions set out in the Instrument of Appointment (the 'Licence') issued thereunder.

The regulatory accounts are separate from the statutory financial statements of the company, which are prepared under International Financial Reporting Standards (IFRS). There are differences between IFRS and the basis of preparation of information provided in the regulatory accounts because the Regulatory Accounting Guidelines specify alternative treatment or disclosure in certain respects. Where the Regulatory Accounting Guidelines do not specifically address an accounting issue, they require adherence to United Kingdom Generally Accepted Accounting Practice (UK GAAP). Financial information other than that prepared wholly on the basis of UK GAAP may not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 2006.

Appointed business

Welsh Water carried out both appointed and non-appointed business during the year ended 31 March 2010. The appointed business, as defined in condition A of the Licence, comprises those activities necessary in order for the Appointee to fulfil the functions and duties of a water and sewerage undertaker in accordance with the Water Industry Act 1991. The non-appointed business comprises those functions and activities which are not regulated under the Licence. In respect of the year ended 31 March 2010, non-appointed business comprised the sale of non-appointed services to third parties including rechargeable works.

Financial results and 'customer dividend'

Historical cost profit before tax for the financial year ended 31 March 2010 was £124.2 million (2009: £62.2 million). In 2009-10, customers benefited from a 'customer dividend' of £28 million, or £22 per household served (£11 for water and £11 for wastewater services), by way of a reduction in bills from the level allowed by Ofwat's price control.

Under Ofwat's Final Determination for Welsh Water for the five-year regulatory period ending 31 March 2015 (the Final Determination) the average bill for water and sewerage customers will reduce over this period by £30 (before inflation). Following this, the Board concluded that application of the 'customer dividend' policy would not be necessary, or appropriate, in the first year of the new regulatory period.

Following publication of the Final Determination Welsh Water has finalised its investment plans and priorities for the regulatory period 2010 to 2015. At £1.2 billion the level of capital expenditure is similar to that for the period 2005 to 2010, and the programme includes important investment to enhance the protection of drinking water quality, mitigate the worst impacts of sewer flooding, substantially reduce the carbon footprint of its activities and improve customer service.

Dividends

During the year, the company has not paid an ordinary dividend.

Directors

The Directors are listed on page 1. With the exception of Stephen Palmer who was appointed on 26 October 2009, all Directors served throughout the financial year. No Director has, or has had, a material personal interest, directly or indirectly, in any contract significant to the company's business.

On 8 March 2010 it was announced that Bob Ayling had been appointed Chairman Designate and that Lord Burns would stand down as Chairman of the Board at the 2010 Annual General Meeting ('2010 AGM'). Subsequently, it was announced on 10 June 2010 that Deirdre Hine would also stand down as a Director at the 2010 AGM.

At this year's AGM the following directors will stand for re-election under the Company's Articles of Association: Stephen Palmer (who would seek re-election under Article 44 at the first AGM since his appointment) and Nigel Annett and Chris Jones (who would retire by rotation under Article 46). In addition, John Bryant, Geraint Talfan Davies and Tony Hobson, who have served on the Board for more than nine years, would also stand down and seek re-election at the 2010 AGM in line with corporate governance best practice for such non executive directors to seek re-election annually.

Directors' report cont'd

Employees

At 31 March 2010 Welsh Water employed 205 people (2009: 192). Other than the Directors of the Company, Glas Cymru has no employees.

On 9 February 2010, Welsh Water announced a major restructuring of the business. On 1 April 2010 and 1 May 2010 1,093 and 476 employees transferred to Welsh Water under the Transfer of Undertakings (Protection of Employment) Regulations 2006 ('TUPE') - these employees having been previously employed by United Utilities Operating Services Limited and Kelda Water Services Wales Limited, respectively. At the date of this Directors' Report, the number of Welsh Water employees is 1,784. Over the next five years there will be a phased reduction of around 300 in the number of employees, which it is intended will be achieved by a combination of retirement, natural turnover and selective voluntary severance.

Welsh Water remains committed to 'Working Together', the framework agreement established with trade unions and staff representatives that has successfully operated since the early 1990s, and to continuing to invest at all levels in the highly committed and motivated work force which is crucial to achieving Glas Cymru's sole purpose. We are also committed to equality of opportunity and aim to treat all employees (including disabled persons) fairly in every aspect of employment, including recruitment, training, career development and promotion. Those who seek employment with Welsh Water are considered solely on their skills and abilities.

In 2009-10, Welsh Water's employee pay and benefits package compared favourably with the local employment market and all staff shared in the success of the business via a staff incentive scheme, which pays an annual bonus linked to the relative financial and customer service performance of Welsh Water. These arrangements are being reviewed currently following the reorganisation of Welsh Water.

Under 'Working Together' Welsh Water employees receive an inflation linked general pay award. In April 2009 this led to an increase of 3% and in April 2010 to a further 0.3%. The Welsh Water defined benefits pension scheme was closed to new entrants on 31 December 2005 and last year employee contribution rates were increased from 6% to 9%. This - coupled with a cash injection by Welsh Water and an increase in employer contributions over a number of years (from an original 12% to 20% last year) - is projected to address the deficit in the pension fund within a reasonable period of time. New employees are invited to join a defined contribution pension scheme to which staff contribute 6% and Welsh Water 11%.

Health and safety

The Board is committed to achieving high standards of occupational health and safety - nothing is more important than the health and safety of the people who work for us, and those we affect through our work.

During 2009-10, the company's process of health and safety management, which also covers Welsh Water's principal contractors, retained certification to the OHSAS 18001: 2007 - the international standard for occupational health and safety management. Our health and safety performance in 2009-10, which disappointingly saw a rise in the number of reportable accidents - for the first time under Glas Cymru's ownership - and our plans to improve on this level of performance are described in our 2010 Health and Safety Report. A copy of this report is available on request or on our website.

Water quality and the environment

The Quality and Environment Committee of the Board (QEC) meets each month to monitor the water quality, customer service and environmental performance of Welsh Water. QEC tracks the development of key operational strategies, as we aim to develop a more sustainable water and wastewater business based on developing best practice and knowledge. QEC also reviews the cause of and Welsh Water's response to all major water quality and environmental incidents. A copy of the 2010 QEC Report is available on our website.

In 'Welsh Water: Our Sustainable Future' we have set out our ambition for the business for the next 25 years. A copy of this report is available on the company's website or on request.

Research and development

Welsh Water monitors and selectively participates in water industry research initiatives, most notably through membership of UK Water Industry Research Limited, which manages and coordinates the research interests of UK water companies. Where appropriate, we also sponsor university research departments and private companies to undertake investigations into issues that relate to our business objectives and priorities for our operational region. The findings from all research initiatives are disseminated through Welsh Water and its contract partners under a reciprocal sharing arrangement.

Directors' report cont'd

Payment policy

Our policy is to agree payment terms at the start of a relationship with a supplier, which will only be changed by agreement. Payment will be made in accordance with agreed terms, save where we advise suppliers when an invoice is contested, which we will do without unreasonable delay. We will seek to remedy disputes as promptly as possible. Standard payment terms will be 30 days from date of receipt of a correct invoice for satisfactory goods or services which have been ordered or received, unless other terms are agreed in a contract.

In 2009-10, the average payment period for the company was 47 days (2009: 51 days). Regulations require that in calculating this we include within trade creditors monies retained under contract in respect of Welsh Water capital investment projects. The level of retentions varies from year to year and affects the average payment period for the year.

Corporate social responsibility

We have a clear and firm commitment to environmental responsibility and in being a good neighbour and trusted partner in the communities we serve. To earn this trust we have to show that we behave fairly and responsibly in the interests of customers, that we use resources wisely, and that we make an appropriate contribution to community. This approach to 'responsible business' is an essential part of our not for profit business model and further information is provided on page ** of this report.

During the year, charitable donations amounted to £45,485 (2009: £44,212). There were four beneficiaries of awards of above £500 in total ranging from £1,120 to £31,567.

It is Board policy not to make donations to political parties or to incur political expenditure and during 2009-10 no donations or payments have been made which are required to be disclosed under section 366 of the Companies Act 2006.

Institutional investors

Glas Cymru welcomes the Institutional Shareholder Committees code of responsibility for investors and the call for more two-way dialogue. Since 2001 Glas Cymru has facilitated this dialogue by holding an annual bondholder/investor in London, shortly after the company's annual general meeting, and by the issue of a quarterly investor report for holders of the group's bonds. We welcome written dialogue at any time and following the announcement of preliminary or interim financial results for any period the Finance Director, often accompanied by an independent non-executive director, will hold informal meetings with bondholders. All issues discussed at meetings with investors are reported to the Board.

Welsh language scheme

We operate an approved Welsh language scheme under the provisions of the Wales Language Act 1993. We welcome dealing with customers and other stakeholders in Welsh or English and aim to provide an equally effective standard of service in both languages.

Going concern

The Directors are satisfied that the business has adequate resources to continue in business for the foreseeable future. Accordingly, the financial statements for the year ended 31 March 2010 have been prepared on a going concern basis.

Auditors

PricewaterhouseCoopers LLP acted as auditors to Dŵr Cymru Cyfyngedig for the accounts for the year ended 31 March 2010.

As part of the audit process Directors have confirmed that as far as each Director is aware (a) there is no relevant audit information of which the company's auditors are unaware, and (b) they have taken all the steps they ought to take as a director to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

A resolution to reappoint PricewaterhouseCoopers LLP will be considered at the 2010 annual general meeting of Glas Cymru Cyfyngedig.

By order of the Board

R G Curtis LLB ACIS
Company Secretary
21 June 2010

How we deliver services

Our job is to deliver high quality and reliable drinking water and sewerage services to Welsh Water's customers at an affordable price, and to look after the water industry in our region on behalf of today's customers and future generations.

Regulation of the water industry

The water industry in England and Wales, and the important public service for which it is responsible, is highly regulated.

Ofwat is the economic regulator and is responsible for setting an upper limit on the price that each regulated water and sewerage company can charge its customers. It is also responsible for promoting the interests of customers by incentivising efficiency and high standards of service and penalising inefficiency and poor service. Every five years Welsh Water, like all the other water companies, prepares its plans for the years ahead, setting out what needs to be done, what it will cost and what it means for bills. Ofwat scrutinises and challenges these plans and sets a maximum price that companies can charge to deliver an agreed amount of work as efficiently as possible. In November 2009, Ofwat published its Final Determination for Welsh Water for the regulatory cycle from 2010 to 2015, known as AMP5 (see below- The 2009 Price Review).

For many years Ofwat had assessed companies' overall delivery of service to customers via its Overall Performance Assessment (OPA), which served two purposes. Firstly, it enabled comparisons of the quality of the overall service companies provide to customers, which is taken into account at each price review. Secondly, it informed customers – and other interested parties - about the overall performance of their local water company. The OPA assessment reflected a broad range of services including water supply, wastewater services, customer service and environmental impact. However, on 1 April 2010 Ofwat replaced OPA with a new framework of serviceability measures and a service incentive mechanism (SIM).

The Drinking Water Inspectorate is the regulator for drinking water quality, while the Environment Agency regulates Welsh Water's environmental performance, specifically with regard to the way in which it abstracts water from rivers and reservoirs and then discharges wastewater after it has been cleaned. The Countryside Council for Wales and, in England, Natural England, oversees Welsh Water's management of designated sites for nature conservation and how the Company meets its obligation to conserve and improve biodiversity.

The Consumer Council for Water is the independent body established to represent the interests of customers. It investigates complaints and champions customer concerns, and audits Welsh Water's performance on customer service more generally, as well as influencing policy. The Welsh Assembly Government has a key role in determining water and environmental quality standards as well as setting the framework for other public policy matters.

All aspects of Welsh Water's water and wastewater operations are subject to extensive performance monitoring against standards and targets set by regulators and government. Each year, regulators publish reports that assess and compare the performance of the regulated water companies across a wide range of measures, including water quality, environmental quality, customer service, affordability and cost efficiency. Each has powers that can sanction Welsh Water in the event that performance falls short of required standards.

The 2009 Price Review

The regulatory contract that Welsh Water is required to deliver in the five year period ending on 31 March 2015 is the most challenging the company has been set since the industry was privatised in 1989. Under Ofwat's Final Determination the average bill for Welsh Water's water and sewerage customers will reduce over the period to 31 March 2015 by £30 (before inflation). To deliver this level of bill reduction Welsh Water would need to significantly reduce operating costs, by around 20% of costs that can be managed or influenced by management, whilst at the same time improving customer service performance to meet new serviceability targets set out in the Final Determination - which are also very challenging - and delivering a £1.2 billion capital investment programme.

Following careful consideration, Welsh Water decided not to appeal to the Competition Commission against Ofwat's Final Determination. However, the sharp reduction revenues has meant that the progressive 'customer dividend', which was appropriate when customer bills were rising - and which between 2003 and 2010 returned over £150 million to customers - is not appropriate at the start of this next regulatory period. This also recognises that Ofwat has adopted new standards of 'serviceability', comprising 20 measures over 4 service areas, which, if they are not met, could lead to substantial financial penalties being imposed at the time of the next price review.

Delivering services for customers

Since 2001 many of the regulatory and customer service activities of Welsh Water have been delivered by partners under contracts secured through competitive tender. Control of these activities remained with Welsh Water and the company retained its access to the staff, information and knowledge required to meet legal and regulatory obligations. Welsh Water determined asset strategy and retained responsibility for decisions on key assets, and each contract specified performance measures that reflected the quality and service standards by which Welsh Water's performance is judged. In 2009-10, some 85% of Welsh Water's operating and investment expenditure was covered by these contracts, which were let in 2005.

Operating and financial review cont'd

From this wide range of measures the Board identified eight key performance indicators for the regulatory period 2005-10 (KPIs) to measure the overall success of the business and the progress of its key strategies. These strategies are designed to deliver long-term financing efficiency and improve customer service, while always ensuring that everyone who works for us is able to return home safely at the end of each day. These are marked: **i**

Further information regarding the definition, purpose and target for these KPIs can be found on page 20 of this report. The Board will select a new set of key performance indicators for the regulatory period 2010-15.

How we measure our performance

| | Monitoring plan target ⁽²⁾ | Previous performance 2008-09 | Actual performance 2009-10 | At or better than previous year |
|--|---------------------------------------|------------------------------|----------------------------|---------------------------------|
| Water quality | | | | |
| Overall water quality compliance 'at the tap' ^{(1)(C)} | n/a | 99.9% | 99.9% | ✓ |
| i Bacteriological compliance 'at the tap' ^{(1)(C)} (see page *) | n/a | 99.8% | 99.8% | ✓ |
| Iron compliance 'at the tap' ^(C) | 99/1% | 99.4% | 99.3% | ✗ |
| Operational Performance Index ^(C) | n/a | 99.9% | 99.8% | ✗ |
| Operational Performance Index (TIM) ^{(2)(C)} | n/a | 99.8% | 99.7% | ✗ |
| Environment | | | | |
| Leakage (m ³ /km/day) | 7.5 | 7.2 | 7.1 | ✓ |
| Number of 'category 1 and 2' pollution incidents ^(C) | n/a | 3 | 9 | ✗ |
| Number of 'category 3' pollution incidents ^(C) | n/a | 230 | 311 | ✗ |
| Wastewater treatment works assessed as complying with 'look up' table ^(C) | n/a | 100% | 99.9% | ✗ |
| Sewage sludge recycled satisfactorily ^(C) | 100% | 100% | 100% | ✓ |
| 'Mandatory' coastal bathing water compliance at EU designated bathing beaches ^(C) | 100% | 99% | 100% | ✓ |
| 'Guideline' coastal bathing water compliance at EU designated bathing beaches ^(C) | 'Stable' | 77% | 91% | ✓ |
| Customer service | | | | |
| i Customer satisfaction (see page *) | n/a | 80% | 83% | ✓ |
| Properties 'at risk' of receiving low pressure | 242 | 197 | 194 | ✓ |
| Properties affected by unplanned water supply interruptions lasting more than 6 hours | 1,080 | 894 | 477 | ✓ |
| Properties 'at risk' of sewer flooding | 308 | 265 | 250 | ✓ |
| Properties flooded due to hydraulic overload | 106 | 106 | 73 | ✓ |
| Properties flooded due to other causes | 120 | 186 | 198 | ✓ |
| Billing enquiries answered within 5 days | 100% | 100% | 100% | ✓ |
| Written complaints answered within 10 days | 99.9% | 99.3% | 99.6% | ✓ |
| Number of written complaints received | n/a | 12,486 | 13,313 | ✗ |
| Customer meters read within year | 99.9% | 99.9% | 99.9% | ✓ |
| Telephone calls abandoned | 1.3% | 4.7% | 2.1% | ✓ |
| Telephone calls receiving engaged tone | 0% | 0.04% | 0.9% | ✗ |
| Call handling satisfaction (score out of 5) | n/a | 4.65 | 4.72 | ✓ |
| People | | | | |
| i Reportable accidents (see page *) | n/a | 34 | 34 | ✗ |
| Finance | | | | |
| i Bond credit rating ⁽⁴⁾ (see page *) | n/a | Class B bonds A/A3/A | | ✗ |
| i Customer dividend (see page *) | n/a | £22 | £22 | ✗ |
| i Gearing (see page *) | n/a | 72% | 72% | ✗ |
| i Interest cover (see page *) | n/a | 3.4 | 3.4 | ✗ |
| Overall performance | | | | |
| i Ofwat's OPA score (see page *) | n/a | 406 | 406 (estimated) | ✗ |

(1) This measure is based on 'Mean Zonal Compliance'

(2) Incorporates performance against turbidity, iron and manganese

(3) The Monitoring Plan sets out the targets agreed with regulators at the Regulatory Price Review in 2004 and covers the five year period to 31 March 2010

(4) Standard & Poor's, Moody's and Fitch respectively

(C) Calendar year 2009, all other figures are for the year ended 31 March 2010.

Drinking water supply

Our biggest obligation is to protect public health by providing a safe and reliable supply of drinking water to our customers at all times.

Supplying water is a complex operation and to do this we employ a large network of assets: 67 water treatment works supply around 850 million litres of water a day to 1.2 million households and over 100,000 business customers through a network of 557 service reservoirs and over 27,000 km of water mains.

Drinking water quality

The quality of the water we supply is assessed against the results of some 280,000 tests which we take each year. These measure our performance against a combination of health-based and aesthetic-based standards set by EU directives and national legislation, and cover all stages in the process - from the treatment works to the customer's tap. All results are submitted to the Drinking Water Inspectorate (DWI) for assessment and provide a broad picture of the quality of the tap water we supply to our customers.

The overall quality of the drinking water we supplied in 2009 remained at a high level and, while the number of water quality events investigated by the DWI reduced only slightly, there was a 50% reduction in events relating to the disinfection process at water treatment works. This helped us to:

- maintain bacteriological compliance at the tap at 99.8% (2008: 99.8%)
- maintain mean zonal compliance at 99.95% of tests meeting the required regulatory standards
- improve performance against the DWI's disinfection control index to above industry average 99.98% (2008: 99.88%).

In 2010 we aim to maintain or improve our performance against each of the DWI's six indices which assess overall performance – last year we improved against two, were stable against two but declined slightly against two others.

We are confident our performance will improve as we deliver our £200 million programme to improve our water treatment works over the next five years. Schemes at Cwellyn and Rhiwgoch water treatment works have already been completed under early start funding made available under the Glas Cymru business model. Until the whole programme has been completed, the risk associated with a gradual deterioration in the quality of the raw water we abstract for the public water supply is being mitigated at a number of water treatment works by additional ultra violet treatment installed as a precautionary measure during 2008 and 2009 to protect against the threat to public health posed by cryptosporidium.

Managing water quality risk

We have a Drinking Water Safety Plan for each of Welsh Water's 22 areas of supply documenting all potential risks to water quality (from source to tap). These plans are continually reviewed and updated. Our proactive approach to managing water quality risk includes the holding of events on catchment management to consult and engage with landowners, local businesses, public health and local authorities and others whose activities can have an effect on catchments that are used for abstraction of drinking water. The aim was to increase understanding of the potential risks to water supply and public health, and how we can best work together to minimise those risks.

Water Health Partnership for Wales

Now in its fourth year, the Water Health Partnership for Wales organised three training events across Wales in 2009. 76 people attended with representation from most Local Authorities, The National Public Health Service for Wales and The Environment Agency. The events are designed to improve inter-agency knowledge of drinking water quality issues and included presentations and discussions on common causes of customer complaints, lead and cryptosporidium followed by a visit to a local water treatment works. This is a good example of the 'working together' approach Welsh Water prefers to adopt.

Safeguarding the environment today

It is our responsibility to collect and treat our customers' wastewater in a way that protects public health and the environment - in many places this is made more difficult by the volume of highway and surface water that drains into the public sewer network.

We collect and treat 5% of the UK's total wastewater flow yet operate 13% of the UK's treatment works – over 800 of them. Because of our topography, we employ more assets per customer than most other water companies in England and Wales. For our 19,000 km sewer network we have over 1,900 pumping stations and 3,200 combined sewer overflows. How we manage these assets is monitored by the Environment Agency against a range of regulatory and other measures of performance, which together ensure the quality and reliability of service received by our customers and our compliance with environmental standards.

Wales can boast of some of the highest quality rivers and coastal waters in the UK. We are proud of the part we have played in securing this outcome. We have invested more than £2 billion over the last 15 years to protect this high quality environment, which has contributed to the number of Blue Flags awarded to Wales' beaches rising from 2 to 50, but maintaining this will continue to be a real challenge.

Wastewater treatment compliance

All of our wastewater treatment works have discharge consents which are regulated by the Environment Agency. Some 550 of them also have more detailed consents where the treated water discharge is sampled over the course of the year and tested against parameters, including biological oxygen demand, suspended solids and ammonia.

Compliance with what are called 'look up' discharge consents – permits for the discharge of waste water - was 100% in 2008, but slipped to 99.7% in 2009 after 12 small wastewater treatment works failed to meet the required standard, most of them for the first time in many years. Of these, nine serve a population of less than 500 and have biological treatment processes that are vulnerable to surface water flows during severe wet weather and unauthorised connections. These treatment works simply could not cope with the heavy rain and high storm water flows we saw in 2009.

We have therefore looked again at this risk at all our small works, and during the coming five years, we will be investing in the improvement of wastewater treatment works.

Reliability of the sewer network

In 2009, the number of sewer flooding incidents caused by blockages or sewer collapse fell by around 20%, and the number of incidents caused by an overload of wastewater remained the same as the previous year – despite periods of prolonged heavy rainfall, and that fact that around a third of our sewer network is more than 100 years old. However, the number of sewer collapses remains one of the highest rates of asset breakdown in the industry. Reducing the risk of flooding and pollution from asset breakdown is one of our biggest challenges.

Over the last regulatory period 2005-2010, we invested to reduce the risk of repeat flooding from overloaded sewers and as a result the number of properties at risk of repeat flooding following very heavy rainfall had by March 2010 reduced to 250 (2009: 265). We recognise that this is the most serious service shortfall we can have and that it is especially hazardous to public health, so we are pleased that Welsh Water came top in the Consumer Council for Water's assessment of company responses to sewer flooding. In the next five years we will be investing to further reduce the risk of sewer flooding.

Disappointingly, the number of serious pollution incidents caused by asset breakdown and problems on our sewer network rose from 3 in 2008 - one of the best performances in the industry – to 9 last year, the same as in 2007. The total number of pollution incidents also went up last year, however, this is largely explained by an increase in the proportion of these that are self-reported by Welsh Water which rose from 32% to 45%. We have plans in place to reduce the number of pollution incidents caused by our operations in 2010-11.

Coastal and river water quality

In 2009 all of Wales's 81 EU-designated beaches passed the mandatory bathing water standard - and 92% of them, the highest proportion for any region of the UK, passed the much higher guideline standard. This result has helped secure 50 Blue Flag beach and marina awards for the 2009 season (2008: 43), which is again over one third of the total awarded for the UK. Wales also secured 48 Green Coast awards for rural beaches. This is particularly important to the Welsh tourist industry, because Welsh Assembly Government statistics tell us that the tourist industry employs 8% of the Welsh workforce and contributes some £3 billion a year to Welsh economy.

The quality of rivers in Wales continues to be amongst the best in the UK. The latest available survey of river water quality, published by the Environment Agency, confirmed that 95% of rivers in Wales were good or excellent on the assessment for chemical quality and 87% were good or excellent on the assessment for biological quality.

Operating and financial review cont'd

Water abstraction and leakage

Water is a valuable resource and we abstract from our rivers no more than we need to for public water supply. We are committed to keeping leakage – in other words, wastage - to a minimum. With 27,000km of mains network, the average age of which is more than 60 years, this requires a continuous cycle of work. In 2009-10 we met our mandatory target for leakage reduction, as we have in each year to date, and over the last five years we have reduced leakage by one third. This means that leakage in our region, once one of the highest in the UK, is now in line with the water industry average. As a result of this, and falling demand for water from industry, we have in the last 10 years been able to reduce the volume of water abstracted from our rivers by a quarter.

Achieving the leakage target was a big challenge because there was a sharp increase in leakages from burst pipes in the thaw following a period of prolonged freezing weather in December and January. At one stage we were putting nearly 20% more water into supply than usual and more than the peak summer demand for water in the past two years. To hit the leakage target required a major reallocation of resources and round-the-clock 7-day working at an additional cost of some £2 million.

Safeguarding the environment for tomorrow

We aim to operate our business in a sustainable way that safeguards the environment and, where an impact is unavoidable, in a way that minimises any adverse environmental effect.

We place a strong emphasis on the careful management of the water resources in our area, and we are working to mitigate the expected impact of climate change on our industry as well as to reduce Welsh Water's carbon footprint.

Managing water resources

Our job is to ensure that our customers have sufficient water to meet their needs today and in the future. In terms of water resources, we are in a relatively strong position in Wales, but we have a number of zones where demand is exceeding – or is forecast to exceed – available supply in drought conditions. This is complicated by the fact that Welsh Water has nearly half the industry's discrete water resource zones, which can mean that our ability to transfer water from one area to another is limited. This can create local supply problems during droughts and other extreme weather conditions.

Our plans to increase supplies of water and manage the balance between supply and demand are set out in our draft 25-year water resource strategy, but this is to be republished in 2010 following confirmation by the Environment Agency of substantial reductions in water abstraction from some rivers in accordance with the Habitats Directive. In these plans we have had to consider all the factors which could potentially impact upon either the availability of water supplies or the demands made on our resources. This also includes forecast changes in population and the amount of water we all use, and the effects of climate change.

Water efficiency

We promote water efficiency through our 'Be Waterwise' campaign, through which we encourage all customers to use water wisely and avoid waste – in the interests of both the environment and our customers. Our core message to customers is 'use as much drinking water as you need, but please don't waste it', and that small measures to save water can, when aggregated, help manage the effects of climate change and contain any increase in overall water consumption.

As part of the 'Be Waterwise' campaign we attend various events and roadshows around our region, where we give customers free water saving cistern devices called 'hippo-bags'. Information is available via our website and publications on how to save water in the home and the garden. We are also developing a 'Green plumbers of Wales' training scheme, which focuses on plumbing best practice in the installation and maintenance of water efficient equipment.

Climate change and carbon

The pattern of greater variability in weather conditions and more extreme weather events, which we have seen in each of the past three years, was repeated in 2009-10. Irrespective of whether or not this can be attributed to climate change, it is having a significant impact on Welsh Water's business. Last year saw failures at a number of small wastewater treatment works where problems have not been seen before, and we are investigating why variable weather conditions appear to be having more of an impact in north Wales than in other parts of our region.

Treating and pumping water and wastewater across a large region of variable terrain makes Welsh Water a high energy user and one of the top carbon emitters in Wales. Each year there is an upward pressure on energy use arising from investment in new assets and in treatment processes required to meet higher drinking water quality and environmental standards.

Operating and financial review cont'd

Reducing our carbon footprint

Welsh Water was one of 7 organisations awarded the Carbon Trust Standard in 2009 after demonstrating our commitment to carbon reduction. The Carbon Trust commended the Company's programme including the trialling of low carbon treatment, sustainable urban drainage schemes and surface water management, advanced sludge digestion, renewable energy generation and a wide ranging energy efficiency programme.

80% of Welsh Water's carbon emissions relate to energy use, so control of energy costs has both financial and environmental benefits. After a review of the efficiency of the aeration process at our largest wastewater treatment works in Cardiff, the lessons learnt have been extended to 5 other works during 2009-10. In the first full year of operation, this will save over 6 gigawatt hours of energy, or over £300,000.

In 2009-10, Welsh Water increased its renewable energy generation by around a quarter. This comes mainly from combined heat and power (CHP) schemes, which capture and burn 'waste' methane gas at 12 wastewater treatment works, but it also includes the first of our advanced digestion schemes which convert wastewater sludge to electricity. This is at Eign in Herefordshire and has been generating power since October 2009.

Two further schemes will be completed by Spring 2011 at our Cardiff and Afan works which, with Eign, will deliver some 7Mwh of green energy, saving over 30,000 tCO₂ of emissions. Also in 2009-10:

- Feasibility studies for 2 hydrogeneration schemes were completed, for which we have set aside some £6million over the next five years to provide micro hydro capacity at up to a dozen sites.
- Small improvements in efficiency are important too, especially in such a large network of assets. Each small improvement in efficiency makes a contribution to reducing our carbon footprint. At our wastewater works at Llanina in west Wales we invested £6,500 to replace a blower, saving £9,000 in operating costs each year. We monitor closely the operational and energy efficiency of all plant – replacing an inefficient pump, of which Welsh Water has many thousands, can save up to 20% in energy use.

Meeting customers' expectations

We want all our customers to feel confident that their water supply and sewerage services are well looked after.

Improving customer service

During 2010, Welsh Water is opening a new customer contact and operations centre in Cardiff, which compliments our three-year £100 million programme to update a number of key IT systems and working practices. Staff at the new centre will have more real-time information available to them, enabling us to deal with customer queries and problems more efficiently. Our aim is to get things right first time and give our customers a prompt and courteous response every time they contact us.

The majority of our customers prefer to contact us by telephone, and last year the volume of calls was up 3% on the previous year. In general, all calls are answered by a 'real person' straightaway, as we only use automation in emergencies. Two thirds of the calls we get are from customers wanting to pay their bill or who have a bill or payment plan query. We also received written queries about bills and payment options, 99.9% of which we responded to within 5 working days.

More customers are continuing to contact us as a result of the current difficult economic climate, and many calls are taking longer to deal with than in the past. Mainly because of a single incident at Treharris, the total number of calls during the year that got an engaged tone because all staff were busy on another call rose to around 1%, from the more typical 0.3%. We have responded to this by investing in a new telephony system which will come online in October 2010. In 2009-10 the number of abandoned calls, which rose to over 5% last year, returned to a more typical level of less than 3%.

Helping customers pay their bill

In 2009-10, we introduced our Welsh Water Assist tariff, designed to help households on low incomes and customers with particular needs. This new tariff capped the bill for eligible customers at £250.

Our other assistance tariff, Water Direct, reduces the bill by £25 when customers opt to pay their water bill by direct deduction from benefits. Customers have also benefited from our Customer Assistance Fund, a scheme run with the assistance of the Citizens Advice Bureau to help customers who have fallen into arrears with their bills. All our assistance tariffs are designed to be self funding.

Additional Services

Many of our customers may have other needs for which we can offer a range of additional services. These include large print or Braille bills, bottled water during emergencies, a password scheme for home visits and a 'knock and wait' service for those who need a little more time to answer the door. At the end of the year 3,600 customers were registered for one or more of these additional services.

Operating and financial review cont'd

Customer satisfaction

The industry regulator, Ofwat, carries out independent research into customer satisfaction with call handling across the sector, and last year we again scored one of the best results in the industry. We also carry out independent market research to track customer views and satisfaction levels on a range of issues and services, including satisfaction with drinking water quality, coastal environmental quality and how our customers judge Welsh Water's value for money when compared to other utilities. The latest research shows that satisfaction with drinking water quality remains high.

Employer of choice

We want everyone who works for Welsh Water to recognise the importance of the job we do for the three million people who rely on us.

In 2009-10 the staff employed directly by Welsh Water were responsible for financial management, strategic asset planning and investment, managing regulatory issues and ensuring that our outsourced working arrangements delivered an efficient and high quality service to Welsh Water's customers. This changed in April and May 2010 when 1569 staff who deliver day-to-day operations and maintenance services to customers, who were previously employed by United Utilities Operational Services and Kelda Water Services Wales, transferred to Welsh Water under the Transfer of Undertaking Regulations. Merging three teams with different cultures is an additional challenge for the company and ensuring that customer service and safety standards are maintained during this period of change is a top priority for us.

The final quarter of 2009-10 was committed to planning the transition for this major restructuring of the business, and included the appointment of a new leadership team reporting to the Directors. The new team covers key leadership roles, of which five have been filled by high calibre leaders who were not employed by Welsh Water in 2009-10. The new structure is designed to ensure that we take full advantage of the operating systems and procedures introduced under our programme of IT-enabled change and will support our continued drive to improve service standards and efficiency still further, building on our strong track record since 2001.

There are some things that will not change under this new structure. Our focus stays firmly fixed on protecting public health, the environment and the occupational health and safety of those who work for us. Our culture will remain one in which all our people understand the vital purpose of Welsh Water and their role in achieving this purpose, where they feel they accomplish something worthwhile at work and regard Welsh Water as a good employer. These key messages were reinforced by our Managing Director in a series of 20 roadshow events in March and April 2010, attended by 95% of all staff.

To meet the efficiency targets set for the next five years, we will need to reduce the total number of people employed by Welsh Water by some 300. This will be achieved under our Working Together Agreement with the trade unions, the essential principles of which have remained in place since they were first established in the mid 1990's. Wherever possible, staff reduction will be achieved by a combination of retirement, natural movement and voluntary severance.

At the same time, we will maintain the progress of recent years through continued investment in operator training and management development training. We will continue our graduate recruitment programme through which we aim to attract potential leaders for the future with appropriate skills in engineering and scientific disciplines. To achieve this, we have further strengthened our ties with a number of universities to enable us to attract strong candidates from the disciplines we most need.

Asset Management Alliance

For the past 5 years, the Welsh Water Asset Management Alliance (AMA), which includes Welsh Water and its capital investment and other service partners, has set a high standard in partnership working – and we will not lose this under our new structure. We will continue to take a collaborative approach with all parties working together to deliver a common set of business objectives. The AMA supports these objectives by promoting a safe and stimulating working environment for our staff, by focusing on continuous improvement to deliver the right balance of 'best in class' and value of money customer service, and by promoting Welsh Water as a credible and responsible business in terms of our impact on the environment.

Operating and financial review cont'd

Health and safety

Although we have reduced the number of reportable accidents in the past 5 years and have one of the best safety records in the sector, 2009-10 was disappointing because performance slipped and was the first year under Glas Cymru's ownership in which the number of reportable accidents did not fall. Last year, there were 39 reportable accidents. Returning to a downward trend is our priority for next year.

We operate a 'Journey to Zero' strategy and a no-blame safety culture, which encourages near-hit reporting - an event that could have caused injury to staff but which did not on this occasion - so that lessons for continuous improvement can be taken on board. We keep the focus of staff across the business on occupational health and safety through a risk-based programme. In 2009-10 this involved delivering local improvement 'goals' overseen by 20 managers who hold a NEBOSH (National Examination Board in Occupational Safety and Health) accredited health and safety qualification. This strategy and approach has not changed under our new structure.

We have maintained our certification to the OHSAS (Occupational Health and Safety Advisory Services) 18001:2007 international standard for occupational health and safety management with an extended scope of service, and introduced a new system to make the health and safety performance of all main contractors and subcontractors immediately visible to Welsh Water, including the results of independent audits conducted on our behalf. Last year's annual health and safety conference was attended by 300 staff from across the AMA, when three health and safety awards were issued and staff were able to gain from the experience of three prominent independent speakers.

Further details of our health and safety performance and approach are available in our '2010 Health and Safety Report' which is available on our website.

Responsible Business

We are committed to being a good neighbour and a trusted partner in the communities we serve.

Managing our community assets

We are the custodian of a national asset in Wales - some 40,000 hectares of scenic land that is rich in both biodiversity and heritage. This land base also provides significant opportunity for public recreation, and each year almost a million people visit one of the 17 major reservoir sites where we provide a variety of sporting, recreational and leisure resources. This makes a valuable contribution to tourism and the local economy, and encourages public health and well being.

We encourage conservation best practice across the business. A good example of this is at Talybont in Powys, where in 2009 we commissioned a £16.8m refurbishment of our treatment works and where staff in our graduate development programme are working with the Brecon Beacons National Park to provide a new wetland and wildflower conservation area. This followed a review of the site-specific habitat and species plan which we implement at all our major reservoirs, and gave Welsh Water the opportunity to support delivery of the biodiversity action plans of the National Park.

Minimising the impact of our activities

We cannot deliver essential water and sewerage services without having to dig up roads to lay and refurbish pipes, have materials delivered to our construction sites or have waste removed from our treatment works. It is pleasing therefore that a number of our schemes have received an award under the national Considerate Constructors Scheme where our arrangements for public safety and community impact and liaison are assessed independently. It is always the aim of Welsh Water to minimise the disruptive impact of our activities.

Supporting education

Last year was another successful year for our education service, with some 12,100 primary school children receiving lessons at one of our four 'Living and Learning with Water' centres. These 'hands on' lessons, provided free of charge and designed and delivered by qualified teachers, are aimed at pupils from 7-11 years old and cover different aspects of science, geography, history and sustainable development. Lessons are backed up by our education website (www.livingandlearningwithwater.com) where teachers can download materials and information to support them in the classroom.

The range of free education resources was extended last year with the launch of a new education pack for GCSE and BTEC students of applied science. Designed in collaboration with science teachers from across Wales to fit closely with the curriculum, the new resource provides students with an insight into how science is used in the workplace and where there are opportunities for science-based employment.

Operating and financial review cont'd

Our peripatetic community programme delivers vital messages on water conservation and public safety to the wider community and to schools and community groups unable to visit one of our centres. In the last academic year, this service delivered 85 community-based sessions, reaching over 7,000 additional young people and adult learners, including events supported by the Hereford Waterworks Museum and the National Botanical Gardens, two of Welsh Water's education partners.

Over 1,600 schools in our region are Eco-Schools, for who we sponsor a 'water efficiency award'. Under this scheme, we encourage water efficiency by:

- issuing water efficiency packs.
- providing advice through an Eco-Schools handbook.

At schools where trials have been conducted, it has been demonstrated that involving schoolchildren in water efficiency measures and the adoption of water efficient devices can reduce metered consumption by up to 40% in both primary and secondary schools.

Over 100 teacher placement students in their final year at UWIC (Cardiff) spent 2 days at Cog Moors Living and Learning with Water Centre finding out about the delivery of environmental education and the resources that will be available when they secure teaching positions in the future. In addition, environmental education awareness events were held for teachers at Welsh Water's four centres.

Supporting community projects

As befits our not-for-profit business model, we do not engage in corporate sponsorship. Instead we focus on supporting staff in community schemes. A 'World of Work' scheme provides business mentoring and interview support for young people about to leave school and, under our management development programme, staff take part in a volunteer project to enhance their skills and help the community.

Supported by Business in the Community's Cares Scheme, 12 staff tackled an environmental project at Treforest Wholefood Association, a social enterprise committed to educating and training people in sustainable horticulture, including groups of excluded 16-18 year-olds, unemployed and school children. This involved staff in planning, financing and helping to restore and conserve a community allotment and local pond habitat.

WaterAid

We support WaterAid, the international charity, which brings sustainable water and sanitation schemes and hygiene education to some of the world's poorest communities in Africa and Asia.

Financial Review

The Board considers that maintaining gearing at around 70% will provide best value for money for customers, balancing the cost of funding the business with continued investment in important projects to improve customer service, drinking water quality and the environment.

While Welsh Water has not been immune to the impact of the recent economic recession, we have delivered a sound financial performance during the year to 31 March 2010. However, achievement of Ofwat's Final Determination for 2010 to 2015 is a big challenge and, as a result, we are making a major change to our business operations.

Appointed revenue has grown due to regulatory price increases which support our extensive capital investment and the delivery of better customer service, after taking into account the 'customer dividend' of £22 per customer. Operational expenditure (before exceptional items) has fallen due to lower power costs, partly offset by an increase in the bad debt charge.

Capital investment in our regulated water and wastewater operations, including infrastructure renewals expenditure ('IRE'), amounted to £361 million during the year. This is 2% higher than last year, and represents a record level of investment spend for Welsh Water.

Revenue

Welsh Water's appointed turnover in the year to 31 March 2010 was £682 million (2009: £650 million), an increase of 4.8% on last year. This increase primarily reflects the price increase of 5.4%, however our 'customer dividend' policy means that our total charges were some £28 million lower than if we had applied the full price increase determined by Ofwat (2009: £27 million lower). Additional revenue from new customers has been offset by household customers switching to metered charging. Our unique range of customer assistance tariffs has continued to help support customers who have difficulty paying their bills. By 31 March 2010 some 27,000 customers were benefiting from one of these tariffs.

Operating and financial review cont'd

Operating expenditure

Welsh water's total appointed business operational costs (excluding IRC and depreciation and before exceptional items) were £259 million (2009: £260 million), lower power costs being offset by an increase in the provision for bad debts.

In the years to 31 March 2010, around two thirds of operational costs related to outsourced service contracts. The major contracts were with United Utilities Operating Services ('UUOS', for the operation of the water network and the wastewater network in North Wales) and with Kelda Water Services ('KWS', for the operation of the wastewater network in South Wales and Herefordshire). These contracts included a target cost mechanism aimed at enhancing operating efficiency to the end of the AMP4 regulatory period in 2010.

All water and sewerage companies need to draw on significant energy resources, particularly for water treatment and pumping processes, and Welsh Water – with its network spread across Wales' undulating topography – is no exception. This year we have experienced reductions in energy prices which have seen power costs fall by around 20% to £35 million (2009: £43 million).

Customer debt recovery remains a high priority for Welsh Water and our billing and income contract partner, Veolia Water. In a challenging economic environment, in which water companies have no sanction to disconnect supplies to non-paying domestic customers, cash collection has continued to be challenging. The bad debt charge for the year of £22 million (2009: £19 million) represents around 3% of annual turnover (2009: 3%), and reflects an increase in the provision based on a review of historical collections and having regard to the deterioration experienced, particularly during the first half of the year.

The current cost depreciation charge was £123 million (2009: £157 million). The fall is primarily the impact of revaluing the asset base to its Modern Equivalent Asset Value (see current cost accounting policies on page 11).

The infrastructure renewals charge was £60 million (2009: £62 million). The charge has been reviewed to take into account the projected future expenditure per Ofwat's 2009 Final Determination and reflects the medium to long-term maintenance needs of the infrastructure network.

Exceptional operational expenditure

On 9 February 2010 it was announced that Welsh Water was to undertake the biggest restructuring of the company since it was bought by Glas Cymru and became a 'not-for-profit' company – to meet the toughest efficiency targets the company has ever faced. The price limits for the next 5 years, set last November by Ofwat, will allow Welsh Water to invest £1.2 billion in water quality and other improvements. But Welsh Water must also reduce its day-to-day operating costs by some 20% to enable the average household bill to fall by £30 before inflation.

Since 2001, UUOS and then also KWS have helped us to cut our operating costs by more than any other water and sewerage company in the regulated water industry in England and Wales. But in order to deliver the price reductions required over the next five years we must make a further step change in our cost efficiency.

Over the past year we have had lengthy discussions with UUOS and KWS through the five-yearly price and performance review of the contracts we undertook with both companies. We recognise and appreciate the considerable efforts made by both companies to meet our requirements. However, it did not prove possible to reach agreement with either company in relation to the terms for a continuation of those contracts for a further five years.

In light of this, we reached agreement with both UUOS and KWS that their staff would transfer to Welsh Water. On 1 April 2010 1,093 UUOS employees transferred, followed by 476 KWS employees on 1 May 2010.

We have also announced, as part of the drive to cut our operating costs by 20%, a phased reduction, over the next five years, of around 300 in the number of people required to deliver water and wastewater services to Welsh Water's customers. We are working closely with staff and our trade union colleagues and intend to achieve this through a combination of retirements, natural staff turnover and voluntary severance.

Included in the 2009-10 results are exceptional items totalling £30 million. These provide for the costs of terminating the United Utilities and Kelda Water Services contracts and for the estimated severance pay and pension top-up required to achieve our planned headcount reduction. These are necessary enabling costs which will help us to create the efficiencies required to meet Ofwat's challenging target.

Operating and financial review cont'd

Financing costs

Net interest payable of £104m is £64m lower than last year. The impact of lower interest rates has been combined with an indexation credit in respect of the index-linked bonds (calculated using July 2008 to July 2009 RPI). The average cost of debt during the period was 3.7% (2009: 6.6%).

In response to the crisis in the banking markets, the company tightened its criteria for investing cash deposits such that maximum deposits with any single counterparty were reduced and the maximum term limited to 3 months. Consequently, the average interest receivable rate has fallen from 3.9% to 0.4% and remains below the average 3 month LIBOR over the same period (which fell from 4.4% to 0.8%).

Profit before taxation and 'customer dividend'

The appointed business current cost profit before tax was £166 million (2009: loss of £2 million). This profit was made after funding the 'customer dividend' of £22 for all customers receiving both water and wastewater services, at a total of £28 million (2009: £21 per customer, totalling £27 million). Since 2003, 'customer dividends' have totalled some £152 million.

Taxation

The taxation charge for the year of £1 million comprises a deferred tax charge of £3 million, offset by a current tax credit of £2 million. The company has tax trading losses carried forward of approximately £288 million, which it believes should be sufficient to eliminate tax on trading profits in the five years ending 31 March 2015, subject to any changes in tax law.

Liquidity

Welsh Water aims to offer a secure, low risk investment to long-term investors. By building and maintaining a strong financial position, we intend to keep our borrowing costs low, enabling us to finance future investment in the business efficiently, whilst retaining the scope to return money to our customers and keep bills affordable.

The company had strong liquidity as at 31 March 2010 - cash balances of £249 million, together with an undrawn loan facility of £75 million and undrawn revolving credit facilities of £345 million. The cash balances include the proceeds of the £140 million index-linked bond issue on 31 March 2010.

On 7 May 2010, in view of the very high level of available liquidity (£669 million), the level of undrawn revolving credit facilities was reduced to £100 million and on 3 June 2010 agreement was reached to repurchase £113 million of Class C1 bonds following a tender offer to bond holders. The amount repurchased represents a take-up of 90% and settlement will be made in cash on 7 June 2010.

Gearing and financial reserves

On Glas Cymru's acquisition of Welsh Water in May 2001, gearing stood at 93%. Since then, its financial position has improved steadily, such that gearing had fallen to 71% as at 31 March 2010 and 'financial reserves' (RCV less net debt) were almost £1.1 billion.

Credit ratings and bond spreads

The strong credit quality of the business is reflected in credit ratings which are now the highest in the water sector, despite a very challenging Final Determination. On 8 March 2010 Standard & Poor's placed our ratings on negative outlook, reflecting their assessment of the potential impact of Ofwat's Final Determination following the 2009 Price Review.

There has been a significant downward reduction in the spread differential to Government gilts during the year across the water sector, reflecting an easing of the difficult credit conditions over the last year. The bonds continue to trade at spread differentials generally below those of equivalent water sector bonds of similar maturities.

Debt financing and interest rate management

Despite difficult conditions in the borrowing and capital markets, on 31 March 2010 Welsh Water issued £140m of 2048 index-linked series B bonds. A further £35 million of funding, provided by KfW Bank, was drawn on 15 December 2009.

To protect Welsh Water's high credit quality, the Board has always adopted prudent financial policies, predominantly covering the fixing of interest rates and the investment of cash balances. Welsh Water's policy is to minimise its exposure to movements in market rates, with a minimum of 85% of its liabilities being fixed rate, index-linked to the UK Retail Price Index ('RPI') or matched by cash balances. The Board considers that linking debt to UK RPI inflation is particularly appropriate, as Welsh Water's revenues and Regulatory Capital Value are also linked to RPI through the regulatory system operated by Ofwat. Implementation of the policies is delegated to a small team of specialists which operates to ensure that Welsh Water meets the requirements of its licence, and therefore undertakes no speculative trading. As at 31 March 2010, approximately 60% of gross debt was index-linked via bonds and derivatives (2009: 58%).

The expected maturity of the outstanding fixed rate and index-linked bonds ranges from 2011 to 2057, with not more than 20% falling due in any 2 year period, in accordance with our refinancing policy.

Operating and financial review cont'd

Capital investment

Welsh Water's strong financial position has been built up over the last 8 years, and provides a stable base from which it can respond positively to the challenges of the recent economic recession and drive forward its largest ever capital programme. Over £1.5 billion has been invested since April 2005, bringing sustained improvements to customer service, drinking water quality and the environment.

Total capital expenditure by Welsh Water during the year (including IRE) was a record £361 million (2009: £355 million), bringing the total expenditure over the 5 year AMP4 period to £1,521 million. Welsh Water works with an alliance of capital investment partners to deliver the investment programme at the best value for money for customers. Welsh Water is planning to invest some £1.2 billion over the next AMP period which will run from 2010 to 2015.

Looking ahead

The Board's policy is to reduce gearing to around 70%, and maintain it at around this level. A key part of our strategy is to minimise customer bills in the long term, and the Board judges that this level of gearing will enable the company to efficiently fund the AMP5 investment programme which will run to 2015.

Ofwat has set us an efficiency target of a reduction of some 20 per cent in our day to day running costs. In addition to the headcount reduction, we will do this by exploiting our recent large investment in new technology, by eliminating the profit element, overhead and contract management costs of the previously outsourced services, and by investing in 'green energy' and processes to reduce power costs. This involves considerable expenditure by the company and forms part of our planned £1.2 billion investment programme to improve services over the next five years. In the face of these major changes, our priority will remain the essential task of guaranteeing safe and reliable services for all our customers, as well as safeguarding the environment.

Disclaimer

This report contains certain forward looking statements with respect to the future business prospects and the strategies of the Glas Cymru Group. These statements and forecasts involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results or developments to differ materially from those expressed or implied by these forward looking statements. Past performance is no guide to future performance and persons needing advice should consult an independent financial adviser.

Planning for the future

The investment decisions we make today will be felt for decades to come.

Every five years Ofwat carries out a periodic price review, and in November 2009 Ofwat published its 'Final Determination' setting the price limits and investment programme which Welsh Water will be required to deliver in the next five years, from April 2010 to March 2015.

Customer bills and investment

Much of what Welsh Water does to deliver a high quality and reliable customer service every day of the year involves operating and maintaining a large network of often very long-life assets - reservoirs, treatment works, pumping stations, mains and sewers. The performance of the network is key to the service we give our customers as well as our ability to protect the environment from pollution. The key discussion, therefore, with our economic and quality regulators during the periodic price review was the trade-off between investment in our network of assets and customer affordability.

Under Ofwat's 'final determination', the average customer bill for water and sewerage services in the Welsh Water region will have fallen by £30 (before inflation) by March 2015. Ofwat also confirmed the capital investment programme Welsh Water will be required to deliver by March 2015, which at £1.2 billion is about the same size as the programme for the last five years. This has struck a good balance between affordability on the one hand and quality and reliability of service on the other, one we believe our customers will recognise as good value for money.

What we will deliver between 2010 and 2015

Nearly all of the critical investment we set out in our Final Business Plan for 2010-2015, which we regarded as necessary to protect public health and the environment in the region we serve, has been confirmed in Ofwat's final determination. This will enable us to begin to make progress towards the goals set out in 'Our Sustainable Future', published in 2007, which set out our long-term vision for the water industry in our region.

Protecting public health

Our biggest responsibility is to provide a safe and reliable drinking water supply to our customers at all times. In the next five years we plan to improve facilities at 23 water treatment sites to deal with deteriorating source water quality and other risks to the quality of drinking water identified in our Drinking Water Safety Plans. We will also renew over 500km of water mains that cause repeat interruption to supply.

Operating and financial review cont'd

Safeguarding the environment

In the next 5 years we are targeting a significant reduction in flooding and pollution incidents caused by breakdowns on our sewer network, plus additional treatment stages at some 14 wastewater sites to protect river and coastal water quality.

Responding to climate change

Work is already well advanced on advanced sludge digestion schemes at 3 wastewater sites by which, with improved energy efficiency, we are seeking to achieve a 15% reduction in our 'carbon footprint' by 2015. Through our Green Space Wales strategy in the next five years, we will also invest in sustainable urban drainage schemes to reduce the risk of flooding from overloaded sewers, providing added protection in locations at most risk of flooding.

Meeting our customers' expectations

In autumn 2010, we will be opening our new customer service and operational control centre in Cardiff, where the latest technology delivered under our £85m programme of IT-enabled change will make it possible to anticipate service failures and improve customer service by giving first-time resolution to daily problems. The new centre will also improve our ability to respond to the need for infrastructure to supply new housing and to support economic development.

Looking after our assets

Our priorities and long-term investment decisions are determined using our Strategic Investment Planning System. The priorities of Welsh Water are reviewed and updated annually.

Financing the business

We are targeting gearing at around 70% and an 'A grade' corporate rating to help drive down the level of customer bills, which we will achieve by continuing with our financing strategy.

Employer of choice

In the final quarter of 2009-10, we announced we would bring the people who deliver water and sewerage services into the direct employment of Welsh Water – which was successfully completed on 1 May 2010. Our priority for the next 5 years is to invest in the training and development of this highly skilled team of people, who are committed to high quality customer care and looking after our industry for future generations.

Affordability and value for money

Affordability will always be a top priority for Welsh Water. In 2001 Welsh Water's average bill was the second highest in the industry, but now it is close to the UK average bill. By March 2015 it will be £30 lower than March 2010, following Ofwat's final determination. We will continue to address affordability through one of the widest range of tariffs and schemes available in the industry designed to help our least well-off customers.



Managing risk

Glas Cymru cannot diversify into non-core activities, but otherwise we face the same risks as any other company in the UK utility sector.

It is a key principle of our business model that Glas Cymru cannot diversify into activities unrelated to the water and sewerage business in the region served by Welsh Water. This ensures we cannot be distracted from the single purpose for which Glas Cymru was established and also serves to contain the range of risks that we face. Many of the risk factors affecting the Company are business risks which can be mitigated by ensuring that appropriate controls are in place. However, the Company is affected by many risks outside our control which could have a material effect on our long-term performance. No company is insulated from the impact of economic recession, climate change or of a changing regulatory environment. The most important risks facing Welsh Water are described below.

Business Operations Changes

Following the decision to end arrangements for the outsourcing of the day-to-day operation and maintenance of our network of water and sewerage assets, the proportion of annual operating and capital expenditure that will be undertaken by service partners working for Welsh Water under contract through competitive tender has been significantly reduced. However, significant outsourced contracts remain in place for the design and construction of major capital investment schemes, for ICT and for customer contact and billing.

The above change was the Board's response to meeting the challenges set by a very tough price review. The move to these new arrangements involved a period of additional uncertainty and risks and arrangements were put in place to ensure that public health, staff safety, customer service and environmental performance standards did not fall. This included detailed and audited transition project plans and governance, and the successful closure of the previously outsourced contracts which enabled the TUPE transfer of staff to be completed for United Utilities Operational Services Limited and Kelda Water Services Wales Limited on 1 April 2010 and 1 May 2010, respectively. There was limited additional risk associated with the management of business systems and data as operating partners had always used Welsh Water's core systems and processes.

Regulatory risk

Regulatory risk can arise from Ofwat's price control determinations, from the requirement to comply with Ofwat's extensive data requirements and more generally from changes in the regulatory environment. The changing nature of regulatory risk was illustrated in the 2009 regulatory price review in which Welsh Water was subject to a shortfall adjustment of £12 million for failing, by only a small margin, one of the asset serviceability standards set retrospectively by Ofwat for 2005-10. In the period 2010-15 Ofwat will assess the water industry against 20 standards of serviceability.

Ofwat's Final Determination of price limits for the period 2010-15 is one of the most challenging Welsh Water has been set since privatisation – and we have the toughest efficiency targets in the sector. Furthermore, Ofwat's cost assumptions for the sector are based on benign economic conditions in which, for example, power prices and bad debts are no higher than they were in 2008-09.

Welsh Water aims to achieve this cost reduction by:

- exploiting recent large investment in new technology.
- eliminating duplication in management.
- investing in green energy processes to reduce power costs.
- a phased reduction over the next five years of around 300 in the number of staff required to deliver water and wastewater services, to be achieved by a combination of retirement, natural staff turnover and voluntary severance.

The net effect of the price review is that the Company's financial plans will be subject to greater uncertainty and so the company has decided to pursue a prudent approach to issues such as the 'customer dividend' until that uncertainty is resolved.

One significant regulatory risk was removed in December 2009 when the European Court of Justice determined that stretches of the north east Irish Sea would not be designated as 'sensitive waters' under the Urban Wastewater Treatment Directive. This means that Welsh Water will not have to extend coastal wastewater treatment works, avoiding the need for substantial investment.

A number of other regulatory risks remain. The expected transfer of private sewers to Welsh Water will increase our sewer network by more than 70%, and we judge that the condition of these private sewers is poor - below the standard of assets that the industry is generally required to operate. The Welsh Assembly Government has indicated that this transfer will take place sometime after April 2011.

The Environment Agency has indicated that Welsh Water should plan for major reductions in the volumes of water we abstract from a number of rivers, mostly in South Wales, in order to comply with the EU Habitats Directive.

Operating and financial review cont'd

These potential changes to our obligations, which together could require a very large increase in investment expenditure, are not included in our investment programme for 2010-15 and, if confirmed, may fall to be funded through an 'interim determination' of price limits or 'logged up' to be taken into account at a subsequent price review.

Welsh Water has to provide extensive data to regulators each year in respect of all aspects of our business. Failure to provide reliable, accurate and complete data would trigger regulatory sanctions and fines, and all regulatory data is subject to significant independent scrutiny and due diligence. In 2008, our process of data collation and verification was accredited to ISO 9001:2000, and this accreditation has been retained with an extended scope of service.

Ofwat has a duty to promote competition where it judges it to be in the best interests of customers, and in 2009 judicial clarification was given on an important point of principle following Ofwat's grant of an inset appointment – the appointment of a new company to supply water and sewerage services to a specific area - to a new entrant in the water industry.

Ofwat's proposal that the industry accounts for each element in the 'value chain' separately, as a possible precursor to legal separation of distinct activities, would require changes to the current legal framework. The Welsh Assembly government has indicated it will consult on the conclusions of the Cave Review of competition in water markets. Some of the Review's conclusions would, if adopted, lead to a change in the structure of the industry and have serious implications for the Company. The competitive market in Wales is currently limited to business customers using more than 250 megalitres of water per annum (50 megalitres in England) - of which Welsh Water has some 120 customers who account for around 4% of total turnover.

Operational risk

We have reassessed operational risk following the experience of the last few years where we have experienced more extreme patterns of weather, particularly storms and periods of prolonged freezing conditions. Wales is currently one of the least constrained parts of the UK in terms of water resources (subject to the regulatory risk to abstraction licence review referred to above), but customers in our region are not immune from the effects of periods of drought.

More generally, operational risk is varied and may include:

- the impact of major operational incidents on public health, environmental quality or customer service, whether arising from equipment failure, from natural events - such as 'acts of God' or more extreme weather events as a possible consequence of climate change.
- changes in environmental, consumer protection and public health and safety law and regulation, which typically require ever higher standards of performance.
- the health and safety risk associated with the operation of a large and complicated network of water and sewerage assets
- the risk of losing and failing to recruit key people in Welsh Water to ensure we have the competencies and experience needed to meet our long-term obligations.
- the changes associated with our programme of IT-enabled change which is upgrading old IT systems and introducing simplified and more robust business processes. The Board has approved policies and operational strategies to mitigate each of the risks to the reputation, operating results and financial position of Welsh Water. Business risk is also mitigated by the availability and terms of insurance - covering property, business interruption, public liability, environmental pollution and employer's liability.

Financial risk

Welsh Water is exposed to a number of financial risks, many of which are heightened at a time of economic recession. These include:

- revenue risk, such as a reduction in metered demand and the loss of large business customers.
- the collection of customer charges and non-recovery of customer debt.
- external cost pressures, such as changes in the price of chemicals or power pricing.
- deflation and the impact on both revenues and regulatory asset value from a negative Retail Prices Index.
- access to capital markets while the business needs to finance a continuing large capital investment programmes and to refinance some existing debts.

The overall financial risk is that Glas Cymru may not be able to finance the operating and capital investment obligations of Welsh Water, which continue to be financed from cash flow from operations – in other words, customers' bills - and the raising of finance from the capital markets. Under our funding arrangement we are required to ensure that the business has sufficient committed facilities available to meet at least 12 months anticipated net cash requirement.

Financial risk is mitigated in three ways:

- the group's financial position at 31 March 2010 shows a significant balance of cash and undrawn borrowing facilities available, which gives the business a high degree of liquidity.
- following the successful £140 million bond issue in March 2010, Welsh Water has funding for its investment programme for substantially the whole of the next five-year regulatory period.
- the impact of deflation is mitigated by the high proportion of index-linked debt issued by the Company.

Operating and financial review cont'd

Definition, purpose and target for each KPI

| Measure | Purpose | Source | Target | Progress to Target |
|---|---|--|--|--------------------|
| Overall bacteriological water quality Strategy: Customer service | An important measure of the quality of water supplied to customers is compliance with bacteriological standards. There is also a correlation between failures in bacteriological quality and unsatisfactory water supplied to customers. This measure is not a component of Ofwat's OPA index. | Drinking Water Inspectorate | 100% of all assets compliant. We achieved 99.77% compliance in 2008-09. | X |
| Customer satisfaction Strategy: Customer service | Since 2001 the Board has monitored customer satisfaction with the services provided by Welsh Water via a six monthly customer opinion survey undertaken by Beaufort Research. Although customer opinion can be influenced (often adversely) by media coverage of events elsewhere in the UK water industry, this is an important indicator of the company's progress. | Beaufort Research | To maintain consistent high level of customer satisfaction. This has been maintained in 2008-09. | ✓ |
| Health and safety (Accident Incident Rate – AIR) Strategy: Occupational health and safety | AIR is a statistical index used by the Health and Safety Executive (HSE) to benchmark company and sector relative performance. It is the number of reportable incidents occurring in a reported period per 100,000 employees. | June Return | To have one of the best AIR of the UK's water and sewerage companies and to compare favourably with appropriate HSE benchmark for AIR. This target was achieved in 2008-09. | ✓ |
| Bond credit rating Strategy: Financing | A direct way of further reducing Welsh Water's financing cost is to improve the credit rating of the group's corporate bonds. Executive directors are incentivised to maintain bond ratings. | Rating agencies apply their own definition and methodology in assessing bond credit rating. Bond ratings are independently determined by three rating agencies: Standard & Poor's, Moody's and Fitch Lovell. | Corporate credit rating of 'A' grade. This was maintained in 2008-09 | ✓ |
| Customer Dividend Strategy: Customer value | As well as improving credit quality, financing efficiency is used to build up reserves to insulate Welsh Water and its customers from unexpected costs and to have scope to return money to customers through sustained 'customer dividends'. Through the 'customer dividend', therefore, the customers of Welsh Water share in the success of the business. | Glas Cymru Audited Accounts | Progressive 'customer dividend' policy. This has been maintained – the 'customer dividend' was increased to £21 in 2008-09 (2007-08: £20). It was further increased to £22 for the financial year that commenced on 1 April 2009. | ✓ |
| Gearing Strategy: Financing | The Glas Cymru business model aims to reduce Welsh Water's asset financing cost, the industry's single biggest cost. Improved credit quality is key to keeping Welsh Water's cost of finance as low as possible. Gearing is the ratio of Net Debt to Regulatory Capital Value of Welsh Water. | Glas Cymru Investor Report | To reduce gearing to around 70%. At 31 March 2009 gearing was 72% (2008: 72%). | ✓ |
| Interest cover Strategy: Financing | Meeting interest cover covenants is key to maintaining investor confidence and to keeping Welsh Water's cost of finance as low as possible. Interest cover is the ratio of operating cashflow (before maintenance) to net interest (excluding indexation). | Glas Cymru Investor Report | To maintain interest cover consistent with target credit rating. This has been maintained in 2008-09. | ✓ |
| Overall Performance Assessment (OPA) Strategy: Customer service | OPA is the measure published by Ofwat of each company's overall delivery of service to customers. It reflects a broad range of services provided to customers across key areas of water supply, sewerage service, security of supply, customer service and environmental impact. | Ofwat | Upper quartile performance relative to the ten water and sewerage companies in England and Wales. We believe this has been achieved in 2008-09 in which we scored 406 OPA points. | ✓ |

The measures of performance reported on page 5 derive from Welsh Water's annual regulatory report to Ofwat (the "June Return") and are measures defined and monitored by Ofwat, the Drinking Water Inspectorate or the Environment Agency. An Overview of the latest June Return is available on request or from our website www.dwrcymru.com.

Directors' pay and standards of performance

Welsh Water is the only trading company of the Glas Cymru Group. The Directors of Welsh Water are also Directors of Glas Cymru. Directors' service contracts, pay and incentive arrangements are set by Glas Cymru's Remuneration Committee. The role of the Remuneration Committee is to approve, implement and keep under review the remuneration policy and practice.

Remuneration Policy

The Committee considers the principles and provisions of The Combined Code on Corporate Governance - June 2008 ('the Combined Code') when setting the policy and terms for senior executive remuneration and believes it is fully compliant. The Committee also considers the remuneration structures (strategy, policy and approach) across the Group as a whole and to any broader social, environmental and governance issues.

The aim of the remuneration policy, which is broadly consistent for employees, is to support recruitment, retention and motivation and reward high performance – thereby ensuring that the business is managed by high calibre executives who are incentivised to produce sector-leading performance. The policy is designed to align as closely as practicable the interests of the individual with the longer-term interests of the business and, especially, the interests of the customers of Welsh Water. A high proportion of Executive Directors' remuneration is variable and dependent on Welsh Water's performance in terms of protecting public health, protecting the environment and customer service.

The executive remuneration package comprises four elements: base salary and benefits; two elements of variable pay - an annual incentive and a longer term performance related incentive; and a pension.

The general remuneration policy applies to Executive Directors and to the senior leadership team and has been founded on the following principles:

- when setting levels of pay the Remuneration Committee exercises judgement such that, having regard to an individual's experience and responsibility, total remuneration shall be fair and competitive when compared to the relevant market and the organisation generally;
- salary is the only element of total remuneration that is pensionable and is reviewed annually;
- Ofwat and other stakeholders judge the success of the business against water and environmental quality, customer service standards and financial performance - and these are the hard auditable and comparable performance criteria and determinants that underpin the remuneration policy;
- the remuneration policy shall reflect the intention of the Board that Welsh Water should be one of the best performing companies in the sector - a significant proportion of the Directors' remuneration should therefore be variable and dependent on the achievement of stretching performance targets that ensure that the interests of management are aligned with the longer term objectives of the Board and Welsh Water's customers;
- annual variable pay will have a strong focus on operating efficiency and service standards measured against absolute (not relative) targets set by the Committee; and
- there will be a claw back of variable rewards (including long term variable pay) where rewards are made on the basis of performance that subsequently proves to be misstated.

When setting remuneration, the Remuneration Committee is advised by HNBS in respect of remuneration policy in the UK water companies (both quoted and unquoted) taking into account, amongst others, turnover and business complexity (e.g. regulatory versus non regulatory business and international exposure) of the comparator companies. In addition, reference is made to remuneration practice in the FTSE 250. The Committee may also have regard to a Director's function and job size and to individual and company performance.

As explained at last year's Annual General Meeting, the Committee has reviewed the remuneration policy and has made some material changes to the chosen performance metrics that will apply during the new AMP. Accordingly the next two sections of this report describe the variable pay arrangements that applied during 2009-10 and then a description is given of the revised remuneration policy that is in place for 2010-11.

Annual variable pay in 2009-10

In 2009-10, the maximum annual variable pay payable was 100 percentage points of base salary ('PPBS'), with payment of the maximum available amount divided across three components: customer service performance (40 PPBS), financial performance (40 PPBS) and performance against four specific operational measures (20 PPBS, 5 PPBS per measure).

The customer service component is determined with reference to the 'Overall Performance Assessment' ('OPA') published by Ofwat. 40 PPBS would be earned for achieving 1st position in the OPA ranking of the ten water and sewerage companies of England and Wales ('OPA League Table'), and 8 PPBS (20% of the maximum for this element) would be payable for achieving median performance, being the average score of the 5th and 6th ranked companies, with ranking above this (but not below) rewarded on a linear scale.

Directors' pay and standards of performance cont'd

The OPA includes non-financial performance measures for:

- water supply: including drinking water quality compliance, interruptions to supply and restrictions on supply;
- sewerage measures: including sewage flooding incidents and a quality of effluent discharges to the environment that meets legal and regulatory standards; and
- customer service performance: including speed of response to telephone and written billing enquiries and handling of written complaints.

At the discretion of the Committee, this element of variable pay may be adjusted up or down by up to 10 PPBS to reflect identifiable and significant aspects of customer service performance not captured by OPA. In November 2009 the Committee reduced the amount payable in respect of the financial year 2008-09 by 5 PPBS to reflect the higher number of water quality incidents experienced by Welsh Water in 2008.

The financial component of the annual performance related variable pay was based on net cash flow (before capital expenditure but after net interest payable) and can earn up to 40 PPBS. Performance is rewarded on a linear scale from zero for meeting the annual cash flows in the regulatory settlement for 2005-10 announced by Ofwat in December 2004 (the 'Final Determination'), 25 PPBS (62.5% of maximum for this element) and 40 PPBS for reaching the respective target and maximum levels approved by the Committee. To achieve target level payment requires that Welsh Water outperform the Final Determination.

The specific operational measures are determined by the Committee on an annual basis and are structured as absolute measures and as such dependent on improved performance by Welsh Water, and not simply good relative performance. The Committee set challenging targets to be met to earn this element of variable pay with no amount being payable for performance at or below performance in 2008-09 and (except for measure (a) below) to earn maximum payment would have required performance equal to the best performance in the sector.

The measures and targets selected by the Committee for 2009-10 were:

- (a) Avoidable customer complaints, being complaints that relate to a service failure by Welsh Water, which shall not include complaints as regards matters of Board policy or activity relating to the collection of customer charges.
- (b) Sewer flooding attributed to 'other causes' - i.e. other than due to hydraulic overload of the sewer network.
- (c) Category 3 pollution incidents. Any environmental damage is a concern and all of these less significant pollution events are investigated as a 'near-hit' for a significant event to ensure that lessons are learned.
- (d) The Operational Performance Index ('OPI'): is the Drinking Water Inspectorate index used by Ofwat as a measure to assess overall drinking water quality.

Annual performance-related bonus payments

The 2009-10 Accounts include an accrual of £227,040 (equivalent to 34.4 PPBS) reflecting the Committee's current estimate of Welsh Water's relative performance for the year ended 31 March 2010. The first element of annual variable pay will be paid in June 2010 and the Committee will make its assessment of amounts payable in respect of service performance for 2009-10 in the Autumn 2010, following publication by Ofwat of its annual Levels of Service Report. The estimated amounts payable to each Executive Director are:

| | |
|--------------|---------|
| Nigel Annett | £89,440 |
| Chris Jones | £70,520 |
| Peter Perry | £67,080 |

Rolling Long Term Incentive Scheme in 2009-10

2009-10 was the final year in which awards could be made under the longer-term incentive scheme introduced on 1 April 2005 (the 'RLTIS'). Five annual awards have been made under the RLTIS. The maximum amount payable under RLTIS in 2009-10 is 60 PPBS, with 30 PPBS (50% of the maximum) being payable for reaching 'target' performance. This is divided equally between customer service and financial performance components.

Payments will normally be made within 9 months of the end of the final year to which they relate, but payment may be deferred at the discretion of the Committee in the event that there is a significant deterioration in performance. Deferral may be for up to 2 years, or until the shortfall has been remedied, whichever is the earlier. In addition, payment of up to 20 PPBS will be deferred in the event that the underlying rating of any of the Company's bonds have been put on 'credit watch' by any of the Rating Agencies, either until taken off 'credit watch' or until they have been downgraded, in which case the 20 PPBS shall be forfeited.

Directors' pay and standards of performance cont'd

The customer service component is determined with reference to Welsh Water's position in an adjusted OPA League Table, compiled by aggregating OPA scores for each of the last 3 years up to and including the relevant year of assessment. This will be payable on a sliding scale of 100% (30 PPBS) for achieving 1st position, 75% for 2nd, 50% for 3rd, 25% for 4th and zero for being ranked 5th or below of the 10 comparator companies.

The financial performance component is based on 'Financial Reserves' (Regulatory Capital Value less net debt) as at 31 March 2010, as defined for the purposes of the quarterly Investor Report routinely published by the Company. For the period 2005-2010, growth in Financial Reserves was considered the best financial measure of customers' interest in the business, as it is from Financial Reserves that the 'customer dividend' and additional investment to deliver service improvements has been funded.

Under RLTI, the target range for 2009-10 was set 3 years ago, subject to consideration by the Committee of circumstances that might, at the discretion of the Committee, require the target range to be revised. These include: (a) where there are differences between actual inflation and the assumptions originally made; (b) where the Board modified relevant policy after the original forecast was made; and (c) where there is any other material influence on Financial Reserves not originally foreseen and which the Committee determines to be outside the control of Executive Directors. Amounts payable for 2009-10 will be measured by reference to a lower limit, the Final Determination for the period 2005-2010, at which no payment will be earned, a target level at which 50% of maximum will be earned and an upper limit, set by the Committee, at which maximum payment will be earned. To achieve target level payment therefore requires that Welsh Water outperform the Final Determination.

The Committee may also, at its discretion, adjust any payment calculation up or down to reflect events or factors that are not captured by the formulae described above, providing that justification for any such adjustment is disclosed in the next annual remuneration report.

Rolling long-term incentive scheme payments

The 2009-10 Financial Statements include an accrual of £152,460 (equivalent to 23.1 PPBS) reflecting the Committee's current estimate of Welsh Water's relative performance for the three-year period ended 31 March 2010. The Committee will make its final assessment of amounts payable under the RLTI for 2009-10 in the Autumn 2010 following publication by Ofwat of its Levels of Service Report for the year.

| | |
|--------------|---------|
| Nigel Annett | £60,060 |
| Chris Jones | £47,355 |
| Peter Perry | £45,045 |

Remuneration policy for 2010-11

The Committee has agreed that a new framework for variable pay is needed to reflect the regulatory contract that Welsh Water is required to deliver in the five year regulatory period ending on 31 March 2015, which is the most challenging the Company has been set since the industry was privatised in 1989. Under Ofwat's Final Determination the average bill for Welsh Water's water and sewerage customers will reduce over the period to 31 March 2015 by around £30 (before inflation). To deliver this level of bill reduction Welsh Water would need to significantly reduce those operating costs that can be managed or influenced by management ('controllable costs') by around 20%, whilst at the same time (i) improving customer service performance; (ii) meeting new serviceability targets set out in the Final Determination which are also very challenging; and (iii) delivering a £1.2 billion capital investment programme, which includes a number of 'named outputs'.

Directors' pay and standards of performance cont'd

The following table summarises the new remuneration policy for the executive directors:

| Element of remuneration | Purpose | Policy | How it works |
|--|---|--|--|
| Base salary | Help recruit and retain key employees Reflect individual role/experience | Recognise individual experience/responsibility Set at level so total pay is fair relative to market and organisation generally | Paid monthly (cash) Reviewed annually Nominal benefits in kind Any increases to be reflective of staff pay |
| Pension | Reward sustained contribution | Provide competitive post retirement benefits No compensation for public policy/tax changes | Competitive defined benefits pension scheme Benefits accrue relative to length of service at retirement Remuneration Committee reviewing alternatives for directors in response to tax changes |
| Annual variable pay (for 2010-2011) | Incentivise delivery of specific predetermined goals Reward ongoing good stewardship of business Promote team culture | 3 elements (40% new dashboard – see below; 40% operating cost efficiency - 20% strategic and personal measures Maximum of 100% base salary Remuneration Committee has discretion to adjust (range - 10% to +10%) to give a fair result | Paid annually (cash) Measured vs. annual targets set by Remuneration Committee Subject to claw-back if found to be flawed |
| Long term variable pay scheme (for 2010-2015) | Incentivise long term performance/ business outcomes aligned to interest of Welsh water's customers | Half subject to relative customer service performance; annual awards of up to 30% of salary to be made Half subject to creation of customer equity in excess of business plan; a one off award of up to 150% of salary phased across five years | Paid in phased annual instalments (cash) Customer service measured annually on a relative basis across 3 years Customer equity measured over the 5 year regulatory period (2010-2015) |

The total variable pay opportunity for the new regulatory period has not been increased, but as shown above changes have been made to some of the metrics upon which it will be assessed. The most radical change has been to the annual plan where relative OPA has been replaced with a new corporate 'dashboard' of 20 measures based around six groupings:

1. Our own wellbeing
2. Safe drinking water
3. Safe sanitation
4. Protecting our environment
5. Brilliant customer service
6. Delivering cost efficiency

This dashboard of measures will apply across the organisation, from executive director to operator level. This should promote a team culture, create organisational alignment as well as demonstrate our performance assessment in a clear and concise manner.

The Committee has agreed and has put in place a new long term variable pay scheme, which, while capable of revision at any time, is intended to operate for a five year period commencing on 1 April 2010 (the 'LTVPS').

Directors' pay and standards of performance cont'd

Remuneration: Chairman and Non-Executive Directors

Responsibility for determining the fees of the Chairman of the Board and of the Non-Executive Directors sits with the Committee and with the Board respectively. These fees are reviewed annually. There was no change in the fees of the Chairman and the Non-Executive Directors in 2009-10 as the Remuneration Committee wished to set a clear example in the economic conditions that prevailed at that time.

Following a 2 year benchmark review undertaken in February 2010, the fees payable for the financial year 2010-11 are:

- o Chairman £196,000 (2009: £190,000)
- o Non-Executive Directors £ 54,000 (2009: £52,500)

No additional amount is payable to the Chairman or any Non-Executive Director for the chairmanship of, or membership of, Board Committees or for the undertaking of any special responsibilities. The Chairman and the Non-Executive Directors are appointed under letters of appointment, terminable by either party on 3 months' written notice.

Remuneration: Executive Directors

Consistent with the decision of the Committee in respect of the Chairman's fees, the salaries of the Executive Directors for 2009-10 were unchanged from the previous year.

Following a 2 year benchmark review undertaken in February 2010, the base salaries payable for the financial year 2010-11 are:

| | |
|--------------|---------------------------|
| Nigel Annett | £268,000 (2009: £260,000) |
| Chris Jones | £211,000 (2009: £205,000) |
| Peter Perry | £201,000 (2009: £195,000) |

There are 9 executives, for who the remuneration policy is broadly consistent with that followed for executive directors, whose basic salary exceeds £100,000.

Licence condition F6A certificate

Extract of minutes of a meeting of Directors held at the Dŵr Cymru Cyfyngedig Office, Cardiff Wastewater Treatment Works on 4 June 2010.

Approval of the Regulatory Accounts for the year ended 31 March 2010

The Regulatory Accounts of the Company for the year ended 31 March 2010 were tabled and discussed. IT WAS RESOLVED that they be and are hereby approved.

The Secretary was asked to send to the Water Services Regulation Authority a certificate in accordance with Condition F Paragraph 6A.2A of the Instrument of Appointment (as amended) as follows:-

Directors' certificate on the protection of the appointed business

THAT in the opinion of the Directors, the Company will have available to it sufficient financial resources and facilities to enable it to carry out, for at least the next twelve months, the Regulated Activities (including the investment programme necessary to fulfil the Company's obligations under the Instrument of Appointment);

THAT in the opinion of the Directors, the Company will, for at least the next twelve months, have available to it management resources which are sufficient to enable it to carry out the Regulated Activities (including the investment programme necessary to fulfil the Company's obligations under the Instrument of Appointment);

THAT in the opinion of the Directors, the Company will, for at least the next twelve months, have available to it systems of planning and internal control which are sufficient to enable it to carry out its Regulated Activities (including the investment programme necessary to fulfil the Company's obligations under the Instrument of Appointment);

THAT in the opinion of the Directors, all contracts entered into with any associated company include all the necessary provisions and requirements concerning the standards of services to be supplied by the company, to ensure that it is able to meet all its obligations as a water and sewerage undertaker; and

THAT in the opinion of the Directors, the Company has sufficient rights and assets to comply with the requirements of paragraph 3.1 of Condition K of the Licence.

The following factors have been taken into account by Directors in giving this declaration:

- a) The financial strength of the Company and the management and other resources available to the Company as recorded in the Regulated Accounts for the year ended 31 March 2010;
- b) The bond programme of financing implemented by Dŵr Cymru (Financing) Limited, an associate company, inter alia, to provide future financing for the Company (including the investment programme necessary to fulfill the Company's obligations under the Instrument of Appointment);
- c) The termination of the outsourced contracts for operational services and the Company's plans for the integration of these services into a single business;
- d) The outcome of the 2009 regulatory price review for the five year period to 31 march 2015 and its impact on the Company's business plans;
- e) The results from the ongoing monitoring of financial, operational and compliance controls and the risk management process reported to the board via four formal committees; the Audit Committee, the Remuneration Committee, the Nominations Committee and the Quality and Environment Committee. The group's internal audit function has carried out a programme of work, which incorporates a review of the control environment;
- f) The Board has reviewed the effectiveness of internal controls in compliance with the requirements of the Combined Code; and
- g) The Undertaking that Glas Cymru Cyfyngedig ("Glas Cymru") has given following the acquisition of the Company, in which Glas Cymru confirms that it (and each of its subsidiaries other than the Company) will:-
 - Provide the Company with all such information as may be necessary to enable the Company to comply with the requirements of the conditions of Appointments, or such additional information as the Director may reasonably require about their activities and the financing of them;
 - Refrain from any action which would or may cause the Company to breach any of its obligations under the Act or conditions of Appointments;

Licence condition F6A certificate cont'd

- Ensure that at all times the Board of the Company contains a majority of non-executive directors;
- Comply with the Principles of Good Governance and Code of Best Practice (or any successor document having a similar purpose or intent) as may from time to time be appended to or approved for the purposes of the Listing Rules of the UK Listing Authority; and
- Not make any changes to their respective Memorandum and Articles of Association without the consent of the Director.

THAT in the opinion of Directors, the company has sufficient rights and assets to comply with the requirements of paragraph 3.1 of Condition K of the Licence.

Disclosure of transactions with associates

There were no transactions with any associated companies except for:

- The directors of Dŵr Cymru Cyfyngedig are also directors of other companies within the Glas Cymru group. However, the emoluments of the directors are paid in full by Dŵr Cymru Cyfyngedig as their activities are predominantly related to the regulated water and sewerage business. During the year the directors' emoluments amounted to £1,416,344 (2008-09: £1,335,369).
- Debtors include a loan to the Company's immediate parent company, Dŵr Cymru (Holdings) Limited, of £370.5 million (2009: £370.5m). The interest rate on this loan is 12%. Loan interest of £44.6 million (2009: £44.6m) has been waived by the company during the year. The interest waiver is a practical alternative to funding the interest otherwise receivable by the company by means of an ordinary dividend.
- The proceeds of the group's bond programme have been on-lent to Dŵr Cymru Cyfyngedig under an intercompany loan agreement. Under the terms of this agreement, the interest rates payable by the company are based on the interest rates payable to the bondholders, after taking into account interest rate and currency swaps, plus a margin of 0.01%

Certified a true copy

R G Curtis LLB ACIS
Company Secretary

21 June 2010

Report on procurement activities

Under paragraph 9 of Condition F1 of the Welsh Water Licence, the Company is required to submit to Ofwat each year a written report on its procurement activities.

Welsh Water has undertaken a limited amount of procurement in the period April 2009 to March 2010. The majority of our requirements are covered under contracts established during 2005 and 2006. These include contracts for operational services with United Utilities Operational Services and Kelda Water Services Wales; capital investment services with Laing O'Rourke, Costain, MorganEst, Morrison, Imtech and Black and Veatch; billing and income services with Veolia; IT services with Tata Services, Capgemini UK plc, Logica, laboratory and analysis services with Severn Trent Laboratories Ltd and network development consultancy services with Hyder Consulting UK Ltd. These contracts cover the provision of the vast majority of the external services required by DCWW.

During the past year Welsh Water undertook an extensive process of review and re-negotiation of the operations contracts and this has resulted in the conclusion of the contracts with United Utilities Operational Services and Kelda Water Services and the activities have been re-integrated within Dwr Cymru. In line with the provisions of the asset investment contracts we also undertook a detailed review and re-negotiation with our existing contractors. The framework arrangements were extended until 2015 with MorganEst, Costain, Morrisons, Laing O'Rourke, Black and Veatch and Imtech. Similarly Welsh Water has extended the leakage services contract with RPS until 2015.

Other Procurement activities

In addition to managing the main outsourced arrangements Welsh Water has also carried out procurement activity relating to the following areas:

- Market research
- Insurance of the capital programme
- Office stationery
- Office furniture and fit out
- Security
- Small tools
- H&S vendor assessment
- IT benchmarking
- Efficiency modelling

Directors' responsibilities for the regulatory accounts

The Directors are required by the terms of the Instrument of Appointment to prepare regulatory accounts for each financial year in accordance with Condition F of the Instrument of Appointment and the Regulatory Accounting Guidelines. In preparing the regulatory accounts, the Directors ensure that appropriate accounting policies have been adopted and applied consistently, that applicable accounting standards have been followed and that reasonable and prudent judgements and estimates have been made.

It is the Directors' responsibility to maintain adequate accounting records and to institute and maintain systems and controls designed to safeguard the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board

R G Curtis LLB ACIS
Company Secretary

21 June 2010

Independent auditors' report to the Water Services Regulation Authority and Directors of Dŵr Cymru Cyfyngedig

We have audited the regulatory accounts of Dŵr Cymru Cyfyngedig ('the company') on pages 33 to 78 which comprise:

- the regulatory historical cost accounting statements comprising the regulatory historical cost profit and loss account, the regulatory historical cost balance sheet, the regulatory historical cost statement of total recognised gains and losses, the historical cost cash flow statement and the related notes to the historical cost financial statements including the statement of accounting policies and the historical cost reconciliation between statutory and regulatory accounts; and
- the regulatory current cost accounting statements for the appointed business comprising the current cost profit and loss account, the current cost balance sheet, the current cost statement of total recognised gains and losses, the current cost cash flow statement and the related notes to the current cost financial statements including the statement of accounting policies.

This report is made, on terms that have been agreed, solely to the company and the Water Services Regulation Authority ('the WSRA') in order to meet the requirements of Condition F of the Instrument of Appointment granted by the Secretary of State for the Environment to the company as a water and sewerage undertaker under the Water Industry Act 1991 ('the Regulatory Licence'). Our audit work has been undertaken so that we might state to the company and the WSRA those matters that we have agreed to state to them in our report, in order (a) to assist the company to meet its obligation under the company's Instrument of Appointment to procure such a report and (b) to facilitate the carrying out by the WSRA of its regulatory functions, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the WSRA for our audit work, for this report or for the opinions we have formed.

Basis of preparation

The regulatory accounts have been prepared in accordance with Condition F of the Appointment and the Regulatory Accounting Guidelines, the accounting policies set out in the statement of accounting policies and, in the case of the regulatory historical cost accounting statements, under the historical cost convention.

The regulatory accounts are separate from the statutory financial statements of the company. There are differences between United Kingdom Generally Accepted Accounting Principles ('UK GAAP') and the basis of preparation of information provided in the regulatory accounts because the Regulatory Accounting Guidelines specify alternative treatment or disclosure in certain respects. Where the Regulatory Accounting Guidelines do not specifically address an accounting issue, then they require UK GAAP to be followed. Financial information other than that prepared wholly on the basis of UK GAAP may not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 2006.

Respective responsibilities of the WSRA, the directors and auditors

The nature, form and content of regulatory accounts are determined by the WSRA. It is not appropriate for us to assess whether the nature of the information being reported upon is suitable or appropriate for the WSRA's purposes. Accordingly we make no assessment.

The directors' responsibilities for preparing the regulatory accounts in accordance with Regulatory Accounting Guidelines are set out in the statement of directors' responsibilities for regulatory information on page 29.

Independent Auditors' report to the Water Services Regulation Authority and the Directors of Dŵr Cymru Cyfyngedig cont'd

Our responsibility is to audit the regulatory accounts in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board, except as stated in the 'Basis of audit opinion' below, and having regard to the guidance contained in Audit 05/03, 'Reporting to Regulators of Regulated Entities'.

We report to you our opinion as to whether the regulatory historical cost accounting statements present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of the appointee and its appointed business in accordance with the company's Instrument of Appointment and Regulatory Accounting Guideline 2.03 (Guideline for the classification of expenditure), Regulatory Accounting Guideline 3.06 (Guideline for the contents of regulatory accounts) and Regulatory Accounting Guideline 4.03 (Guideline for the analysis of operating costs and assets); and whether the regulatory current cost accounting statements on pages 66 to 78 have been properly prepared in accordance with Regulatory Accounting Guideline 1.04 (Guideline for accounting for current costs and regulatory capital values), Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03. We also report to you if, in our opinion, the company has not kept proper accounting records as required by paragraph 3 of Condition F and whether the information is in agreement with the appointee's accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03.

We read the other information contained in the regulatory accounts, including any supplementary schedules on which we do not express an audit opinion, and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the regulatory accounts. The other information comprises the operating and financial review, the notes on regulatory information and the additional information required by the company's Regulatory Licence.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board, except as noted below. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the regulatory accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the regulatory accounts, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the regulatory accounts are free from material misstatement, whether caused by fraud or other irregularity or error. However, as the nature, form and content of regulatory accounts are determined by the WSR, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under International Standards on Auditing (UK and Ireland).

Our opinion on the regulatory accounts is separate from our opinion on the statutory financial statements of the company on which we report, which are prepared for a different purpose. Our audit report in relation to the statutory accounts of the company (our 'statutory' audit) was made solely to the company's members, as a body, in accordance with sections 495, 496 and 497 of the Companies Act 2006. Our statutory audit work was undertaken so that we might state to the company's members those matters we are required to state to them in a statutory auditors' report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the company and the company's members as a body for our statutory audit work, for our statutory audit report, or for the opinions we have formed in respect of that statutory audit.

The regulatory historical cost accounting statements on pages 33 to 65 have been drawn up in accordance with Regulatory Accounting Guideline 3.06 in that infrastructure renewals accounting as applied in previous years should continue to be applied and accordingly that the relevant sections of Financial Reporting Standards 12 and 15 be disappplied. The effect of this departure from Generally Accepted Accounting Principles, and a reconciliation of the balance sheet drawn up on this basis to that drawn up in the statutory accounts under International Financial Reporting Standards and the Companies Act 2006, is given on pages 64 to 65.

Independent Auditors' report to the Water Services Regulation Authority and the Directors of Dŵr Cymru Cyfyngedig cont'd

Opinion

In our opinion the regulatory accounts of the company for the year ended 31 March 2010 fairly present, in accordance with Condition F of the Instrument of Appointment granted by the Secretary of State for the Environment to the company as a water and sewerage undertaker under the Water Industry Act 1991, the Regulatory Accounting Guidelines issued by the WSRA and the accounting policies set out on pages 43 to 48 and 70, the state of the company's affairs at 31 March 2010 on an historical cost and current cost basis, the historical cost and current cost profit for the year and the historical and current cost cash flow for the year and have been properly prepared in accordance with those conditions, guidelines and accounting policies.

In respect of this information we report that, in our opinion:

- proper accounting records have been kept by the appointee as required by paragraph 3 of Condition F of the Instrument;
- the information is in agreement with the appointee's accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA;
- the regulatory historical cost accounting statements on pages 33 to 65 present fairly, under the historical cost convention, the revenues and costs, assets and liabilities and cash flows of the appointee and its appointed business in accordance with the company's Instrument of Appointment and Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA; and
- the regulatory current cost accounting statements on pages 66 to 78 have been properly prepared in accordance with Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors

21 June 2010

1. The maintenance and integrity of the company website is the responsibility of the company and the maintenance and integrity of the Regulator's web site is the responsibility of the WSRA; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the regulatory accounts since they were initially presented on the websites.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements and regulatory accounts may differ from legislation in other jurisdictions.

Historical cost financial statements and accompanying notes
for the year ended 31 March 2010

Historical cost profit and loss account for the year ended 31 March 2010

| | Note | 2010 £m | 2009 £m |
|--|------|---------------|--------------|
| Turnover | 3a | 688.2 | 657.2 |
| Operating costs: | | | |
| Before exceptional items | 4 | (430.1) | (428.2) |
| Exceptional items | 4 | <u>(29.5)</u> | <u>-</u> |
| | | (459.6) | (428.2) |
| Operating profit | | <u>228.6</u> | <u>229.0</u> |
| Loss on disposal of fixed assets | 6 | (0.4) | (0.8) |
| Profit on ordinary activities before interest | | <u>228.2</u> | <u>228.2</u> |
| Interest payable | 7a | (107.1) | (174.8) |
| Interest receivable | 7a | 3.4 | 8.6 |
| Other finance (expense)/income | 7b | <u>(0.3)</u> | <u>0.2</u> |
| | | (104.0) | (166.0) |
| Profit on ordinary activities before taxation | 3b | 124.2 | 62.2 |
| Current taxation | 8 | 1.7 | - |
| Deferred taxation | 8 | <u>(2.5)</u> | <u>14.6</u> |
| | | (0.8) | 14.6 |
| Profit on ordinary activities after taxation | | 123.4 | 76.8 |
| Dividends on ordinary shares | | - | - |
| Retained profit for the year | | <u>123.4</u> | <u>76.8</u> |

All operations are continuing.

Historical cost statement of total recognised gains and losses for the year ended 31 March 2010

| | Note | 2010 £m | 2009 £m |
|---|------|--------------|-------------|
| Profit for the year | | 123.4 | 76.8 |
| Actuarial loss recognised in the pension scheme | 27 | (1.5) | (10.4) |
| Movement on deferred tax asset relating to pension scheme | 8 | <u>(0.1)</u> | <u>2.9</u> |
| Net loss recognised directly in equity | | (1.6) | (7.5) |
| Total recognised gains for the year | | <u>121.8</u> | <u>69.3</u> |

Historical cost profit and loss account for the year ended 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2010.

| | Appointed business 2010 £m | Non- appointed business 2010 £m | Total 2010 £m |
|--|-------------------------------------|---|---------------------|
| Turnover | 681.8 | 6.4 | 688.2 |
| Operating costs | (289.2) | (6.0) | (295.2) |
| Historical cost depreciation | (164.4) | - | (164.4) |
| Other expense | (0.4) | - | (0.4) |
| Operating profit | 227.8 | 0.4 | 228.2 |
| Interest payable | (107.1) | - | (107.1) |
| Interest receivable | 3.2 | 0.2 | 3.4 |
| Other finance expense | (0.3) | - | (0.3) |
| | (104.2) | 0.2 | (104.0) |
| Profit on ordinary activities before taxation | 123.6 | 0.6 | 124.2 |
| Current taxation | 1.7 | - | 1.7 |
| Deferred taxation | (2.5) | - | (2.5) |
| | (0.8) | - | (0.8) |
| Retained profit for the year | 122.8 | 0.6 | 123.4 |

Historical cost statement of total recognised gains and losses for the year ended 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2010.

| | Appointed business 2010 £m | Non- appointed business 2010 £m | Total 2010 £m |
|---|-------------------------------------|---|---------------------|
| Profit for the year | 122.8 | 0.6 | 123.4 |
| Actuarial loss recognised in the pension scheme | (1.5) | - | (1.5) |
| Movement on deferred tax asset relating to pension scheme | (0.1) | - | (0.1) |
| Net loss recognised directly in equity | (1.6) | - | (1.6) |
| Total recognised gains for the year | 121.2 | 0.6 | 121.8 |

Historical cost profit and loss account for the year ended 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2009.

| | Appointed business 2009 £m | Non- appointed business 2009 £m | Total 2009 £m |
|--|-------------------------------------|---|---------------------|
| Turnover | 650.4 | 6.8 | 657.2 |
| Operating costs | (260.3) | (6.5) | (266.8) |
| Historical cost depreciation | (161.4) | - | (161.4) |
| Other income | (0.8) | - | (0.8) |
| Operating profit | 227.9 | 0.3 | 228.2 |
| Interest payable | (174.8) | - | (174.8) |
| Interest receivable | 7.3 | 1.3 | 8.6 |
| Other finance income | 0.2 | - | 0.2 |
| | (167.3) | 1.3 | (166.0) |
| Profit on ordinary activities before taxation | 60.6 | 1.6 | 62.2 |
| Current taxation | - | - | - |
| Deferred taxation | 14.6 | - | 14.6 |
| | 14.6 | - | 14.6 |
| Retained profit for the year | 75.2 | 1.6 | 76.8 |

Historical cost statement of total recognised gains and losses for the year ended 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2009.

| | Appointed business 2009 £m | Non- appointed business 2009 £m | Total 2009 £m |
|---|-------------------------------------|---|---------------------|
| Profit for the year | 75.2 | 1.6 | 76.8 |
| Actuarial loss recognised in the pension scheme | (10.4) | - | (10.4) |
| Movement on deferred tax asset relating to pension scheme | 2.9 | - | 2.9 |
| Net loss recognised directly in equity | (7.5) | - | (7.5) |
| Total recognised gains for the year | 67.7 | 1.6 | 69.3 |

Historical cost balance sheet at 31 March 2010

| | Note | 2010 £m | 2009 £m |
|--|------|------------------|------------------|
| Fixed assets | | | |
| Tangible assets | 10 | 3,411.8 | 3,235.4 |
| Investment - loan to group company | 11a | 370.5 | 370.5 |
| Investment - other | 11b | 0.1 | 0.1 |
| | | <u>3,782.4</u> | <u>3,606.0</u> |
| Current assets | | | |
| Debtors: amounts falling due within one year | 12 | 139.0 | 120.0 |
| Cash at bank and in hand | | 3.6 | 2.9 |
| Short term investments | 13 | 244.0 | 135.5 |
| | | <u>386.6</u> | <u>258.4</u> |
| Current liabilities | | | |
| Creditors: amounts falling due within one year | 14 | (282.9) | (151.6) |
| Net current assets | | | |
| | | 103.7 | 106.8 |
| Total assets less current liabilities | | | |
| | | 3,886.1 | 3,712.8 |
| Creditors: amounts falling due after one year | 14 | (2,761.8) | (2,739.8) |
| Retirement benefit obligations | 27 | (5.8) | (5.4) |
| Provisions for liabilities and charges | 18 | (270.1) | (239.5) |
| Deferred income | 19 | (26.3) | (27.8) |
| | | <u>(3,064.0)</u> | <u>(3,012.5)</u> |
| Net assets | | | |
| | | <u>822.1</u> | <u>700.3</u> |
| Capital and reserves | | | |
| Called up share capital | 20 | 309.9 | 309.9 |
| Capital redemption reserve | 21 | 166.2 | 166.2 |
| Profit and loss account | 21 | 346.0 | 224.2 |
| Total capital and reserves | | <u>822.1</u> | <u>700.3</u> |

The regulatory accounts on pages 32 to 63 were approved by the Board of Directors on 21 June 2010 and were signed on its behalf by:

N C Annett
Managing Director

C A Jones
Finance Director

Historical cost balance sheet as at 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2010.

| | Appointed business 2010 £m | Non- appointed business 2010 £m | Total 2010 £m |
|---|-------------------------------------|---|---------------------|
| Fixed assets | | | |
| Tangible assets | 3,411.8 | - | 3,411.8 |
| Investment - loan to group company | 370.5 | - | 370.5 |
| Investment - other | 0.1 | - | 0.1 |
| | <u>3,782.4</u> | - | <u>3,782.4</u> |
| Current assets | | | |
| Infrastructure renewals prepayment | 26.3 | - | 26.3 |
| Debtors | 112.7 | - | 112.7 |
| Cash at bank and in hand | 3.6 | - | 3.6 |
| Short term investments | 210.2 | 33.8 | 244.0 |
| | <u>352.8</u> | <u>33.8</u> | <u>386.6</u> |
| Current liabilities | | | |
| Creditors: amounts falling due within one year: | | | |
| - borrowings | (144.3) | - | (144.3) |
| - other creditors | (138.6) | - | (138.6) |
| | <u>(282.9)</u> | - | <u>(282.9)</u> |
| Net current assets | 69.9 | 33.8 | 103.7 |
| Total assets less current liabilities | 3,852.3 | 33.8 | 3,886.1 |
| Creditors: amounts falling due after one year: | | | |
| - borrowings | (2,723.8) | - | (2,723.8) |
| - other creditors | (38.0) | - | (38.0) |
| | <u>(2,761.8)</u> | - | <u>(2,761.8)</u> |
| Retirement benefit obligations | (5.8) | - | (5.8) |
| Provisions for liabilities and charges: | | | |
| - provision for deferred taxation | (230.6) | - | (230.6) |
| - other provisions for liabilities and charges | (39.5) | - | (39.5) |
| | <u>(270.1)</u> | - | <u>(270.1)</u> |
| Deferred income | (26.3) | - | (26.3) |
| Net assets | <u>788.3</u> | <u>33.8</u> | <u>822.1</u> |
| Capital and reserves | | | |
| Called up share capital | 309.9 | - | 309.9 |
| Capital redemption reserve | 166.2 | - | 166.2 |
| Profit and loss account | 312.2 | 33.8 | 346.0 |
| Total capital and reserves | <u>788.3</u> | <u>33.8</u> | <u>822.1</u> |

Historical cost balance sheet as at 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2009.

| | Appointed business 2009 £m | Non- appointed business 2009 £m | Total 2009 £m |
|---|-------------------------------------|---|---------------------|
| Fixed assets | | | |
| Tangible assets | 3,235.4 | - | 3,235.4 |
| Investment - loan to group company | 370.5 | - | 370.5 |
| Investment - other | 0.1 | - | 0.1 |
| | <u>3,606.0</u> | - | <u>3,606.0</u> |
| Current assets | | | |
| Infrastructure renewals prepayment | 19.2 | - | 19.2 |
| Debtors | 100.8 | - | 100.8 |
| Cash at bank and in hand | 2.9 | - | 2.9 |
| Short term investments | 102.3 | 33.2 | 135.5 |
| | <u>225.2</u> | <u>33.2</u> | <u>258.4</u> |
| Current liabilities | | | |
| Creditors: amounts falling due within one year: | | | |
| - borrowings | (13.1) | - | (13.1) |
| - other creditors | (138.5) | - | (138.5) |
| | <u>(151.6)</u> | - | <u>(151.6)</u> |
| Net current assets | 73.6 | 33.2 | 106.8 |
| Total assets less current liabilities | 3,679.6 | 33.2 | 3,712.8 |
| Creditors: amounts falling due after one year: | | | |
| - borrowings | (2,704.8) | - | (2,704.8) |
| - other creditors | (35.0) | - | (35.0) |
| | <u>(2,739.8)</u> | - | <u>(2,739.8)</u> |
| Retirement benefit obligations | (5.4) | - | (5.4) |
| Provisions for liabilities and charges: | | | |
| - provision for deferred taxation | (228.0) | - | (228.0) |
| - other provisions for liabilities and charges | (11.5) | - | (11.5) |
| | <u>(239.5)</u> | - | <u>(239.5)</u> |
| Deferred income | (27.8) | - | (27.8) |
| Net assets | <u>667.1</u> | <u>33.2</u> | <u>700.3</u> |
| Capital and reserves | | | |
| Called up share capital | 309.9 | - | 309.9 |
| Capital redemption reserve | 166.2 | - | 166.2 |
| Profit and loss account | 191.0 | 33.2 | 224.2 |
| Total capital and reserves | <u>667.1</u> | <u>33.2</u> | <u>700.3</u> |

Historical cost cash flow statement for the year ended 31 March 2010

| | Note | 2010 £m | 2009 £m |
|---|------|----------------|------------|
| Net cash inflow from operating activities | 23a | 408.8 | 422.1 |
| Returns on investment and servicing of finance | | | |
| Interest received | | 3.4 | 9.8 |
| Interest paid | | (100.4) | (98.3) |
| Interest element of finance lease rental payments | | (15.8) | (31.3) |
| Net cash flow from returns on investments and servicing of finance | 23b | (112.8) | (119.8) |
| Capital expenditure and financial investment | | | |
| Purchase of tangible fixed assets | | (292.2) | (296.5) |
| Costs of disposal of tangible fixed assets | | (0.4) | (0.8) |
| Infrastructure renewals expenditure | | (67.4) | (73.8) |
| Grants and contributions received | | 12.3 | 13.6 |
| Net cash flow from investing activities | | (347.7) | (357.5) |
| Net cash outflow before use of liquid resources and financing | | (51.7) | (55.2) |
| Management of liquid resources | | | |
| Net movement in deposits | | (108.5) | (14.8) |
| Net cash flow before financing | | (160.2) | (70.0) |
| Financing | | | |
| Finance leases received | | - | 60.0 |
| Net loan received from group undertaking | | 134.9 | 20.6 |
| New term loan | | 35.0 | - |
| Other loan repayments | | (0.4) | (0.3) |
| Capital element of finance lease repayments | | (8.6) | (10.4) |
| Net cash flow from financing | | 160.9 | 69.9 |
| Increase/(decrease) in cash in the year | 25 | 0.7 | (0.1) |

Historical cost cash flow statement for the year ended 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2010.

| | Appointed business 2010 £m | Non- appointed business 2010 £m | Total 2010 £m |
|---|-------------------------------------|---|---------------------|
| Net cash inflow from operating activities | 408.4 | 0.4 | 408.8 |
| Returns on investment and servicing of finance | | | |
| Interest received | 3.2 | 0.2 | 3.4 |
| Interest paid | (100.4) | - | (100.4) |
| Interest element of finance lease rental payments | (15.8) | - | (15.8) |
| Net cash flow from returns on investments and servicing of finance | (113.0) | 0.2 | (112.8) |
| Capital expenditure and financial investment | | | |
| Purchase of tangible fixed assets | (292.2) | - | (292.2) |
| Costs of disposal of tangible fixed assets | (0.4) | - | (0.4) |
| Infrastructure renewals expenditure | (67.4) | - | (67.4) |
| Grants and contributions received | 12.3 | - | 12.3 |
| Net cash flow from investing activities | (347.7) | - | (347.7) |
| Net cash outflow before use of liquid resources and financing | (52.3) | 0.6 | (51.7) |
| Management of liquid resources | | | |
| Net movement in deposits | (107.9) | (0.6) | (108.5) |
| Net cash flow before financing | (160.2) | - | (160.2) |
| Financing | | | |
| Finance leases received | - | - | - |
| Net loan received from group undertaking | 134.9 | - | 134.9 |
| New term loan | 35.0 | - | 35.0 |
| Other loan repayments | (0.4) | - | (0.4) |
| Capital element of finance lease repayments | (8.6) | - | (8.6) |
| Net cash flow from financing | 160.9 | - | 160.9 |
| Increase in cash in the year | 0.7 | - | 0.7 |

Historical cost cash flow statement for the year ended 31 March 2010 cont'd

Analysis of historical cost financial information between appointed and non-appointed business for the year ended 31 March 2009.

| | Appointed business 2009 £m | Non- appointed business 2009 £m | Total 2009 £m |
|---|-------------------------------------|---|---------------------|
| Net cash inflow from operating activities | 421.8 | 0.3 | 422.1 |
| Returns on investment and servicing of finance | | | |
| Interest received | 8.5 | 1.3 | 9.8 |
| Interest paid | (98.3) | - | (98.3) |
| Interest element of finance lease rental payments | (31.3) | - | (31.3) |
| Net cash flow from returns on investments and servicing of finance | (121.1) | 1.3 | (119.8) |
| Capital expenditure and financial investment | | | |
| Purchase of tangible fixed assets | (296.5) | - | (296.5) |
| Costs of disposal of tangible fixed assets | (0.8) | - | (0.8) |
| Infrastructure renewals expenditure | (73.8) | - | (73.8) |
| Grants and contributions received | 13.6 | - | 13.6 |
| Net cash flow from investing activities | (357.5) | - | (357.5) |
| Net cash outflow before use of liquid resources and financing | (56.8) | 1.6 | (55.2) |
| Management of liquid resources | | | |
| Net movement in deposits | (13.2) | (1.6) | (14.8) |
| Net cash flow before financing | (70.0) | - | (70.0) |
| Financing | | | |
| Finance leases received | 60.0 | - | 60.0 |
| Net loan received from group undertaking | 20.6 | - | 20.6 |
| Other loan repayments | (0.3) | - | (0.3) |
| Capital element of finance lease repayments | (10.4) | - | (10.4) |
| Net cash flow from financing | 69.9 | - | 69.9 |
| Decrease in cash in the year | (0.1) | - | (0.1) |

Notes to the historical cost financial statements for the year ended 31 March 2010

1 Accounting policies

Basis of preparation

The financial statements are prepared in accordance with the historical cost convention and with applicable accounting standards in the UK except for the dis-application of certain sections of FRS 12 and FRS 15 in relation to infrastructure renewals accounting as described below, and with the Companies Act 2006 except for the treatment of certain capital contributions. An explanation of this departure from the requirements of the Companies Act 2006 is given in the "Grants and customer contributions" section below and in note 10(c).

Turnover

Turnover represents the income receivable in the ordinary course of business for services provided and excludes value added tax. Where services have been provided but for which no invoice has been raised at the year-end, an estimate of the value is included in turnover.

i) Billing of unoccupied properties

An unoccupied property is a connected property or premises that is unoccupied and unfurnished and does not have use of any water or sewerage service. This definition is applied in the following ways:

a) Unmeasured supplies

If an unmeasured property is furnished normal charges will apply (subject to allowances, e.g. if the sole occupier is in a nursing home, hospital, prison or is overseas long-term).

Unfurnished and unoccupied properties do not incur charges unless they are in use, e.g. under renovation or redecoration, in which case the customer will be offered the option of being compulsorily metered, continuing on unmeasured charges or being disconnected.

Unmeasured properties will be billed a 'surface water only' charge if the water supply is temporarily disconnected.

b) Metered supplies

Metered standing charges are applied to each metered property unless there is zero water consumption, the property owner cannot be identified and it is unfurnished.

ii) Billing 'the occupier'

Very few premises are billed as 'the occupier'; no bills are sent speculatively in this manner, only when there is evidence suggesting an actual occupier (e.g. a visit, finance check or Land Registry check).

iii) Revenue from 'charges on income'

No revenue is generated in this manner.

iv) New properties

All new properties are metered. The developer, being the consumer, is billed for water and sewerage charges between the date of connection and first occupancy. Income from the developer for metered charges is recognised as turnover.

v) There are no differences between the recognition of turnover in the regulatory and accounts and the recognition of revenue in the statutory financial statements. Bills raised for customers having a record of non-payment are recognised as turnover. Only in the following circumstances are bills not recognised as turnover:

a) Voids adjustment for local authority agreements. Welsh Water bills local authorities for all of their tenanted premises, whether occupied or not and the collection commission we pay local authorities includes a proportion to cover the voids. An adjustment is therefore made between commission costs (included in operating costs) and turnover in respect of the amount relating to voids; and

b) Where bills are subject to formal legal pricing disputes, we do not recognise as turnover the disputed portion of bills raised.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

Tangible fixed assets and depreciation

Tangible fixed assets comprise:

- (i) infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls); and
- (ii) other assets (including properties, above ground operational structures and equipment and fixtures and fittings).

Tangible fixed assets are stated at cost of construction or purchase price and directly attributable costs. The carrying value of tangible fixed assets is reviewed for impairment if circumstances dictate that it may not be recoverable.

Infrastructure assets

Infrastructure assets comprise a network of systems. Expenditure on infrastructure assets relating to increases in capacity, enhancements or replacements of the network is treated as additions, which are included at cost after deducting grants and contributions.

The infrastructure renewals charge (IRC) is based on the estimated level of annual expenditure required to maintain the operating capability of the network over the medium to long-term. The company's policy, which remains consistent with prior years, is to calculate a 15 year forward-looking average using latest forecasts. The charge for the year to 31 March 2010 has been calculated using updated information received from Ofwat within the 2009 Final Determination.

The regulatory historical cost balance sheet has been prepared in accordance with RD15/99, with the relevant sections of FRS 12 and FRS 15 being dis-applied in relation to infrastructure renewals accounting. As a result, any cumulative difference between IRC and actual infrastructure renewals expenditure in the year is held as a prepayment or accrual in the balance sheet.

Other assets

Other assets are included at cost less accumulated depreciation. Freehold land is not depreciated. Other assets are depreciated over their estimated useful economic lives, which are principally as follows:

| | |
|--|-----------------------|
| Freehold buildings | up to 60 years |
| Leasehold properties | over the lease period |
| Operational structures | 40-80 years |
| Fixed plant | 8-40 years |
| Vehicles, mobile plant, equipment and computer hardware & software | 3-16 years |

Assets in the course of construction are not depreciated until commissioned.

Leased assets

Where assets are financed by leasing arrangements, which transfer substantially all the risks and rewards of ownership of an asset to the lessee (i.e. finance leases), the assets are treated as if they had been purchased and the corresponding capital cost is shown as an obligation to the lessor. Leasing payments are treated as consisting of a capital element and finance costs, the capital element reducing the obligation to the lessor and the finance charges being written off to the profit and loss account over the period of the lease in reducing amounts in relation to the written down amount. The assets are depreciated over the shorter of their estimated useful life and the lease period. All other leases are regarded as operating leases. Rental costs arising under operating leases are charged to the profit and loss account in the year to which they relate.

Grants and customer contributions

Grants and customer contributions relating to infrastructure assets have been offset against fixed assets (see note 10(c)). Grants and customer contributions in respect of expenditure on other fixed assets are treated as deferred income and recognised in the profit and loss account over the expected useful economic lives of the related assets.

Capital expenditure programme incentive payments

The company's agreement with its construction partners involved in delivering the capital expenditure programme incorporates incentive bonuses payable after completion of the programmes. The cost of fixed asset additions include an accrual for the proportion of incentive bonuses earned to date, relating to projects substantially completed at the year end, where the likelihood of making the incentive payment is considered probable. Amounts recoverable from contract partners, relating to targets not being achieved are recognised only on completed projects.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

Target cost contracts

The company maintains target cost contracts with its main operating partners. The company's policy in respect of pain/gain share receivables/payables arising from these contracts is to recognise gain payables over the period to which the charge relates, and pain receivables as income only when final agreement with the relevant service partner has been reached.

Pension costs

The company operates two pension schemes, a defined contribution scheme and a defined benefit scheme.

In respect of the defined contribution scheme, the amount charged to the profit and loss account represents contributions payable to the independent investment managers, who operate the schemes, in funds separate from those of the company.

The defined benefit scheme is funded by both employer and employee contributions. The assets are held by the Trustees separately from the assets of the company. The fund is valued every three years by a professionally qualified independent actuary. In the intervening years the actuary reviews the continuing appropriateness of the rates. The assets of the defined benefit scheme are measured using closing market rates. Pension scheme liabilities are measured using the attained age method and discounted at the current rate of return on high quality corporate bonds of equivalent terms. The increase in the present value of the scheme expected to arise from employees' service during the period is charged to operating profit. The expected return on scheme assets and the increase during the period in the present value of the scheme liabilities, arising from the passage of time, are included as an interest expense. Actuarial gains and losses are recognised in the statement of total recognised gains and losses.

Debt and debt issue costs

Debt is initially stated at the amount of the net proceeds after deduction of issue costs. Debt issue costs are recognised in the profit and loss account over the term of such instruments at a constant rate on the carrying amount.

Investments

Long term investments are held as fixed assets and stated at cost less amounts written off or provided to reflect permanent diminution in value. Short term investments are held as current assets and stated at the lower of cost and net realisable value.

Financial instruments

Derivative instruments utilised by the company are interest rate and inflation swaps and certain power price hedging contracts. Derivatives are used for hedging purposes to alter the risk profile of existing underlying exposures within the company.

Interest differentials, under swap arrangements used to manage interest rate exposure on borrowings and current asset investments, are recognised by adjusting interest payable or receivable as appropriate.

Research and development

Research and development expenditure is charged to the profit and loss account in the year in which it is incurred.

Taxation

The charge for current taxation is based on the profit for the period as adjusted for disallowable and non-taxable items. In accordance with FRS 19 "Deferred tax" full provision is made for all deferred tax liabilities arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in tax computations. Deferred tax assets are only recognised to the extent that they are considered recoverable. Recoverability is defined as when it can be regarded as more likely than not that there will be sufficient taxable profits from which future reversal of the timing differences can be deducted. Deferred tax is not discounted.

Provision for insurance liabilities

Provision is made for all known and estimated liabilities arising from uninsured claims against the company where there is a present obligation and it is probable that a transfer of economic benefits will be required.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

2 Consolidated financial statements

The company has taken advantage of section 400 of the Companies Act 2006 not to produce consolidated financial statements as it is a wholly-owned subsidiary of Glas Cymru Cyfyngedig.

3 Segmental analysis by class of business

(a) Turnover

| | 2010 £m | 2009 £m |
|---|--------------|--------------|
| Regulated water and sewerage activities | 681.9 | 650.4 |
| Non-regulated activities | 6.3 | 6.8 |
| | 688.2 | 657.2 |

(b) Profit on ordinary activities before taxation

| | 2010 £m | 2009 £m |
|---|--------------|-------------|
| Regulated water and sewerage activities | | |
| Operating profit | 227.8 | 227.9 |
| Net interest payable | (103.9) | (167.5) |
| Other finance (expense)/income - pension scheme (note 27) | (0.3) | 0.2 |
| | 123.6 | 60.6 |
| Non-regulated activities | | |
| Operating profit | 0.4 | 0.3 |
| Interest receivable | 0.2 | 1.3 |
| | 0.6 | 1.6 |

(c) Net assets

| | 2010 £m | 2009 £m |
|---|--------------|--------------|
| Regulated water and sewerage activities | 788.9 | 667.1 |
| Non-regulated activities | 33.2 | 33.2 |
| | 822.1 | 700.3 |

All turnover and profit before taxation, by origin and destination, was attributable to the UK.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

4 Net operating costs

| | Before exceptional items 2010 £m | Exceptional items 2010 £m | Total 2010 £m | Total 2009 £m |
|---|--|------------------------------------|---------------------|---------------------|
| Operating charges from outsourced activities | | | | |
| - Operating services agreements | 131.2 | (5.0) | 126.2 | 138.3 |
| - Customer services agreement | 18.7 | - | 18.7 | 19.5 |
| - Laboratories and analytical services | 6.6 | - | 6.6 | 6.7 |
| - Other contracts | 14.1 | - | 14.1 | 14.2 |
| - Contract termination costs | - | 10.8 | 10.8 | - |
| - Restructuring and rationalisation | - | 15.4 | 15.4 | - |
| | 170.6 | 21.2 | 191.8 | 178.7 |
| Staff costs | | | | |
| - Wages and salaries | 10.7 | - | 10.7 | 10.7 |
| - Social security | 1.1 | - | 1.1 | 1.0 |
| - Pension costs (excluding actuarial loss) | 1.7 | - | 1.7 | 1.0 |
| - Restructuring and rationalisation | - | 7.2 | 7.2 | - |
| | 13.5 | 7.2 | 20.7 | 12.7 |
| Research and development expenditure | 0.5 | - | 0.5 | 0.5 |
| Charge for bad and doubtful debts | 22.3 | - | 22.3 | 18.8 |
| Rates | 26.9 | - | 26.9 | 25.5 |
| Environment Agency charges | 15.1 | - | 15.1 | 14.9 |
| Fees paid to auditors | 0.2 | - | 0.2 | 0.2 |
| Staff costs capitalised | (5.9) | - | (5.9) | (5.7) |
| Other operating charges | 22.5 | 1.1 | 23.6 | 21.2 |
| Total operational expenditure | 265.7 | 29.5 | 295.2 | 266.8 |
| Infrastructure renewals charge | 60.2 | - | 60.2 | 61.9 |
| Depreciation and amortisation | | | | |
| - Owned assets | 69.0 | - | 69.0 | 67.8 |
| - Under finance leases | 36.7 | - | 36.7 | 33.1 |
| - Amortisation of grants and contributions | (1.5) | - | (1.5) | (1.4) |
| | 104.2 | - | 104.2 | 99.5 |
| | 430.1 | 29.5 | 459.6 | 428.2 |

Exceptional items

On 9 February 2010 Glas Cymru announced its intention to restructure Welsh Water following the decision to bring back in house the operational activities which had been outsourced (for further information, see Operating and Financial Review). Restructuring costs of £29.5m are considered exceptional by nature and are disclosed separately in the table above. These include the costs of terminating the outsourced contracts along with the estimated restructuring costs associated with a reduction in the headcount by some 300. Contract termination costs include agreed payments in lieu of the profit element for year 6 and early agreement of an adjustment reflecting year 5 performance. It is not anticipated that any further significant expenditure will be incurred in relation to the restructuring of the business.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

4 Net operating costs cont'd

Auditors' remuneration

Auditors during the period were PricewaterhouseCoopers LLP. They were used primarily for audit services, including regulatory audit services carried out to meet Ofwat reporting requirements.

| | 2010 £'000 | 2009 £'000 |
|---|---------------|---------------|
| Non-discretionary audit fees | | |
| Statutory audit of parent company and consolidated financial statements | 11 | 11 |
| Statutory audit of subsidiary companies | 77 | 75 |
| Total statutory audit fees | <u>88</u> | 86 |
| Review of interim financial statements | 22 | 21 |
| Regulatory audit services pursuant to legislation | 39 | 33 |
| Review of draft business plan (required by Ofwat) | - | 81 |
| Total audit fees | <u>149</u> | 221 |
| Other services | | |
| Tax advisory services | 5 | 10 |
| Services relating to bond prospectus update and bond issue | 25 | - |
| Other | 10 | 2 |
| Total other services | <u>40</u> | 12 |
| Total cost of services provided by the group's auditor | <u>189</u> | 233 |

Regulatory audit services include work on the regulatory accounts, June Return and Principal Statement. In addition to the above services, PricewaterhouseCoopers LLP acted as auditor to the DCWW Pension Scheme. The appointment of auditors to the pension scheme and the fees paid in respect of the audit are agreed by the trustees of the scheme, who act independently from the management of the Group. The fees paid in respect of audit services to the pension scheme during the year were £11,000 (2009: £13,000).

The Board has adopted a formal policy with respect to services received from external auditors. The external auditor will not be used for internal audit services and all non-audit work above a threshold of £25,000 will be subject to prior competitive tendering and approval by the Audit Committee.

5 Directors and employees

(a) Directors' emoluments

The combined emoluments of the Directors of Dŵr Cymru Cyfyngedig for their services as Directors of the company are set out below:

| | 2010 £'000 | As restated 2009 £'000 |
|-------------------------------------|---------------|------------------------------|
| Salary (including benefits in kind) | 888 | 830 |
| Fees | 528 | 505 |
| | <u>1,416</u> | 1,335 |
| Long term incentive plan | <u>152</u> | 211 |

Retirement benefits are accruing to three Directors (2009 – three) under a defined benefit scheme.

The financial statements for the year ended 31 March 2010 include a provision of £227,040 (2009: £169,620) for bonus potentially payable to Executive Directors for performance in the financial year 2009-10. The final amount to be paid to each Director will be determined when Ofwat publishes its Overall Performance Assessment (OPA) results for 2009-10 in the autumn of 2010 and could be higher or lower. An amount of £152,460 (2009: £211,200) has also been provided under the terms of the Executive Directors' Long Term Incentive Plan.

The comparatives have been restated to reflect the final performance bonus for 2008-09. The actual performance bonus in respect of 2008-09 was paid in November 2009 following the publication of Ofwat's OPA report for 2008-09, and amounted to £169,620 compared to the amount accrued at 31 March 2009 of £333,960. The aggregate emoluments of the highest paid Director reduced by £66,820 to £327,374 and total Directors' emoluments reduced by £164,340 to £1,335,369.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

5 Directors and employees cont'd

| | 2010 £'000 | 2009 £'000 |
|--|---------------|---------------|
| Highest paid director: N C Annett (2009: N C Annett) | | |
| Aggregate emoluments | <u>350</u> | <u>327</u> |
| Accrued pension under defined benefit scheme | 108 | 102 |
| Long term incentive plan | <u>60</u> | <u>83</u> |

(b) Staff costs

| | 2010 £m | 2009 £m |
|-----------------------|-------------|-------------|
| Wages and salaries | 10.7 | 10.7 |
| Social security costs | 1.1 | 1.0 |
| Pension costs | <u>1.7</u> | <u>1.0</u> |
| | <u>13.5</u> | <u>12.7</u> |

Of the above, £5.9m (2009: £5.7m) has been charged to capital.

(c) Average monthly number of employees during the year (including Executive Directors)

| | 2010 Number | 2009 Number |
|---|----------------|----------------|
| Regulated water and sewerage activities | <u>200</u> | <u>187</u> |

6 Loss on disposal of fixed assets

| | 2010 £m | 2009 £m |
|----------------------------------|--------------|--------------|
| Loss on disposal of fixed assets | <u>(0.4)</u> | <u>(0.8)</u> |

7 a) Net interest payable

| | 2010 £m | 2009 £m |
|--|----------------|----------------|
| Interest payable on loans | (86.4) | (135.3) |
| Interest payable on finance leases | (18.4) | (36.9) |
| Other interest payable and finance costs | <u>(2.3)</u> | <u>(2.6)</u> |
| Interest payable | <u>(107.1)</u> | <u>(174.8)</u> |
| Interest receivable | 3.4 | 8.6 |
| Net interest payable | <u>(103.7)</u> | <u>(166.2)</u> |

Included within interest payable are amounts payable to group undertakings of £87.1m (2009: £134.9m).

b) Other finance (expense)/income

| | 2010 £m | 2009 £m |
|---|--------------|------------|
| Other finance (expense)/income - pension scheme (note 27) | <u>(0.3)</u> | <u>0.2</u> |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

8 Taxation

Analysis of (charge)/credit in period

| | 2010 £m | 2009 £m |
|--|------------|---------------|
| Current tax | | |
| - Prior year | (1.7) | - |
| Deferred tax | | |
| - Origin and reversal of timing differences - current year | 23.0 | (15.6) |
| - Origin and reversal of timing differences - prior years | (20.5) | 1.0 |
| | 2.5 | (14.6) |
| Movement on deferred tax asset relating to pension scheme | 0.1 | (2.9) |
| | 2.6 | (17.5) |
| Total taxation charge/(credit) | 0.9 | (17.5) |

Factors affecting current tax charge for period

| | 2010 £m | 2009 £m |
|---|--------------|------------|
| Profit on ordinary activities before tax | 124.2 | 62.2 |
| Profit before tax multiplied by the corporation tax rate in the UK of 28% (2009: 28%) | 34.8 | 17.4 |
| Effects of: | | |
| Expenses not deductible for tax purposes | 2.0 | 3.0 |
| Other timing differences | 5.1 | 11.2 |
| Tax losses utilised | (2.3) | (1.5) |
| Capital allowances in excess of depreciation | (39.6) | (30.1) |
| | - | - |
| Adjustments in respect of prior years | (1.7) | - |
| Total current tax charge | (1.7) | - |

9 Dividends

| | 2010 £m | 2009 £m |
|-------------------------------------|------------|------------|
| Dividends on ordinary shares | | |
| £1 ordinary shares | - | - |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

10 Tangible fixed assets

(a) Analysis by type

| Current year | Freehold land & buildings £m | Infrastructure assets £m | Operational structures £m | Vehicles, plant, equipment, computer hardware and software £m | Total £m |
|--|------------------------------------|--------------------------------|---------------------------------|--|----------------|
| Cost | | | | | |
| At 1 April 2009 | 34.4 | 2,339.0 | 2,383.6 | 366.2 | 5,123.2 |
| Additions net of grants and contributions | - | 110.4 | 194.7 | 44.2 | 349.3 |
| Disposals | - | - | - | (6.4) | (6.4) |
| At 31 March 2010 | 34.4 | 2,449.4 | 2,578.3 | 404.0 | 5,466.1 |
| Accumulated depreciation | | | | | |
| At 1 April 2009 | 16.8 | 746.0 | 899.4 | 225.6 | 1,887.8 |
| Charge for the year | 0.5 | 67.4 | 90.1 | 14.9 | 172.9 |
| Released on disposal | - | - | - | (6.4) | (6.4) |
| At 31 March 2010 | 17.3 | 813.4 | 989.5 | 234.1 | 2,054.3 |
| Net book value | | | | | |
| At 31 March 2010 | 17.1 | 1,636.0 | 1,588.8 | 169.9 | 3,411.8 |
| At 31 March 2009 | 17.6 | 1,593.0 | 1,484.2 | 140.6 | 3,235.4 |
| Analysis of net book value at 31 March 2010 | | | | | |
| Owned | 17.1 | 1,024.2 | 1,188.0 | 169.9 | 2,399.2 |
| Held under finance leases | - | 611.8 | 400.8 | - | 1,012.6 |
| | 17.1 | 1,636.0 | 1,588.8 | 169.9 | 3,411.8 |

Tangible fixed assets at 31 March 2010 include £189.7m (2009: £179.0m) of assets in the course of construction, which are not depreciated until commissioned.

In accordance with RD 15/99, the infrastructure renewals charge reported in the profit and loss account was £60.2m (2009: £61.9m). The difference between the profit and loss account charge and the depreciation charge in respect of infrastructure assets shown above is included within prepayments and accrued income.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

10 Tangible fixed assets cont'd

(b) Analysis by service

| Current year | Water services £m | Sewerage services £m | General £m | Total £m |
|--|-------------------------|----------------------------|---------------|----------------|
| Cost | | | | |
| At 1 April 2009 | 2,109.3 | 2,689.7 | 324.2 | 5,123.2 |
| Additions | 149.1 | 156.1 | 44.1 | 349.3 |
| Disposals | - | - | (6.4) | (6.4) |
| At 31 March 2010 | 2,258.4 | 2,845.8 | 361.9 | 5,466.1 |
| Accumulated depreciation | | | | |
| At 1 April 2009 | 817.2 | 857.7 | 212.9 | 1,887.8 |
| Charge for the year | 75.0 | 80.8 | 17.1 | 172.9 |
| Released on disposal | - | - | (6.4) | (6.4) |
| At 31 March 2010 | 892.2 | 938.5 | 223.6 | 2,054.3 |
| Net book value | | | | |
| At 31 March 2010 | 1,366.2 | 1,907.3 | 138.3 | 3,411.8 |
| At 31 March 2009 | 1,292.1 | 1,832.0 | 111.3 | 3,235.4 |
| Analysis of net book value at 31 March 2010 | | | | |
| Owned | 1,123.0 | 1,137.9 | 138.3 | 2,399.2 |
| Held under finance leases | 243.2 | 769.4 | - | 1,012.6 |
| | 1,366.2 | 1,907.3 | 138.3 | 3,411.8 |

All tangible fixed assets held by the company are of an appointed nature.

- (c) The accounting treatment for grants and customer contributions in respect of infrastructure assets is described in the principal accounting policies in note 1. This treatment is not in accordance with Companies Act 2006 provisions requiring fixed assets to be shown at the purchase price or production cost and hence grants and contributions would be presented under the Act as deferred income. The treatment explained in note 1 has been adopted in accordance with section 403(5) of the Companies Act 2006 in order to show a true and fair view as, in the opinion of the Directors, it is not appropriate to treat grants and contributions on infrastructure assets as deferred income. The fixed assets to which they relate do not have determinable finite lives and therefore no basis exists for releasing any deferred income to the profit and loss account. As a consequence, the net book value of fixed assets and deferred income is £261m (2009: £249m) lower than it would have been the case had grants and contributions been treated as deferred income indefinitely.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

11 (a) Investment – loan to group company

| | 2010 £m | 2009 £m |
|--------------------------------|--------------|--------------|
| Cost and net book value | | |
| At 1 April and 31 March | <u>370.5</u> | <u>370.5</u> |

Interest of £44.6m for the year (2009: £44.6m) has been waived by the company on the amount owed by group undertakings.

(b) Investment - other

| | 2010 £m | 2009 £m |
|--------------------------------|------------|------------|
| Cost and net book value | | |
| At 1 April and 31 March | <u>0.1</u> | <u>0.1</u> |

Equity of less than 10% is held in the following unlisted company:

| | Principal activity | Country of incorporation | Holding |
|----------------------------------|--------------------|--------------------------|---------------------------|
| Water Research Centre (1989) plc | Water research | England and Wales | "B" Ordinary Shares of £1 |

In addition, the company holds 5% Convertible Unsecured Loan Stock 2014 at a cost of £23,326 in Water Research Centre (1989) plc.

100% interest in the following subsidiary:

| | Principal activity | Country of incorporation | Holding |
|-----------------------------------|--------------------|--------------------------|-----------------------|
| Welsh Water Utilities Finance plc | Raising finance | England and Wales | Ordinary shares of £1 |

12 Debtors

| | 2010 £m | 2009 £m |
|---|--------------|--------------|
| Amounts falling due within one year: | | |
| Trade debtors | 40.4 | 37.4 |
| Other debtors | 10.1 | 1.4 |
| Infrastructure renewals prepayment | 26.3 | 19.2 |
| Prepayments and accrued income | 62.2 | 62.0 |
| | <u>139.0</u> | <u>120.0</u> |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

13 Short term investments

| | 2010 £m | 2009 £m |
|---|--------------|------------|
| Investments in fixed term and call deposits due within one year | 244.0 | 135.5 |
| | 244.0 | 135.5 |

Short term investments include highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. Such investments are normally those with less than three months' maturity from the date of acquisition and typically comprise deposits with banks or other financial institutions.

Treasury activities are managed under policies, procedures and authorities approved by the Board of Directors.

14 Creditors

| | Note | 2010 £m | 2009 £m |
|---|------|----------------|------------|
| Amounts falling due within one year | | | |
| Loans | | | |
| - Owed to group undertakings | 15 | 134.1 | 4.2 |
| - External | 15 | 0.3 | 0.3 |
| Obligations under finance leases | 16 | 9.9 | 8.6 |
| | | 144.3 | 13.1 |
| Interest accruals | | | |
| - Owed to group undertakings | | - | 0.1 |
| - External | | 5.9 | 6.9 |
| | | 5.9 | 7.0 |
| Trade creditors | | 20.5 | 26.9 |
| Capital creditors | | 56.5 | 53.4 |
| Amounts owed to group undertakings | | 3.7 | 3.7 |
| Other taxation and social security | | 0.5 | 0.4 |
| Other creditors | | 51.5 | 47.1 |
| | | 282.9 | 151.6 |
| Amounts falling due after more than one year | | | |
| Loans | | | |
| - Owed to group undertakings | 15 | 1,813.3 | 1,819.0 |
| - External | 15 | 36.9 | 2.3 |
| Obligations under finance leases | 16 | 873.6 | 883.5 |
| Interest accruals | | 38.0 | 35.0 |
| | | 2,761.8 | 2,739.8 |

As part of the Glas Group's bond programme, a security package was granted by the company for the benefit of holders of senior bonds, finance lessors and other senior financial creditors. The obligations of the company are guaranteed by Glas Cymru Cyfyngedig, Glas Cymru (Securities) Limited and Dŵr Cymru (Holdings) Limited.

The main elements of the security package are:

- a first fixed and floating security over all of the company's assets and undertaking, to the extent permitted by the Water Industry Act, other applicable law and its licence; and
- a fixed and floating security given by the guarantors referred to above which are secured on each of the company's assets, including, in the case of Dŵr Cymru (Holdings) Limited, a first fixed charge over its shares in the company.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

15 Loans due to group undertakings and other loans

| | 2010 | 2009 |
|------------------------------|----------------|----------------|
| | £m | £m |
| Repayable as follows: | | |
| Within one year | 134.4 | 4.5 |
| Between one and two years | 14.0 | 134.1 |
| Between two and five years | 56.3 | 41.0 |
| After more than five years | 1,779.9 | 1,646.2 |
| | <u>1,984.6</u> | <u>1,825.8</u> |

| Interest rates on these loans ranged as follows: | 2010 | 2009 |
|---|----------------|----------------|
| Index-linked debt | 1.48% to 5.44% | 1.48% to 5.52% |
| Other debt | 0.91% to 8.17% | 3.27% to 8.17% |

Costs directly attributable to the raising of debt are capitalised in accordance with FRS4 and are amortised to the profit and loss account over the term of the debt.

16 Finance leases

| | 2010 | 2009 |
|------------------------------|--------------|--------------|
| | £m | £m |
| Repayable as follows: | | |
| Within one year | 9.9 | 8.6 |
| Between one and two years | 11.9 | 9.9 |
| Between two and five years | 75.5 | 51.1 |
| After more than five years | 686.2 | 822.5 |
| | <u>783.5</u> | <u>892.1</u> |

17 Capital commitments

The company's business plan at 31 March 2010 shows net capital expenditure of £252m (2009: £350m) during the next financial year. While only a portion of this amount has been formally contracted for, the company is effectively committed to the total as part of its overall capital expenditure programme approved by its regulator.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

18 Provisions for liabilities and charges

| | Note | 2010 £m | 2009 £m |
|------------------------------------|------|--------------|--------------|
| Deferred taxation | (a) | 230.6 | 228.0 |
| Restructuring provision | (b) | 28.4 | - |
| Dilapidations provision | (c) | 2.2 | 1.4 |
| Provision for uninsured losses | (d) | 6.8 | 7.7 |
| Provision for loss on swap closure | (e) | 2.1 | 2.4 |
| | | <u>270.1</u> | <u>239.5</u> |

(a) Deferred taxation

| | 2010 £m | 2009 £m |
|--|--------------|--------------|
| Tax effect of timing differences | | |
| Excess of tax allowances over depreciation | 347.4 | 333.8 |
| Other timing differences | (116.9) | (105.8) |
| Provision for deferred tax | <u>230.5</u> | <u>228.0</u> |
| Provision at 1 April | 228.0 | 242.6 |
| Deferred tax charge/(credit) for year in profit and loss | 2.6 | (14.6) |
| Net deferred tax provision at 31 March | <u>230.6</u> | <u>228.0</u> |

The provision for deferred tax represents the tax effect of timing differences, which are expected to crystallise over periods of up to 85 years.

(b) Restructuring provision

This provides for the costs of terminating the outsourced contracts along with the estimated restructuring costs associated with a reduction in the headcount by some 300.

| | £m |
|-----------------------------------|-------------|
| At 1 April 2009 | - |
| Charge to profit and loss account | 28.4 |
| At 31 March 2010 | <u>28.4</u> |

(c) Dilapidations provision

This provision at 31 March 2010 is in respect of payments to be made relating to estimated dilapidation costs, which will be utilised over the next three years.

| | £m |
|-----------------------------------|------------|
| At 1 April 2009 | 1.4 |
| Charge to profit and loss account | 0.8 |
| At 31 March 2010 | <u>2.2</u> |

(d) Provision for uninsured losses

This provision is in respect of uninsured losses; its utilisation period is uncertain due to the nature of insurance claims, but is estimated to be five years.

| | £m |
|-----------------------------------|------------|
| At 1 April 2009 | 7.7 |
| Charge to profit and loss account | 0.7 |
| Utilised in year | (1.6) |
| At 31 March 2010 | <u>6.8</u> |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

18 Provisions for liabilities and charges cont'd

(e) Provision for loss on swap closure

| | £m |
|------------------|--------------|
| At 1 April 2009 | 2.4 |
| Utilised in year | <u>(0.3)</u> |
| At 31 March 2010 | <u>2.1</u> |

This provision is in respect of a liability that arose on the cancellation of certain interest rate swap contracts. These contracts were redeemed early and the loss arising on redemption was settled by setting a higher rate on another swap contract. This provision is being released to the profit and loss account over the life of the revised swap, which expires on 31 March 2031.

19 Deferred income

Deferred income relates to income received and receivable upon completion of assets under construction and will be credited to the profit and loss account over the lifetime of those assets.

| | 2010 £m | 2009 £m |
|-------------------------------------|--------------|--------------|
| At 1 April | 27.8 | 29.2 |
| Released to profit and loss account | <u>(1.5)</u> | <u>(1.4)</u> |
| At 31 March | <u>26.3</u> | <u>27.8</u> |

20 Called up share capital

| | 2010 £m | 2009 £m |
|---|--------------|--------------|
| Authorised | | |
| 501,050,000 ordinary shares of £1 each | <u>501.1</u> | <u>501.1</u> |
| Allotted, called up and fully paid | | |
| 309,876,374 ordinary shares of £1 each | <u>309.9</u> | <u>309.9</u> |

21 Reserves

a) Profit and loss account

| | Total £m |
|--|--------------|
| At 1 April 2009 | 224.2 |
| Retained profit for the year | 123.4 |
| Actuarial loss on pension scheme | (1.5) |
| Movement on deferred tax relating to pension liability | <u>(0.1)</u> |
| At 31 March 2010 | <u>346.0</u> |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

21 Reserves cont'd

b) Capital redemption reserve

| | £m |
|--------------------------------------|--------------|
| At 1 April 2009 and at 31 March 2010 | <u>166.2</u> |

22 Reconciliation of movements in equity shareholders' funds

| | 2010 £m | 2009 £m |
|--|--------------|--------------|
| At 1 April | 700.3 | 631.0 |
| Retained profit for the year | 123.4 | 76.8 |
| Actuarial loss on pension scheme | (1.5) | (10.4) |
| Movement on deferred tax relating to pension liability | (0.1) | 2.9 |
| At 31 March | <u>822.1</u> | <u>700.3</u> |

23 a) Cash inflow from operating activities (appointed business)

| | 2010 £m | 2009 £m |
|--|---------------------|---------------------|
| Current cost operating profit | 210.3 | 170.1 |
| Working capital adjustment | (1.2) | 0.1 |
| Movement in working capital | (12.0) | 13.8 |
| Current cost depreciation | 123.0 | 156.9 |
| Current cost disposal of fixed assets | 0.4 | 0.8 |
| Infrastructure renewals charge | 60.2 | 61.9 |
| Movement in provisions | 27.9 | 18.2 |
| Net cash flow from operating activities | <u>408.6</u> | <u>421.8</u> |

b) Returns on investments and servicing of finance

| | 2010 £m | 2009 £m |
|---|---------------------|---------------------|
| Interest payable per profit and loss account | 107.1 | 174.8 |
| Interest receivable per profit and loss account | (3.4) | (8.6) |
| Less non-cash items: | | |
| - Indexation | 9.5 | (41.5) |
| - Amortisation of bond issue costs | 0.7 | (0.7) |
| - Amortisation of bond issue premium | 0.7 | 0.5 |
| - Movement in prepayments and accruals | (1.8) | (4.7) |
| Net interest paid | <u>112.8</u> | <u>119.8</u> |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

24 Reconciliation of net cash flow to movement in net debt

| | 2010 £m | 2009 £m |
|---|-------------------------|-------------------------|
| Increase in cash in the year | 0.7 | (0.1) |
| Cash inflow from management of liquid resources | 108.5 | 14.8 |
| Cash inflow from movement in debt and lease financing | (160.9) | (69.9) |
| Non-cash flow items | 8.8 | (41.3) |
| Increase in debt in the year | (42.9) | (96.5) |
| Net debt at start of year | <u>(2,251.0)</u> | <u>(2,154.5)</u> |
| Net debt at end of year | <u>(2,293.9)</u> | <u>(2,251.0)</u> |

25 Analysis of net debt

| | 1 April 2009 £m | Cash flow £m | Non-cash items £m | 31 March 2010 £m |
|--|-----------------------|--------------------|-------------------------|-------------------------|
| Net cash | | | | |
| Cash at bank and in hand | 2.9 | 0.7 | - | <u>3.6</u> |
| Liquid resources | | | | |
| Current asset investments | 135.5 | 108.5 | - | <u>244.0</u> |
| Group receivables | | | | |
| Debt owed by parent company due after more than one year | 370.5 | - | - | <u>370.5</u> |
| Debt | | | | |
| Finance leases | (892.1) | 8.6 | - | (883.5) |
| Debt falling due within one year | (4.5) | 4.5 | (134.4) | (134.4) |
| Bond issue costs | 4.9 | - | 1.4 | 6.3 |
| Indexation of intercompany loan | (160.9) | - | 9.5 | (151.4) |
| Accrued interest | (42.0) | - | (1.9) | (43.9) |
| Debt falling due after one year | <u>(1,665.3)</u> | <u>(174.0)</u> | <u>134.2</u> | <u>(1,705.1)</u> |
| | <u>(2,759.9)</u> | <u>(160.9)</u> | <u>8.8</u> | <u>(2,912.0)</u> |
| Net debt | <u>(2,251.0)</u> | <u>(51.7)</u> | <u>8.8</u> | <u>(2,293.9)</u> |

26 Directors' and officers' loans and transactions

No loan or credit transaction with any Director, officer or connected person existed during the year or was outstanding at the year-end.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

27 Pensions

The group operates a funded defined benefit pension scheme for current employees (based on final pensionable salary and pensionable service), the DCWW Pension Scheme. The assets of the scheme are held in a separate trustee-administered fund.

The DCWW Pension Scheme was closed to new members from 31 December 2005 and a new defined contribution scheme, the Dŵr Cymru Defined Contribution Scheme, was introduced from 1 January 2006.

Subsequent to the end of the year, on 1 April 2010 1,093 United Utilities Operational Services ('UUOS') employees transferred to Welsh Water, followed by 476 Kelda Water Services ('KWS') employees on 1 May 2010. Around 1,000 UUOS and KWS employees transferring to Welsh Water are entitled to transfer their existing defined benefit pensions into the DCWW Pension Scheme. In aggregate the transfer is likely to be fully-funded on an actuarial basis, although this result is uncertain and the assumptions used may differ from the calculation under IAS 19.

Assuming that all 1,000 members transfer their pensions into the DCWW Pension Scheme, this would increase scheme assets as at 31 March 2010 by around £177m. Assuming that all members commute the maximum possible pension for cash at retirement, the IAS 19 liability as at the same date would be broadly similar. Scheme membership would increase from around 150 to a total of around 1,150 members.

In the event that the IAS 19 valuation varies from the funded actuarial valuation at the date of transfer, any differences will be taken to the income statement for the year to 31 March 2011.

See also subsequent events note 31.

Total pension costs in the year were as follows:

| | 2010 | 2009 |
|---|--------------|---------------|
| | £'000 | £'000 |
| Defined contribution scheme | 273 | 122 |
| Defined benefit scheme - excluding actuarial losses | <u>1,287</u> | <u>927</u> |
| | 1,560 | 1,049 |
| Net actuarial losses recognised in year | <u>1,512</u> | <u>10,400</u> |
| | 3,072 | 11,449 |

A charge of £1.560m (2009: £1.049m) is included within operating costs. The net actuarial loss is recognised in the statement of total recognised gains and losses.

Defined benefit scheme

A full actuarial valuation of the scheme was undertaken as at 31 March 2009 by Robert Davies of Quantum Advisory, an independent, professionally qualified actuary, using the attained age method. This valuation was updated at 31 March 2010 and the principal assumptions made by the actuaries were:

| | 2010 | 2009 |
|---|-------------------|------------|
| Rate of increase in pensionable salaries | 4.5% | 3.7% |
| Rate of increase in pensions in payment | 3.5% | 2.7% |
| Discount rate | 5.6% | 6.2% |
| Inflation assumption | 3.3% | 2.7% |
| Post retirement mortality (life expectancy): | | |
| - Current pensioners age 65 - males | 87.0 years | 87.0 years |
| - Current pensioners age 65 - females | 89.9 years | 89.9 years |
| - Future pensioners age 65 (currently age 45) - males | 88.1 years | 88.1 years |
| - Future pensioners age 65 (currently age 45) - females | 90.9 years | 90.9 years |
| Expected return on assets | 6.51% | 6.75% |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

27 Pensions cont'd

The expected rates of return on the assets in the scheme were:

| | 2010 | | 2009 | |
|----------|-----------------|-------------------|-----------------|-------------------|
| | Expected return | % of total assets | Expected return | % of total assets |
| Equities | 7.5% | 60.5% | 8.0% | 59.0% |
| Bonds | 5.0% | 39.2% | 5.0% | 39.8% |
| Other | 3.0% | 0.3% | 3.0% | 1.2% |

The following amounts at 31 March were measured in accordance with the requirements of FRS 17: "Retirement benefits".

| | 2010 £'000 | 2009 £'000 |
|---|---------------|---------------|
| Present value of scheme liabilities | (54,796) | (40,051) |
| Total market value of assets | 46,773 | 32,283 |
| Total plan liability | (8,023) | (7,768) |
| Related deferred tax asset | 2,246 | 2,339 |
| Net liability recognised in the balance sheet | (5,777) | (5,429) |

| | 2010 £'000 | 2009 £'000 |
|--|---------------|---------------|
| Current service cost (excluding member contributions) | 852 | 878 |
| Past service cost | 151 | 151 |
| Effect of curtailments/settlements | - | 99 |
| Total included within operating profit | 1,003 | 1,128 |
| Interest cost | 2,538 | 2,353 |
| Expected return on plan assets | (2,254) | (2,554) |
| Total included within other finance (expense)/income | 284 | (201) |
| Total recognised in the profit and loss account | 1,287 | 927 |

| | 2010 £'000 | 2009 £'000 |
|---|---------------|---------------|
| Net actuarial loss recognised in year | 1,512 | 10,400 |
| Total recognised in the statement of total recognised gains and losses | 1,512 | 10,400 |

Movement in surplus/(deficit) during the year:

| | 2010 £'000 | 2009 £'000 |
|---|---------------|---------------|
| At 1 April | (7,768) | 2,047 |
| Interest cost | (2,538) | (2,353) |
| Current service cost | (1,209) | (1,241) |
| Contributions | 2,901 | 1,875 |
| Expected return on scheme assets | 2,254 | 2,554 |
| Past service cost - vested benefits | (151) | (151) |
| Effect of any curtailments or settlements | - | (99) |
| Actuarial loss | (1,512) | (10,400) |
| At 31 March | (8,023) | (7,768) |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

27 Pensions cont'd

| History of experience gains and losses | 2010 | 2009 | 2008 | 2007 |
|---|---------|----------|---------|---------|
| Difference between the actual and expected return on scheme assets: | | | | |
| - Amount (£'000) | 9,977 | (9,301) | (4,704) | (229) |
| - Percentage of scheme assets | (21%) | 29% | 12% | 1% |
| Experience loss on scheme liabilities: | | | | |
| - Amount (£'000) | - | (1,346) | - | (1,961) |
| - Percentage of present value of scheme liabilities | - | 3% | - | 5% |
| Total amount recognised in statement of total recognised gains and losses | | | | |
| - Amount (£'000) | (1,512) | (10,400) | 3,339 | (921) |
| - Percentage of present value of scheme liabilities | 3% | 26% | 8% | 2% |

28 Elan Valley Trust Fund

In 1984 Welsh Water Authority entered into a conditional sale and purchase agreement with Severn Trent Water Authority for the sale of the aqueduct and associated works by which the bulk supply to Severn Trent reservoirs is conveyed.

The sum of £31.7m, representing the consideration for the conditional sale, was invested in a trust fund. The principal function of the fund was to provide an income to Welsh Water Authority, whilst preserving the capital value of the fund in real terms. Welsh Water Authority's interest in this fund was vested in Dŵr Cymru Cyfyngedig under the provisions of the Water Act 1989. The assets of the fund are not included in these financial statements.

Interest receivable includes £2.6m (2009: £2.3m) in respect of the Elan Valley Trust Fund.

29 Disclosure of transactions with associates

There were no transactions with any associated companies except for:

- the Directors of Dŵr Cymru Cyfyngedig are also directors of other companies within the Glas Cymru Group. However, the emoluments of the Directors are paid in full by Dŵr Cymru Cyfyngedig as their activities are predominantly related to the regulated water and sewerage business. During the year the Directors' emoluments amounted to £1,416,344 (2009: £1,335,369);
- investments include a loan to the company's immediate parent company, Dŵr Cymru (Holdings) Limited, of £370.5m (2009: £370.5m), included in debtors. The interest rate on this loan is 12%, and loan interest of £44.6m (2009: £44.6m) has been waived by the company during the year. The interest waiver is a practical alternative to funding the interest otherwise receivable by the company by means of an ordinary dividend; and
- the proceeds of the Group's bond programme have been on-lent to Dŵr Cymru Cyfyngedig under an intercompany loan agreement. Under the terms of this agreement, the interest rates payable by the company are based on the interest rates payable to the bondholders after taking into account interest rate and currency swaps, plus a margin of 0.01%.

30 Immediate and ultimate holding company

The company's immediate parent company is Dŵr Cymru (Holdings) Limited, which is registered in England and Wales.

The smallest and largest group within which the results of this company are consolidated is headed by Glas Cymru Cyfyngedig, whose consolidated financial statements can be obtained from the company Secretary at Pentwyn Road, Nelson, Treharris, Caerphilly CF46 6LY.

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

31 Subsequent events

On 9 February 2010 Welsh Water announced its intention to restructure the business by terminating the outsourced operational contracts with United Utilities Operational Services ('UUOS') and Kelda Water Services ('KWS') and by implementing a phased headcount reduction of around 300 people.

Subsequent to the end of the year, negotiations relating to the termination of the contracts have been finalised, and on 1 April 2010 1,093 UUOS employees transferred to Welsh Water, followed by 476 KWS employees on 1 May 2010.

Around 1,000 UUOS and KWS employees transferring to Welsh Water are entitled to transfer their existing defined benefit pensions into the DCWW Pension Scheme. In aggregate the transfer is likely to be fully-funded on an actuarial basis, although this result is uncertain and the assumptions used may differ from the calculation under IAS 19.

Assuming that all 1,000 members transfer their pensions into the DCWW Pension Scheme, this would increase scheme assets as at 31 March 2010 by around £177m. Assuming that all members commute the maximum possible pension for cash at retirement, the IAS 19 liability as at the same date would be broadly similar.

In the event that the IAS 19 valuation varies from the funded actuarial valuation at the date of transfer, any differences will be taken to the income statement for the year to 31 March 2011.

The financial statements contain exceptional items of £29.5m relating to the costs of terminating the contracts and reorganising the business (see note 4).

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

32 Reconciliation of regulatory accounts to statutory financial statements

Welsh Water's regulatory accounts for the year ended 31 March 2010 are prepared on the basis of Regulatory Accounting Guidelines and UK accounting standards. However, the company's statutory financial statements are prepared under International Financial Reporting Standards (IFRS). The principal differences between the company's regulatory accounts and its statutory financial statements are set out below.

| | 2010 | 2009 |
|--|----------------|----------------|
| | £'000 | £'000 |
| Profit and loss account / income statement | | |
| <u>a) Operating costs</u> | | |
| Per regulatory accounts | 459.6 | 428.2 |
| Difference in infrastructure accounting | 17.1 | 39.2 |
| Difference in depreciation | 33.8 | 32.6 |
| Amortisation of grants and contributions | 1.5 | 1.4 |
| Other UK GAAP/IFRS differences | 0.4 | 0.3 |
| Per statutory financial statements | 512.4 | 501.7 |
| <u>b) Net financing costs</u> | | |
| Per regulatory accounts | 104.0 | 166.0 |
| Capitalisation of borrowing costs in accordance with IAS 23 | (6.1) | - |
| Fair value losses on derivative financial instruments per IAS 39 | 7.3 | 62.2 |
| Per statutory financial statements | 105.2 | 228.2 |
| <u>c) Taxation (charge)/credit</u> | | |
| Per regulatory accounts | (0.8) | 14.6 |
| Prior year UK GAAP/IFRS adjustment | - | 3.0 |
| IFRS impact of abolition of Industrial Buildings Allowances | - | (37.0) |
| Other UK GAAP/IFRS differences | (2.3) | 7.1 |
| Per statutory financial statements | (3.1) | (12.3) |
| | 2010 | 2009 |
| Balance sheet | £'000 | £'000 |
| <u>a) Fixed assets</u> | | |
| <i>Cost</i> | | |
| At 31 March per regulatory accounts | 5,466.1 | 5,123.2 |
| Effect of 2004 IFRS asset revaluation | (449.1) | (449.1) |
| Intangible assets separately identified under IFRS | (116.6) | (101.5) |
| Infrastructure renewals expenditure capitalised in previous years | (304.6) | (222.4) |
| Infrastructure renewals expenditure capitalised in the year | (67.4) | (82.2) |
| Section 19 expenditure capitalised in previous years | (111.1) | (88.2) |
| Section 19 expenditure capitalised in the year | (9.9) | (22.9) |
| Capitalisation of borrowing costs in accordance with IAS 23 | 6.1 | - |
| At 31 March per statutory financial statements | 4,413.5 | 4,156.9 |
| <i>Depreciation</i> | | |
| At 31 March per regulatory accounts | 2,054.3 | 1,887.8 |
| Adjustment to opening balance | (442.9) | (442.9) |
| Intangible assets separately identified under IFRS | (56.5) | (55.3) |
| Depreciation charge for infrastructure assets (net of depreciation on disposal) - prior years | (338.5) | (264.1) |
| Depreciation charge for infrastructure assets (net of depreciation on disposal) - current year | (67.4) | (74.4) |
| Other IFRS differences (relating principally to finance leases) | (4.4) | (5.2) |
| Infrastructure depreciation per IFRS - prior years | 131.2 | 102.8 |
| Infrastructure depreciation per IFRS - current year | 33.8 | 28.4 |
| At 31 March per statutory financial statements | 1,309.6 | 1,177.1 |

Notes to the historical cost financial statements for the year ended 31 March 2010 cont'd

32 Reconciliation of regulatory accounts to statutory financial statements cont'd

Balance sheet cont'd

b) Derivative financial instruments

| | | |
|--|---------------|--------|
| At 31 March per regulatory accounts | - | - |
| Derivative non-current financial assets | 0.8 | - |
| Derivative current financial liabilities | (25.7) | (0.7) |
| Derivative current financial assets | - | 14.2 |
| Derivative non-current financial assets | (61.0) | (92.1) |
| At 31 March per statutory financial statements | (85.9) | (78.6) |

c) Current asset investments / held to maturity investments

| | | |
|--|----------------|---------|
| At 31 March per regulatory accounts | 244.0 | 135.5 |
| Reclassified as cash and cash equivalents for IFRS | (244.0) | (135.5) |
| At 31 March per statutory financial statements | - | - |

d) Cash at bank and in hand / cash and cash equivalents

| | | |
|--|--------------|-------|
| At 31 March per regulatory accounts | 3.6 | 2.9 |
| Reclassified from current asset investments for IFRS | 244.0 | 135.5 |
| At 31 March per statutory financial statements | 247.6 | 138.4 |

e) Debtors due < 1 year

| | | |
|---|---------------|--------|
| At 31 March per regulatory accounts | 139.0 | 120.0 |
| Infrastructure renewals prepayment | (26.3) | (19.2) |
| Reclassification of customer security deposits under IFRS | 1.4 | 1.4 |
| Other difference | (0.1) | 0.1 |
| At 31 March per statutory financial statements | 114.0 | 102.3 |

f) Retirement benefit obligations

| | | |
|--|------------|-----|
| At 31 March per regulatory accounts | 5.8 | 5.4 |
| Add back related deferred tax asset | 2.2 | 2.4 |
| At 31 March per statutory financial statements | 8.0 | 7.8 |

g) Deferred income

| | | |
|--|---------------|--------|
| At 31 March per regulatory accounts | 26.3 | 27.8 |
| Write-back of deferred income under IFRS | (26.3) | (27.8) |
| At 31 March per statutory financial statements | - | - |

h) Deferred taxation provision

| | | |
|--|--------------|-------|
| At 31 March per regulatory accounts | 230.6 | 228.0 |
| Deferred tax on rolled over capital gains | 41.5 | 41.5 |
| Deferred tax on abolition of Industrial Buildings Allowances | 37.0 | 37.0 |
| Deferred tax on retirement benefit obligations | (2.2) | (2.4) |
| Other difference (prior year) | (0.1) | (2.1) |
| At 31 March per statutory financial statements | 306.8 | 302.0 |

Current cost financial statements and accompanying notes for the appointed business for the year ended 31 March 2010

Current cost profit and loss account for the appointed business for the year ended 31 March 2010

| | Note | 2010 £m | 2009 £m |
|---|------|----------------|------------|
| Turnover | 2 | 681.8 | 650.4 |
| Current cost operating costs | | (472.3) | (479.4) |
| Other operating expense | 2 | (0.4) | (0.8) |
| | | 209.1 | 170.2 |
| Working capital adjustment | | 1.2 | (0.1) |
| Current cost operating profit | | 210.3 | 170.1 |
| Interest payable | | (107.2) | (174.8) |
| Interest receivable | | 3.3 | 7.3 |
| Other finance (expense)/income | | (0.3) | 0.2 |
| Financing adjustment | | 59.7 | (5.1) |
| Current cost profit/(loss) before taxation | | 165.8 | (2.3) |
| Current taxation | | 1.7 | - |
| Deferred taxation | | (2.5) | 14.6 |
| Current cost profit on ordinary activities after taxation | | 165.0 | 12.3 |
| Dividends on ordinary shares | | - | - |
| Retained current cost profit for the year | 5a | 165.0 | 12.3 |

Current cost statement of total recognised gains and losses for the appointed business for the year ended 31 March 2010

| | 2010 £m | 2009 £m |
|---|--------------|------------|
| Profit for the year | 165.0 | 12.3 |
| Actuarial loss recognised in the pension scheme | (1.5) | (10.4) |
| Movement on deferred tax asset relating to pension scheme | (0.1) | 2.9 |
| Total recognised gains for the year | 163.4 | 4.8 |

Current cost balance sheet for the appointed business at 31 March 2010

| | Note | 2010 £m | 2009 £m |
|--|------|------------------|------------------|
| Fixed assets | | | |
| Tangible assets | 3c | 24,142.4 | 16,958.8 |
| Grants and contributions | | <u>(261.2)</u> | <u>(242.6)</u> |
| | | 23,881.2 | 16,716.2 |
| Working capital | | | |
| Working capital | 4 | (18.2) | (27.1) |
| Cash | | 3.6 | 2.9 |
| Short term deposits | | 210.4 | 102.3 |
| Infrastructure renewals prepayment | | <u>26.3</u> | <u>19.2</u> |
| Net operating assets | | 24,103.3 | 16,813.5 |
| Non-operating assets and liabilities | | | |
| Borrowings | | (144.3) | (13.1) |
| Non-trade debtors | | 1.7 | 0.1 |
| Non-trade creditors due within one year | | (9.6) | (10.6) |
| Investment - loan to group company | | 370.5 | 370.5 |
| Investment - other | | <u>0.1</u> | <u>0.1</u> |
| Total non-operating assets and liabilities | | 218.4 | 347.0 |
| Creditors: amounts falling due after more than one year | | | |
| Borrowings | | (2,723.8) | (2,704.8) |
| Other creditors | | <u>(38.0)</u> | <u>(35.0)</u> |
| Total creditors falling due after more than one year | | (2,761.8) | (2,739.8) |
| Provisions for liabilities and charges | | | |
| Deferred taxation | | (230.5) | (228.0) |
| Post employment liabilities | | (5.8) | (5.4) |
| Other provisions for liabilities and charges | | <u>(39.5)</u> | <u>(11.6)</u> |
| Total provisions | | (275.8) | (245.0) |
| Net assets | | 21,284.1 | 14,175.7 |
| Capital and reserves | | | |
| Called up share capital | | 309.9 | 309.9 |
| Profit and loss account | 5a | (323.5) | (486.8) |
| Current cost reserve | 5b | 21,131.5 | 14,186.4 |
| Capital redemption reserve | | 166.2 | 166.2 |
| Total capital and reserves | | 21,284.1 | 14,175.7 |

Current cost cash flow statement for the appointed business for the year ended 31 March 2010

| | Note | 2010 £m | 2009 £m |
|---|------|----------------|------------|
| Net cash inflow from operating activities | 6 | 408.6 | 421.8 |
| Returns on investment and servicing of finance | | | |
| Interest received | | 3.2 | 8.5 |
| Interest paid | | (100.4) | (98.3) |
| Interest element of finance lease rental payments | | (15.8) | (31.3) |
| Net cash flow from returns on investments and servicing of finance | | (113.0) | (121.1) |
| Capital expenditure and financial investment | | | |
| Purchase of tangible fixed assets | | (292.2) | (296.5) |
| Sale of tangible fixed assets | | (0.4) | (0.8) |
| Infrastructure renewals expenditure | | (67.4) | (73.8) |
| Grants and contributions received | | 12.3 | 13.6 |
| Net cash flow from investing activities | | (347.7) | (357.5) |
| Net cash outflow before use of liquid resources and financing | | (52.1) | (56.8) |
| Management of liquid resources | | | |
| Net movement in deposits | | (108.1) | (13.2) |
| Net cash flow before financing | | (160.2) | (70.0) |
| Financing | | | |
| Finance leases received | | - | 60.0 |
| Net loan received from group undertaking | | 134.9 | 20.6 |
| New term loan | | 35.0 | - |
| Other loan repayments | | (0.4) | (0.3) |
| Capital element of finance lease repayments | | (8.6) | (10.4) |
| Net cash flow from financing | | 160.9 | 69.9 |
| Increase/(decrease) in cash in the year | 7 | 0.7 | (0.1) |

Current cost notes to the financial statements for the year ended 31 March 2010

1 Accounting policies

The accounting policies used are the same as those adopted in the historical cost financial statements, except as set out below.

Basis of preparation

These financial statements have been prepared for the appointed business of Dŵr Cymru Cyfyngedig in accordance with guidance issued by the Director General of Water Services for modified real terms financial statements suitable for regulation in the water industry. They measure profitability on the basis of real financial capital maintenance, in the context of assets which are valued at their current cost value to the business.

Real financial capital maintenance adjustments

These adjustments are made to historical cost profit in order to arrive at profit after the maintenance of financial capital in real terms.

Depreciation adjustment - this is the difference between depreciation based on the current cost value of assets in these accounts and depreciation charged in arriving at historical cost profit.

Working capital adjustment - this is calculated by applying the change in Retail Price Index (RPI) over the year to the opening total of working capital (see note 5).

Financing adjustment - this is calculated by applying the change in the RPI over the year to the opening balance of net finance, which comprises all monetary assets and liabilities in the balance sheet apart from those included in working capital, and liabilities that are already indexed linked through the historical cost profit and loss account.

Valuation bases for determining depreciation and disposal adjustment

i) Current Cost Asset Values

All fixed assets are valued using the Modern Equivalent Asset Revaluation ('MEAV') completed as part of the PR09 Business Plan, and adjusted for enhancement additions which increase the value of the asset subsequent to 31 March 2008 (being the date of the MEAV). MEAV values are updated using RPI. This ensures assets are valued as closely as possible to their current replacement costs.

ii) Disposals

Asset disposals are recorded as maintenance expenditure is committed to ensure the asset stock is valued at its replacement cost. The value of disposals each year represents the equivalent retirement from the MEAV. This amount is also shown in cumulative current cost depreciation.

iii) Current Cost Depreciation

Assets from the MEAV are depreciated by applying asset lives in line with the historic cost asset register combined with condition grades of the assets at the time of the MEAV. Asset additions are depreciated using asset lives straight out of the historic cost asset register and inflated using RPI to the report year.

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

2 Analysis of turnover and operating income for the appointed business

| | Water services 2010 | Sewerage services 2010 | Appointed business 2010 | Water services 2009 | Sewerage services 2009 | Appointed business 2009 |
|--|---------------------------|------------------------------|-------------------------------|---------------------------|------------------------------|-------------------------------|
| | £m | £m | £m | £m | £m | £m |
| Turnover | | | | | | |
| Unmeasured | 163.1 | 225.5 | 388.6 | 160.4 | 220.9 | 381.3 |
| Measured | 118.7 | 126.9 | 245.6 | 112.1 | 110.0 | 222.1 |
| Trade effluent | - | 8.6 | 8.6 | - | 10.5 | 10.5 |
| Large users and special agreements | 8.8 | 7.3 | 16.1 | 9.0 | 7.7 | 16.7 |
| Non-potable large users and special agreements | 5.9 | - | 5.9 | 5.8 | - | 5.8 |
| Third party (excluding non-potable water) | 10.7 | - | 10.7 | 7.9 | - | 7.9 |
| Other sources | 6.3 | - | 6.3 | 6.0 | 0.1 | 6.1 |
| Total turnover | 313.5 | 368.3 | 681.8 | 301.2 | 349.2 | 650.4 |
| Other operating income | | | | | | |
| Current cost disposal of fixed assets | (0.2) | (0.2) | (0.4) | (0.4) | (0.4) | (0.8) |

The value for large user revenues has been based on potable supplies of 250ML per year and above, which are excluded from the tariff basket. Ofwat have defined "large users" as those using 100ML per year. However, this level has not been agreed within Wales and consequently 250ML per year has been used.

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

3(a) Current cost analysis of tangible fixed assets by asset type: water services

| | Specialised operational properties £m | Non-specialised operational properties £m | Infrastructure assets £m | Other tangible assets £m | Total £m |
|---------------------------------|--|--|--------------------------------|--------------------------------|----------------|
| Gross replacement cost | | | | | |
| At 1 April 2009 | 1,795.8 | 23.2 | 6,122.9 | 211.7 | 8,153.6 |
| AMP adjustment | (65.2) | (1.7) | 904.2 | (83.7) | 753.6 |
| RPI adjustment | 76.2 | 1.0 | 312.6 | 6.5 | 396.3 |
| Additions | 101.5 | - | 21.4 | - | 122.9 |
| Disposals | (41.0) | - | - | - | (41.0) |
| At 31 March 2010 | 1,867.3 | 22.5 | 7,361.1 | 134.5 | 9,385.4 |
| Accumulated depreciation | | | | | |
| At 1 April 2009 | 875.1 | 15.6 | - | 131.7 | 1,022.4 |
| AMP adjustment | (31.7) | (1.2) | - | (47.3) | (80.2) |
| RPI adjustment | 37.2 | 0.6 | - | 4.1 | 41.9 |
| Charge for the year | 48.8 | 0.8 | - | 3.6 | 53.2 |
| Disposals | (41.0) | - | - | - | (41.0) |
| At 31 March 2010 | 888.4 | 15.8 | - | 92.1 | 996.3 |
| Net book value | | | | | |
| At 31 March 2010 | 978.9 | 6.7 | 7,361.1 | 42.4 | 8,389.1 |
| At 31 March 2009 | 920.7 | 7.6 | 6,122.9 | 80.0 | 7,131.2 |

3(b) Current cost analysis of tangible fixed assets by asset type: sewerage services

| | Specialised operational properties £m | Non-specialised operational properties £m | Infrastructure assets £m | Other tangible assets £m | Total £m |
|---------------------------------|--|--|--------------------------------|--------------------------------|-----------------|
| Gross replacement cost | | | | | |
| At 1 April 2009 | 2,150.4 | 17.2 | 8,417.2 | 149.2 | 10,734.0 |
| AMP adjustment | 350.0 | 2.5 | 5,660.5 | (13.8) | 5,999.2 |
| RPI adjustment | 110.6 | 0.9 | 626.3 | 6.6 | 744.4 |
| Additions | 137.5 | - | 30.9 | - | 168.4 |
| Disposals | (35.9) | - | - | - | (35.9) |
| At 31 March 2010 | 2,712.6 | 20.6 | 14,734.9 | 142.0 | 17,610.1 |
| Accumulated depreciation | | | | | |
| At 1 April 2009 | 791.2 | 8.6 | - | 106.6 | 906.4 |
| AMP adjustment | 850.0 | 7.9 | - | (20.5) | 837.4 |
| RPI adjustment | 72.7 | 0.7 | - | 4.2 | 77.6 |
| Charge for the year | 65.0 | 0.7 | - | 5.6 | 71.3 |
| Disposals | (35.9) | - | - | - | (35.9) |
| At 31 March 2010 | 1,743.0 | 17.9 | - | 95.9 | 1,856.8 |
| Net book value | | | | | |
| At 31 March 2010 | 969.6 | 2.7 | 14,734.9 | 46.1 | 15,753.3 |
| At 31 March 2009 | 1,359.2 | 8.6 | 8,417.2 | 42.6 | 9,827.6 |

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

3(c) Current cost analysis of tangible fixed assets by asset type: total services

| | Specialised operational properties £m | Non-specialised operational properties £m | Infrastructure assets £m | Other tangible assets £m | Total £m |
|---------------------------------|--|--|--------------------------------|--------------------------------|-----------------|
| Gross replacement cost | | | | | |
| At 1 April 2009 | 3,946.2 | 40.4 | 14,540.1 | 360.9 | 18,887.6 |
| AMP adjustment | 284.8 | 0.8 | 6,564.7 | (97.5) | 6,752.8 |
| RPI adjustment | 186.8 | 1.9 | 938.9 | 13.1 | 1,140.7 |
| Additions | 239.0 | - | 52.3 | - | 291.3 |
| Disposals | (76.9) | - | - | - | (76.9) |
| At 31 March 2010 | 4,579.9 | 43.1 | 22,096.0 | 276.5 | 26,995.5 |
| Accumulated depreciation | | | | | |
| At 1 April 2009 | 1,666.3 | 24.2 | - | 238.3 | 1,928.8 |
| AMP adjustment | 818.3 | 6.7 | - | (67.8) | 757.2 |
| RPI adjustment | 109.9 | 1.3 | - | 8.3 | 119.5 |
| Charge for the year | 113.8 | 1.5 | - | 9.2 | 124.5 |
| Disposals | (76.9) | - | - | - | (76.9) |
| At 31 March 2010 | 2,631.4 | 33.7 | - | 188.0 | 2,853.1 |
| Net book value | | | | | |
| At 31 March 2010 | 1,948.5 | 9.4 | 22,096.0 | 88.5 | 24,142.4 |
| At 31 March 2009 | 2,279.9 | 16.2 | 14,540.1 | 122.6 | 16,958.8 |

4 Working capital

| | 2010 £m | 2009 £m |
|---|---------------|---------------|
| Trade debtors | | |
| - measured household | 7.4 | 6.4 |
| - unmeasured household | 28.3 | 27.2 |
| - measured non-household | 4.1 | 3.1 |
| - unmeasured non-household | 0.5 | 0.7 |
| - other | 8.4 | 1.4 |
| Measured income accrual | 61.1 | 59.2 |
| Prepayments and other debtors | 1.0 | 2.7 |
| Trade creditors | (20.5) | (26.9) |
| Deferred income - customer advance receipts | (48.8) | (44.1) |
| Short term capital creditors | (56.6) | (53.4) |
| Accruals and other creditors | (3.1) | (3.4) |
| | (18.2) | (27.1) |

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

5 Movement on reserves of the appointed business

| | 2010 | 2009 |
|---|-----------------|-----------------|
| | £m | £m |
| a) Profit and loss account | | |
| At 1 April | (486.8) | (491.6) |
| Current cost profit for the year | 165.0 | 12.3 |
| Pension scheme actuarial loss net of deferred tax | (1.6) | (7.5) |
| At 31 March | <u>(323.5)</u> | <u>(486.8)</u> |
| a) Current cost reserve | | |
| At 1 April | 14,186.4 | 14,244.1 |
| AMP adjustment (application of MEA valuation) | 5,995.6 | - |
| | <u>20,182.0</u> | <u>14,244.1</u> |
| RPI adjustments: | | |
| - fixed assets | 1,021.2 | (63.9) |
| - working capital | (1.2) | 0.1 |
| - financing | (59.7) | 5.1 |
| - grants and contributions | (10.8) | 0.9 |
| At 31 March | <u>21,131.5</u> | <u>14,186.3</u> |

6 Reconciliation of current cost operating profit to net cash flow from operating activities for the appointed business

| | 2010 | 2009 |
|--|---------------------|--------------|
| | £m | £m |
| Current cost operating profit | 210.3 | 170.1 |
| Working capital adjustment | (1.2) | 0.1 |
| Movement in working capital | (12.0) | 13.8 |
| Current cost depreciation | 123.0 | 156.9 |
| Current cost disposal of fixed assets | 0.4 | 0.8 |
| Infrastructure renewals charge | 60.2 | 61.9 |
| Movement in provisions | 27.9 | 18.2 |
| Net cash flow from operating activities | <u>408.6</u> | <u>421.8</u> |

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

7 Analysis of net debt

| | 1 April 2009 £m | Cash flow £m | Non-cash items £m | 31 March 2010 £m |
|---|-----------------------|--------------------|-------------------------|------------------------|
| Net cash | | | | |
| Cash at bank and in hand | 2.9 | 0.7 | - | 3.6 |
| Liquid resources | | | | |
| Current asset investments | 102.3 | 108.1 | - | 210.4 |
| Group receivables | | | | |
| Debt owed by parent company, due after more than one year | 370.5 | - | - | 370.5 |
| Debt | | | | |
| Finance leases | (892.1) | 8.6 | - | (883.5) |
| Debt falling due within one year | (4.5) | 4.5 | (134.4) | (134.4) |
| Bond issue costs | 4.9 | - | 1.4 | 6.3 |
| Indexation of intercompany loan | (160.9) | - | 9.5 | (151.4) |
| Accrued interest | (42.0) | - | (1.9) | (43.9) |
| Debt falling due after one year | (1,665.3) | (174.0) | 134.2 | (1,705.1) |
| | (2,759.9) | (160.9) | 8.8 | (2,912.0) |
| Net debt | (2,284.2) | (52.1) | 8.8 | (2,327.5) |

| Maturity profile | Interest rate risk profile | | | Total |
|---------------------------------|----------------------------|------------------|------------------|-----------|
| | Fixed rate | Floating rate | Index- linked | |
| Cash at bank and in hand | | | | 3.6 |
| Short term deposits | | | | 210.4 |
| Debt owed by group company | | | | 370.5 |
| Accrued interest | | | | (43.9) |
| | | | | 540.6 |
| Borrowings: | | | | |
| - less than one year | (125.0) | (19.3) | - | (144.3) |
| - between one and two years | - | (25.7) | - | (25.7) |
| - between two and five years | (16.3) | (131.1) | - | (147.4) |
| - between five and twenty years | (756.0) | (501.5) | (593.0) | (1,850.5) |
| - in more than twenty years | - | (290.2) | (410.0) | (700.2) |
| | (897.3) | (967.8) | (1,003.0) | (2,868.1) |
| Net debt | | | | (2,327.5) |

The fair value of derivative financial instruments is not disclosed in the Regulatory Accounts or June Return 2010 tables, and the impact of these instruments is, accordingly, not taken into account in the interest rate risk profile shown above. However, the Group has entered into swap transactions which do not qualify for hedge accounting, as disclosed in the statutory financial statements prepared under International Financial Reporting Standards.

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

8 Regulatory capital value

The table below shows the regulatory capital value (RCV) used by Ofwat in 2009 in setting the price limits for 2009-10 at 2009-10 prices. Differences between the figures shown below and actual expenditure/charges for the year will not affect the price limits in the current regulatory period. Capital efficiencies will be taken into account in the calculation for the next periodic review in 2014.

| | £m |
|--|-------------------------|
| Closing RCV at 31 March 2009 | 3,574 |
| Indexation (inflating from 2008/09 prices to 2009/10 prices) | <u>160</u> |
| Opening RCV at 1 April 2009 | 3,734 |
| Capital expenditure (excluding IRE) | 181 |
| Infrastructure renewals expenditure | 50 |
| Infrastructure renewals charge | (59) |
| Grants and contributions | (7) |
| Current cost depreciation | (123) |
| Outperformance of regulatory assumptions | <u>(23)</u> |
| RCV at 31 March 2010 | <u>3,753</u> |
| Average RCV during the year | <u>3,660</u> |

On 7 May 2010 Ofwat published with opening RCV for 2010/11. This is different from the closing RCV shown in the table above and reflects the outcome of the 2009 Final Determination of price limits for the period 2010 to 2015.

The table below shows the effect of the Final Determination on the RCV at 31 March 2010.

| | £m |
|---|---------------------|
| RCV at 31 March 2010 per the 2004 Price Review | 3,753 |
| Logging up/down and shortfalls | (64) |
| Change in the notified index | 50 |
| Land sales | (2) |
| RCV at 31 March 2010 per the 2009 Price Review | <u>3,737</u> |

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

9 Operating cost activity table – 2009-10

The operating cost activity tables have been prepared in accordance with Regulatory Accounting Guideline 4.03, 'Guideline for the analysis of operating costs and assets'.

Direct costs have been charged directly to the service to which they relate.

General and support expenditure is, where possible, allocated directly to the service to which it relates. Where apportionments are required to allocate operating costs to the appropriate activity, the apportionment is based on the usage of that service by each activity. The apportionment bases used include employment costs for expenditure incurred in relation to people and resources, energy usage for power-related expenditure and management's assessment where there is no clear cost driver. In the absence of any causal links, general and support expenditure is apportioned on the basis of direct costs.

Business activity costs are analysed on a direct basis where possible, and in other instances apportioned over the service activity using relevant activity drivers:

- Customer services includes costs relating to our income and billing partner, Veolia, which are allocated between water and sewerage in proportion to customer numbers. Council commissions are allocated according to average household bills, while water company commissions are allocated fully to sewerage. Doubtful debts and the costs of regulation are split in proportion to the average household bill.
- Scientific services are split based on sampling activity. Included in this category are also head office costs associated with the management of the scientific, laboratory services and the monitoring of quality.

| | Water supply | | | Service analysis | | | |
|--|-----------------------------|--------------------|--------------------|------------------|------------------|------------------|------------------------|
| | Water resources & treatment | Water distribution | Water supply total | Sewerage | Sewage treatment | Sludge treatment | Sewerage service total |
| | 2009-10 £'000 | 2009-10 £'000 | 2009-10 £'000 | 2009-10 £'000 | 2009-10 £'000 | 2009-10 £'000 | 2009-10 £'000 |
| Direct costs | | | | | | | |
| Employment costs | 5,897 | 5,268 | 11,165 | 3,388 | 8,538 | 1,458 | 13,384 |
| Power | 8,841 | 6,650 | 15,491 | 2,473 | 12,992 | 2,667 | 18,132 |
| Hired and contracted services | 4,950 | 11,358 | 16,308 | 7,007 | 3,341 | 7,903 | 18,251 |
| Materials and consumables | 5,259 | 590 | 5,849 | 252 | 1,450 | 2,229 | 3,931 |
| Service charges | 9,782 | - | 9,782 | 1,784 | 3,545 | - | 5,329 |
| Bulk supply imports | 659 | - | 659 | - | - | - | - |
| Other direct costs | 1,590 | 1,275 | 2,865 | 612 | 1,219 | 548 | 2,379 |
| Total direct costs | 36,978 | 25,141 | 62,119 | 15,516 | 31,085 | 14,805 | 61,406 |
| General and support expenditure | 8,537 | 11,101 | 19,638 | 6,298 | 10,125 | 4,367 | 20,790 |
| Total functional expenditure | 45,515 | 36,242 | 81,757 | 21,814 | 41,210 | 19,172 | 82,196 |
| Business activities | | | | | | | |
| Customer services | | | 12,862 | | | | 13,657 |
| Scientific services | | | 7,729 | | | | 2,438 |
| Other business activities | | | 968 | | | | 1,319 |
| Total business activities | | | 21,559 | | | | 17,414 |
| Rates | | | 15,432 | | | | 11,353 |
| Doubtful debts | | | 9,448 | | | | 12,875 |
| Exceptional items | | | 12,468 | | | | 16,989 |
| Total opex costs less third party services | | | 140,664 | | | | 140,827 |
| Third party services - opex | | | 6,942 | | | | 704 |
| Total opex costs less third party services | | | 147,606 | | | | 141,531 |
| Capital maintenance | | | | | | | |
| Infrastructure renewals charge | 6,755 | 26,826 | 33,581 | 26,207 | - | - | 26,207 |
| Current cost depreciation | 20,360 | 29,675 | 50,035 | 23,184 | 42,147 | 5,126 | 70,457 |
| Capital maintenance less third party services | | | 83,616 | | | | 96,664 |
| Third party services - CCD | | | 2,521 | | | | - |
| Third party services - IRC | | | 445 | | | | - |
| Total capital maintenance | | | 86,582 | | | | 96,664 |
| Total operating costs | | | 234,188 | | | | 238,195 |
| CCA (MEA) values | | | | | | | |
| Service activities | 2,031,413 | 7,130,664 | 9,162,077 | 14,949,460 | 2,364,355 | 210,328 | 17,524,143 |
| Business activities | | | 195,626 | | | | 97,946 |
| Service totals | | | 9,357,703 | | | | 17,622,089 |
| Services for third parties | | | 29,439 | | | | - |
| Total | | | 9,387,142 | | | | 17,622,089 |

Current cost notes to the financial statements for the year ended 31 March 2010 cont'd

Operating cost activity table cont'd – 2008-09

| | Water supply | | | Service analysis | | | |
|---|-----------------------------------|-----------------------|-----------------------|-------------------|------------------|------------------|---------------------------|
| | Water resources & treatment | Water distribution | Water supply total | Sewerage services | | | Sewerage service total |
| | | | | Sewerage | Sewage | Sludge | |
| | | | | treatment | treatment | treatment | |
| 2008-09 £'000 | 2008-09 £'000 | 2008-09 £'000 | 2008-09 £'000 | 2008-09 £'000 | 2008-09 £'000 | 2008-09 £'000 | |
| Direct costs | | | | | | | |
| Employment costs | 5,506 | 5,534 | 11,040 | 3,740 | 7,367 | 1,463 | 12,570 |
| Power | 10,095 | 6,336 | 16,431 | 4,511 | 14,891 | 5,442 | 24,844 |
| Hired and contracted services | 5,007 | 10,456 | 15,463 | 7,053 | 2,954 | 7,463 | 17,470 |
| Materials and consumables | 5,684 | 561 | 6,245 | 190 | 1,064 | 2,288 | 3,542 |
| Service charges | 9,727 | - | 9,727 | 1,705 | 3,493 | - | 5,198 |
| Bulk supply imports | 638 | - | 638 | - | - | - | - |
| Other direct costs | 1,191 | 891 | 2,082 | 511 | 908 | 485 | 1,904 |
| Total direct costs | 37,848 | 23,778 | 61,626 | 17,710 | 30,677 | 17,141 | 65,528 |
| General and support expenditure | 9,833 | 11,161 | 20,994 | 5,791 | 10,053 | 4,941 | 20,785 |
| Total functional expenditure | 47,681 | 34,939 | 82,620 | 23,501 | 40,730 | 22,082 | 86,313 |
| Business activities | | | | | | | |
| Customer services | | | 14,334 | | | | 14,836 |
| Scientific services | | | 7,531 | | | | 1,533 |
| Other business activities | | | 829 | | | | 1,118 |
| Total business activities | | | 22,694 | | | | 17,487 |
| Rates | | | 14,707 | | | | 10,755 |
| Doubtful debts | | | 8,001 | | | | 10,791 |
| Total opex costs less third party services | | | 128,022 | | | | 125,346 |
| Third party services - opex | | | 7,188 | | | | - |
| Total opex costs less third party services | | | 135,210 | | | | 125,346 |
| Capital maintenance | | | | | | | |
| Infrastructure renewals charge | 3,902 | 29,684 | 33,586 | 27,805 | - | - | 27,805 |
| Current cost depreciation | 57,341 | 26,638 | 83,979 | 9,188 | 55,895 | 3,855 | 68,938 |
| Capital maintenance less third party services | | | 117,565 | | | | 96,743 |
| Third party services - CCD | | | 4,034 | | | | - |
| Third party services - IRC | | | 493 | | | | - |
| Total capital maintenance | | | 122,092 | | | | 96,743 |
| Total operating costs | | | 257,302 | | | | 222,089 |
| CCA (MEA) values | | | | | | | |
| Service activities | 1,819,200 | 6,093,461 | 7,912,661 | 8,417,200 | 1,587,615 | 580,085 | 10,584,900 |
| Business activities | | | 211,700 | | | | 149,200 |
| Service totals | | | 8,124,361 | | | | 10,734,100 |
| Services for third parties | | | 29,439 | | | | - |
| Total | | | 8,153,800 | | | | 10,734,100 |