Registered Nº: 2366777

Dŵr Cymru Cyfyngedig

Directors' report and financial statements

for the year ended 31 March 2006

Registered Office:-
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Foreword

These financial statements for Dŵr Cymru Cyfyngedig cover the year to 31 March 2006. The Company's immediate parent company is Dŵr Cymru (Holdings) Limited. The entire share capital of Dŵr Cymru (Holdings) Limited is owned by Glas Cymru (Securities) Cyfyngedig. The ultimate holding company and controlling party is Glas Cymru Cyfyngedig, a company registered in England and Wales.

Full details and analysis of the operational performance of Dŵr Cymru during the year to 31 March 2006 is included in the published report and accounts for Glas Cymru Cyfyngedig.

Directors and advisors

Directors

Lord Burns	Chairman
Nigel Annett	Managing Director
Chris Jones	Finance Director
Jim O'Sullivan	Operations Director
John Bryant	Non-Executive Director
Alison Carnwath	Non-Executive Director
Geraint Talfan Davies	Non-Executive Director
Dame Deidre Hine	Non-Executive Director
Tony Hobson	Non-Executive Director

Company secretary
R G Curtis

Auditors
PricewaterhouseCoopers LLP

Solicitors
Linklaters & Alliance
Edwards Geldard

Principal bankers
National Westminster Bank Plc

Directors' report

The Directors have pleasure in presenting their annual report to the shareholders, together with the audited financial statements for the year ended 31 March 2006 on pages 11 to 40.

Principal activity, business review and trading results

The principal activity of the Company is the supply of water and the treatment and disposal of waste water under the Instrument of Appointment made by the Secretary of State for Wales under the Water Act 1989.

Financial results

Welsh Water's turnover in the year to 31 March 2006 was £554 million (2005: £494 million) – an increase of 12%. The increase primarily reflects the price increase of 12.6% in the year. The effect of 'customer dividends' in the year was that turnover was some £23 million (2005: £12 million) below the level that would have resulted from the full price control allowed by Ofwat. The rate of voluntary customer switching to metered charging in the year slowed somewhat to nearly 27,000 customers (2005: 31,000 customers), whilst some 10,000 new customers were added during the year, who are all metered. There was continuing success from various income initiatives, which have added some £2 million this year to the revenue base, largely by ensuring that customers are being charged correctly for all the services that they receive from the Company.

Net interest charges for the year were effectively unchanged at £150 million (2005: £142 million - including a profit of £6 million on the termination of a finance lease) despite the increase in net debt during the year. In addition, under International Financial Reporting Standards, a charge of £4 million is made against the income statement for the movement in the fair value of financial instruments (2005: £nil), which is a non-cash item.

Profit before tax was £42 million (2005: £4 million). This profit was made after funding the 'customer dividend' of £18 for customers receiving both water and wastewater services. The Board of Welsh Water has decided to increase the 'customer dividend' for 2006-07 to £19, and intends to maintain the 'customer dividend' at least at that level until 2010.

The tax charge for the period was £7 million (2005: £8 million credit), comprising of a £4 million prior year corporation tax and group relief charge and a £3 million deferred tax charge.

Continued focus on cost control

Welsh Water's operating costs (excluding infrastructure renewals expenditure, depreciation and amortisation) were £213 million (2005: £219 million). This reduction in costs reflects the terms of new operations contracts, the cessation of one-off activities in 2004-05 and certain one-off benefits in 2005-06 such as a rates rebate. The business is experiencing significant upward cost pressures notably energy costs, which were some £9 million (or 54%) higher than in the previous year. The costs of the £25 ex gratia payment to some 30,000 customers in North West Wales affected by a boil water notice are included in operating costs.

Around 70% of operating costs were incurred under outsourced service contracts, including the contract 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, effective from 1 April 2005, for the operation of the wastewater network in south Wales and Herefordshire. These new contracts operate on a target cost basis which are designed to incentivise further improvements in operating efficiency in the period up to March 2010.

Customer debt recovery remains subject to very close attention by Welsh Water and by Thames Water, the billing and income services contract partner. Despite a difficult environment - water companies are not allowed to disconnect supplies to domestic customers due to non-payment - cash collection performance was ahead of target. The bad debt charge for the year of £8 million (2005: £8 million) represents less than 2% of annual turnover.

Capital expenditure by Welsh Water during the year (before capital grants and developer contributions and including infrastructure renewals expenditure) was £238 million (2005: £239 million), which is broadly in line with the expected average rate of expenditure over the five-year AMP4 period. Since 1 April 2005, Welsh Water has been working with a new alliance of capital investment partners (Laing

Utilities, Morrison, AMEC, Costain, Meica, and Black and Veatch) with the aim of delivering the AMP4 investment programme at the best value for money for customers. A priority during the first year of the programme has been to reappraise rigorously the design of certain key schemes with a view to achieving the reductions in unit costs assumed by Ofwat in the 2004 Price Review. At this relatively early stage, it is expected that investment expenditure over the AMP4 period as a whole of some £1.2 billion will be broadly in line with the allowance made by Ofwat in the Final Determination.

Financing strategy
The Board considers that it is in the best long-term interests of Welsh Water's customers to continue to reduce the level of gearing, with a view to achieving further reductions in its average cost of finance. These financing savings can then be passed on to customers in the form of sustained 'customer dividends' or additional investment in service improvements. Following extensive financing activity during the year, funding is now largely in place to 2010 for the AMP4 Programme.

Introduction of IFRS
These are Welsh Water's first set of annual financial results following the adoption of International Financial Reporting Standards (IFRS). Comparative figures for the year to 31 March 2005 have also been restated to comply with IFRS. A comprehensive document published by the Group in September 2005 set out the impact of the adoption of IFRS which, for Welsh Water, effects on the Company's reported results and balance sheet but represents an accounting change only and does not affect the underlying cashflows and financial position of the Company.

Future prospects
The objective of the Board will be to continue to improve the financial performance of the Company during the period to 31 March 2010, whilst seeking to at least maintain the current level of 'customer dividend'. The Board believes that its financial strategy will put the Company in a strong position to raise the funding for the following five-year investment programme in the period to 2015 on efficient terms, which is an important part of the Company's strategy to keep down customers' bills in the long-term.

The main risks to the achievement of this financial objective involve upward cost pressures. Most notably, power costs have increased dramatically over the last two years and are expected to increase further in 2006-07 and Welsh Water, like all water and sewerage companies, has a large energy requirement, notably for pumping and treatment processes. The increase in power prices can be only partially offset by improved working practices and investment in energy efficiency schemes. In addition, the unit costs of investment schemes are also under upward pressure. Welsh Water is seeking to mitigate these cost increases and risks by securing the resources for a long-term programme of work with its partners and by revisiting designs and working methods to secure offsetting efficiency improvements.

Welsh Water and its partner, Thames Water, also maintain a tight focus on customer cash collection and have introduced a new debt recovery system for metered customers, in recognition of the continuing risk to cash collection posed by increasing water bills and the absence of a disconnection sanction. Under the target cost arrangements, these upward cost pressures are shared only to an extent between Welsh Water and its relevant partners.

The Company does not expect to pay tax on its trading profits during the year to 31 March 2007, due to the availability of tax allowances on its investment programme. Future tax liabilities beyond that date will also be primarily influenced by this factor.

Disclaimer
This Report contains certain forward-looking statements with respect to the future business and taxation 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.

Dividend

During the year, the Company has not paid an ordinary dividend (2005: £nil) or preference dividends (2005: £14.0m).

Fixed assets

Freehold land and buildings are carried in the accounts at historical cost at a net book value of £17.2m (2005 £18.0m). In the opinion of the Directors there was no significant difference between book values of property capable of disposal within the foreseeable future and market values at 31 March 2006.

Directors' interests

Details of the present Directors are given on page 3. All Directors served throughout the financial year, except for Jim O'Sullivan who was appointed a Director on 12 September 2005. No Director has, or has had, a material interest, directly or indirectly, in any contract significant to the Company's business.

At the 2006 Annual General Meeting on 7 July 2006 ('2006 AGM') Alison Carnwath, Geraint Talfan Davies, Tony Hobson and Jim O'Sullivan will retire and seek re-election as Directors.

Policy on the payment of creditors

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 to suppliers of goods and services 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 2005-06, the average payment period was 61 days (2005: 70 days). Regulations require that in calculating this we include within trade creditors monies retained under contract in respect of capital investment projects. This level of retentions varies from year to year and adversely affects the average payment period for the year.

Employment policies

At 31 March 2006 Welsh Water employed 152 people.

A key part in delivering continuous improvement in the performance of the business and the level of service received by Welsh Water's customers is our ongoing investment in our people at all levels. We are committed to equality of opportunity and aim to treat all employees 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.

We believe all employees should have the opportunity to maximise their potential and individual training and development needs are assessed as part of an annual development review that applies to all our employees.

Welsh Water's outsourced procurement strategy has fundamentally changed the manner in which services have been delivered to customers since 2001 and has made a major contribution to improved levels of customer service in the last five years. This has been achieved, in large part, by the development of operational 'alliances' through which contract partners are encouraged to work with Welsh Water in a 'one-team' approach in the delivery of Welsh Water's business plan.

The success of the business is delivered through our employees, and it is important that they share in this success. We do this through a staff incentive scheme, which pays an annual bonus directly linked to the financial performance and customer service performance of the business (as measured by

Ofwat's 'Overall Performance Assessment'). In addition, last year employees received a longer-term bonus linked to the overall financial performance of the business between 2001 and 2005. As a result, in 2005-06 every employee received the maximum entitlement under these schemes totalling £4,500 each.

There is nothing more important to us than the health and safety of the people who work for us, and those we affect through our work. Our commitment to health and safety and the performance of Welsh Water and its contract partners in 2005-06 is set out in our 2006 Health and Safety Report. A copy of this document is available on request or may be obtained from the Welsh Water website www.dwrcymru.com.

Research and development

The Company continues to monitor and selectively participate in water industry initiatives, most notably through membership of UK Water Industry Research Limited. Through this, and by continuing to benefit from a sharing of best practice from the R&D investment and initiatives by our outsourced contract partners, we aim to maintain our achievements in improving operational efficiency, and to ensure continued compliance with appropriate national and international standards for potable water, sewage effluent and sludge treatment.

Contributions for charitable and political purposes

During the year, charitable donations amounted to £33,395 (2002 £22,394). Individual donations above £200 were made to: Water Aid (£16,000), Keep Wales Tidy (£10,000), Hereford Waterworks Museum (£5,000), Wheel Chair Fund (£1,000), St John's Ambulance (£600) and NSPCC (£500). Of these, Water Aid, St John's Ambulance and NSPCC are national Charities. It is group policy not to make donations to political parties. No payments or donations in kind have been made that are required to be disclosed under the Political Parties, Elections and Referendums Act 2000.

Regulatory accounts

Condition F of the Instrument of Appointment, under which Dŵr Cymru Cyfyngedig operates, requires that Dŵr Cymru Cyfyngedig publish additional financial information as an 'appointed business'. A copy of this information will be published on Dŵr Cymru Cyfyngedig's website or will otherwise be available on request from the Company secretary after 14 July 2006.

Welsh Language Scheme

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. We operate an approved Welsh Language Scheme under the provisions of the Wales Language Act 1993.

International Financial Reporting Standards

During the year, Dŵr Cymru Cyfyngedig adopted International Financial Reporting Standards and this is reflected in the financial results for the year ended 31 March 2006. A reconciliation of the results of the previous reporting period, previously reported under UK GAAP, to IFRS, together with a reconciliation of the Balance sheet as at 1 April 2004, the date of transition, is given in note 30 to the financial statements.

Glas Cymru, Dŵr Cymru Cyfyngedig's parent company, published an IFRS adoption document in September 2005, detailing the main changes to accounting policies and the resulting impact on the group's results. The majority of these are applicable to Dŵr Cymru Cyfyngedig. A copy of this document is available from the Company's website.

Auditors

PricewaterhouseCoopers LLP acted as auditors to Dŵr Cymru Cyfyngedig for the accounts for the year ended 31 March 2006. As part of the audit process each Director has confirmed, as at the date of the financial statements, that as far as the director is aware (a) there is no relevant audit information of which the Company's auditors are unaware, and (b) they have taken steps to make themselves aware

of any relevant audit information and to establish that the Company's auditors are aware of that information.

PricewaterhouseCoopers LLP have expressed their willingness to continue as auditors and a resolution for their reappointment will be considered at the 2006 annual general meeting. However, the Company is currently seeking bids for the provision of external audit services for the financial year commencing 2006-07, which process is expected to conclude in Summer 2006 at which time, unless re-appointed, PricewaterhouseCoopers LLP will resign and the Board will appoint a new auditor to fill the resulting vacancy.

By order of the Board

R Curtis LLB ACIS
Company Secretary

7 June 2006

Directors' responsibilities for the financial statements

The Directors are responsible for preparing the Annual Report and the Company financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare company financial statements for each financial year. They have elected to prepare the Company's financial statements in accordance with International Financial Reporting Standards ('IFRSs') as adopted by the EU.

The Company financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the Company and of the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing the Company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the Directors are also responsible for preparing a Directors' Report that complies with that law and those regulations.

By order of the Board

R Curtis LLB ACIS
Company Secretary

7 June 2006

Independent auditors' report to the members of Dŵr Cymru Cyfyngedig

We have audited the financial statements of Dŵr Cymru Cyfyngedig for the year ended 31 March 2006 which comprise the Income Statement, the Statement of changes in shareholders' equity, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of directors and auditors
The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985. We report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. We also report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

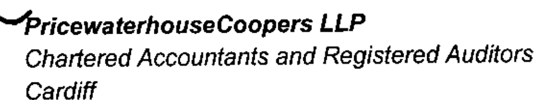
We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, 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 financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion
In our opinion:

- the financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the company's affairs as at 31 March 2006 and of its loss and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.



PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Cardiff

7 June 2006

Income statement for the year ended 31 March 2006

	Note		2006 £m		2005 £m
Revenue			**553.5**		494.1
Operating costs:					
- Operational expenditure			**(213.2)**		(218.9)
- Infrastructure renewals expenditure			**(48.8)**		(43.0)
- Depreciation			**(97.5)**		(89.8)
- Profit on disposal of fixed assets			**0.8**		4.3
Operating profit	4		**194.8**		146.7
Financing costs:					
- Interest payable and similar charges	3a	**(159.5)**		(165.8)	
- Interest receivable	3a	**9.7**		23.5	
- Fair value losses on financial instruments	3b	**(3.5)**		-	
			(153.3)		(142.3)
Profit before taxation			**41.5**		4.4
Taxation	5		**(7.0)**		7.6
Profit for the year			**34.5**		12.0

Statement of changes in Shareholders equity for the year ended 31 March 20006

	Share capital £m	Capital redemption reserve £m	Retained earnings £m	Total Reserves £m
At 1 April 2004	309.9	166.2	(70.4)	405.7
Net Profit for year	-	-	12.0	12.0
Dividends	-	-	(14.0)	(14.0)
At 31 March 2005	309.9	166.2	(72.4)	403.7
Net Profit for year	-	-	34.5	34.5
At 31 March 2006	**309.9**	**166.2**	**(37.9)**	**438.2**

The Company has no other recognised gains or losses in the period (2005: nil) and accordingly a statement of recognised income and expenses has not been presented.

Balance sheet as at 31 March 2006

	Note	2006 £m	2005 £m
Assets			
Non-current assets			
Intangible assets	6	**4.4**	4.4
Property, plant & equipment	7	**2,795.6**	2,720.9
Investments	8	**0.1**	0.1
Trade and other receivables	9b	**370.5**	371.4
Financial assets:			
- derivative financial instruments	14	**6.3**	-
		3.176.9	3,096.8
Current assets			
Trade and other receivables	9a	**86.8**	65.9
Financial assets:			
- held to maturity investments	10	**-**	89.1
- derivative financial instruments	14	**4.2**	-
Cash and cash equivalents	11	**13.9**	234.9
		104.9	389.9
Liabilities			
Current liabilities			
Financial liabilities:			
- borrowings	13	**(124.7)**	(111.0)
Trade and other payables	12	**(122.2)**	(128.7)
		(246.9)	(239.7)
Net current (liabilities) / assets		**(142.0)**	150.2
Non-current liabilities			
Financial liabilities:			
- borrowings	13	**(2,247.2)**	(2,509.3)
- derivative financial instruments	14	**(14.0)**	-
Retirement benefit obligations	22	**(6.6)**	(7.8)
Provisions	16	**(17.3)**	(17.9)
		(2,285.1)	(2,535.0)
Net assets before deferred tax		**749.8**	712.0
Deferred tax	17	**(311.6)**	(308.3)
Net assets		**438.2**	403.7
Shareholders' equity			
Called up share capital	18	**309.9**	309.9
Capital redemption reserve		**166.2**	166.2
Retained earnings		**(37.9)**	(72.4)
Total equity		**438.2**	403.7

The financial statements on pages 11 to 40 were approved by the Board of Directors on 7 June 2006 and were signed on its behalf by:

N C Annett
Managing Director

CA Jones
Finance Director

Cashflow statement for the year ended 31 March 2006

	Note	2006 £m	2005 £m
Cash generated from operations	19	**259.3**	228.3
Interest received		**10.1**	24.3
Interest paid		**(142.7)**	(158.6)
Tax paid		**(1.1)**	-
Preference dividend paid		**-**	(14.0)
Net cash inflow from operating activities		**125.6**	80.0
Cash flows from investing activities			
Purchase of property, plant and equipment		**(182.5)**	(231.2)
Grants and contributions received		**16.8**	11.2
Proceeds from sale of property, plant and equipment		**0.8)**	0.4)
Net cash used in investing activities		**(164.9)**	(219.6)
Net cash outflow before financing activities		**(39.3)**	(139.6)
Cash flows from financing activities			
Long term loans and finance leases received		**259.0**	273.9
Loan repaid to group undertaking		**(525.0)**	(100.0)
Loan repaid from group undertaking		**0.8**	56.2
Capital element of lease termination		**-**	(73.3)
Capital element of finance lease payments		**(5.2)**	(9.4)
Reduction in held to maturity investments		**89.1**	84.8
Other loan repayments		**(0.4)**	(0.3)
Net cash used in financing activities		**(181.7)**	231.9
(Decrease)/increase in net cash	20(b)	**(221.0)**	92.3
Net cash at 1 April		**234.9**	142.6
Net cash at 31 March	11	**13.9**	234.9

Principal accounting policies

1. Accounting policies, financing risk management and accounting estimates

Basis of Preparation

The financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union and those parts of the Companies Act 1984 applicable to reporting under IFRS. The financial statements have been prepared under the historical cost convention as modified by the revaluation of certain financial instruments to fair value in accordance with IFRS and as permitted by the Fair Value Directive as implemented in the amended Companies Act 1985.

At the date of approval of these financial statements, the following Standards and Interpretations which have not been applied in these financial statements were in issue but not yet effective:

IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures; and the related amendment to IAS 1 on capital disclosures
IFRIC 4	Determining whether an Arrangement contains a Lease
IFRIC 5	Rights to Interest Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS29 : Financial Reporting in Hyperinflationary Economies
IFRIC 8	Scope of IFRS 2
IFRIC 9	Reassessment of Embedded Derivatives

The Directors anticipate that the adoption of these Standards and Interpretations in future periods will have no material impact on the financial statements of the Company except for additional disclosures that may be required on financial instruments when the relevant standards come into effect for periods commencing on or after 1 January 2007.

Changes in accounting policies

The accounting policies and basis of preparation differ from those set out in the Report and Accounts for the year ended 31 March 2005, which were prepared in accordance with United Kingdom accounting standards and the Companies Act 1985 (UK GAAP).

IFRS1 "First time adoption of International Financial Reporting Standards" sets out the requirements for companies preparing financial statements under IFRS for the first time and requires the accounting policies to be applied retrospectively. IFRS1 contains the option to take advantage of certain exemptions to the retrospective application. The Company has applied the following optional exemptions:

- To establish a deemed cost for the opening balance sheet carrying value of the water and wastewater infrastructure fixed assets by reference to the fair value at the date of transition to IFRS (1 April 2004).
- To recognise in full all cumulative actuarial gains and losses relating to pension schemes within reserves at the date of transition.

The Company is not taking advantage of the exemptions in respect of financial instruments and has applied IAS39 "Financial Instruments – Recognition and Measurement" and IAS 32 "Financial Instruments – Disclosure and Presentation" retrospectively.

The disclosures required by IFRS 1 for the transition from UK GAAP to IFRS are provided in note 30.

Principal accounting policies cont'd

Consolidated Financial Statements

The Company has taken advantage of Section 228(1) of Companies Act 1985 not to produce consolidated financial statements, as it is a wholly owned subsidiary of Glas Cymru Cyfyngedig.

Accounting policies for the year ended 31 March 2006

The principal accounting policies adopted in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented.

Revenue recognition

Revenue represents the income receivable in the ordinary course of business for services provided, excluding value added tax. Where services have been provided, but for which no invoice has been raised at the year-end, an estimate of the amounts are included in revenue. See further details in the critical accounting estimates section.

Revenue recognised reflects the actual charges levied on customers in the year. The difference between the actual revenue and the level of revenue that could have resulted had the full Ofwat allowed level of charges been levied is referred to as a 'customer dividend'

Property, plant & equipment

Property, plant and equipment are included at cost less accumulated depreciation. Cost reflects purchase price together with any expenditure directly attributable to bringing the asset into use, including directly attributable internal costs but excluding interest.

Property, plant and equipment 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, overground operational structures and equipment, and fixtures and fittings).

The carrying value of assets is reviewed for impairment if circumstances dictate that the carrying value may not be recoverable. Asset lives and residual values are reviewed annually.

Infrastructure assets

Infrastructure assets, which comprise principally of impounding reservoirs and a network of underground water and wastewater systems, are stated at fair value on the date of transition to IFRS as a deemed cost under the exemption available under IFRS1. For accounting purposes, the water system is segmented into components representing categories of asset classes with similar characteristics and asset lives. The wastewater system is segmented into components representing geographical operating areas reflecting the way the Company operates its wastewater activities.

Expenditure on infrastructure assets relating to increases in capacity, enhancements or material replacements of network components, is treated as additions, which are included at cost. Expenditure incurred in repairing and maintaining the operating capability of individual infrastructure components is expensed in the year in which the expenditure is incurred.

The depreciation charge for infrastructure assets is determined for each component of the network and is based on each component's cost, estimated residual value and the expected remaining average useful life. The useful average economic lives of the infrastructure components range from 60 to 150 years.

Principal accounting policies cont'd

Other assets

Other assets are depreciated over their estimated useful economic lives, which are as follows:

Freehold buildings	60 years
Leasehold properties	over the lease period
Operational structures	40 – 80 years
Fixed plant	20-40 years
Vehicles, mobile plant, equipment and computer hardware & software	3-16 years

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

Intangible assets

Intangible assets, which comprise principally computer software and system developments, are included at cost less accumulated depreciation. Cost reflects purchase price together with any expenditure directly attributable to bringing the asset into use, including directly attributable internal costs but excluding interest.

The carrying values of intangible assets are reviewed for impairment if circumstances dictate the carrying value may not be recovered.

Intangible assets are depreciated over their estimated useful economic lives, which range between 3 and 15 years. These asset lives are reviewed annually.

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 (finance leases), the assets are capitalised and included in "property, plant & equipment" with the corresponding liability to the lessor included within "finance liabilities – borrowings". Leasing payments are treated as consisting of a capital element and a finance charge, the capital element reducing the obligation to the lessor with the finance charge being recognised over the period of the lease based on its implicit rate so as to give a constant rate of interest on the remaining balance of the liability.

All other leases are regarded as operating leases. Rental costs arising under operating leases are charged to the income statement on a straight-line basis over the period of the lease.

Grants and customer contributions

Grants and customer contributions in respect of expenditure on property, plant and equipment have been offset against fixed assets.

Grants in respect of revenue expenditure are credited to the Income Statement over the same period as the related expenditure is incurred.

Capital expenditure programme incentive payments

The Company's agreements with its construction partners involved in delivering capital expenditure programmes incorporate incentive bonuses payable after completion of the programmes. The cost of fixed asset additions includes an accrual for 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 only recognised on completed projects.

Principal accounting policies 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 payments / receivables arising from these contracts is to recognise when final agreement with the relevant service partner has been achieved.

Allowance for doubtful debts

Trade receivables are first assessed individually for impairment, or collectively where the receivables are not individually significant. Where there is no objective evidence of impairment for an individual receivable, it is included in a group of receivables with similar credit risk characteristics and these are collectively assessed for impairment. Movements in the provision for doubtful debts are recorded in the income statement.

Cash and cash equivalents

Cash and cash equivalents include highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months maturity from the date of acquisition and typically include cash in hand and deposits with banks or other financial institutions, less any overdrafts.

Pension costs

The majority of the Company's employees belong to the Company pension scheme, which is funded by both employers' and employees' contributions and which is of the defined benefit type. Actuarial valuations of the scheme are carried out at intervals of not more than three years. Contribution rates are based on the advice of a professionally qualified actuary.

For the Company's defined benefit scheme, the net asset or liability recognised in the balance sheet represents the present value of the defined benefit obligations less the fair value of the plan's assets. In accordance with the amendment to IAS19, all cumulative actuarial gains and losses have been recognised in reserves at the date of transition to IFRS.

The full cost of providing pension benefits to employees (including the expected return on scheme assets and interest on scheme liabilities) is reported in the income statement within operating costs. All actuarial gains and losses are also recognised in the year in which they arise in determining the profit or loss for the year.

Financial liabilities – borrowings

Debt is initially measured at fair value, which is the amount of the net proceeds after deduction of directly attributable issue costs, with subsequent measurement at amortised cost. Debt issue costs are recognised in the income statement over the expected term of such instruments at a constant rate on the carrying amount.

Foreign currency borrowings are translated into sterling at the rates ruling at the balance sheet date.

Financial assets

Financial assets represent held to maturity investments that are non-derivative, with fixed or determinable payments and fixed maturities of over three months at the date of acquisition, which the Company intends to hold until maturity.

Derivative financial instruments

Derivative instruments utilised by the Company are currency swaps, currency forward exchange contracts and interest rate swaps. Derivative instruments are used for hedging purposes to alter the risk profile of existing underlying exposures within the group.

Derivatives are recognised initially, and are subsequently remeasured at fair value.

The movement in the fair value between balance sheet dates is recognised in the income statement to the extent that such instruments do not qualify for hedge accounting under IAS 39. At present, no such derivatives qualify for hedge accounting.

Deferred taxation

Deferred corporation tax is provided, using the liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax liabilities are recognised in respect of all temporary differences. Deferred tax assets are recognised for all deductible temporary differences, carry-forward of unused tax assets and tax losses, to the extent that they are regarded as recoverable. They are regarded as recoverable where, on the basis of available evidence, there will be suitable taxable profits against which the future reversal of the underlying temporary differences can be deducted. The carrying value of the amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all, or part, of the asset to be utilised.

Deferred corporation tax assets and liabilities are measured at the tax rates that are expected to apply to the year when the asset is realised or the liability is settled, based on the tax rates that have been enacted at the balance sheet date.

Provisions

Provision is made for all known and estimated liabilities of the Company where there is a present obligation and it is probable that a transfer of economic benefits will be required to settle the obligation.

In the case of leases, where the Company no longer occupies properties, provision is made for the liabilities that are expected to arise in respect of rental payments and dilapidations, prior to disposal or termination of the lease.

Where the Company receives claims that are either not covered by insurance or where there is an element of the claim for which insurance cover is not available, a provision is made for the expected future liabilities.

Financing risk management objectives and policies

Treasury activities are managed within a formal set of treasury policies and objectives, which are reviewed regularly and approved by the Board. The policy specifically prohibits any transactions of a speculative nature and the use of complex financial instruments. Certain detailed policies for managing interest rate, currency and inflation risk and that for managing liquidity risk are approved by the Board and may only be changed with the consent of Dŵr Cymru Cyfyngedig's security trustee (the "Security Trustee"). The risk is further mitigated by limiting exposure to any one counterparty. We use financial instruments, which principally include listed bonds, finance leases bank loan facilities and derivatives, to raise finance and manage risk from our operations.

Credit risk

Surplus cash is invested in short and medium term sterling financial investments. The Board annually establishes the investment criteria, which is restricted to banks and other financial institutions meeting required standards assessed by the major credit rating agencies.

Interest rate / Currency risk

The Company minimises exposure to currency risk in respect of any foreign currency denominated borrowings by using appropriate derivative instruments to hedge these liabilities into sterling obligations.

The Company hedges at least 85% of its total outstanding financial liabilities, including finance leases, into either index-linked or fixed rate obligations. For this purpose interest rate liabilities on floating rate liabilities are hedged through a combination of derivative instruments and cash balances. The regulatory framework, under which revenues and the regulatory asset value are indexed also expose the Company to inflation risk. Subject to market constraints and Board approval the Company therefore may seek to raise new debt through index-linked instruments or to enter into appropriate hedging transactions.

The "hedges" established to manage currency risks are economic in nature, but do not satisfy the specific requirements of IAS 39 in order to be treated as hedges for accounting purposes.

Liquidity risk

Liquidity risk is managed by maintaining a balance between the continuity of funding and flexibility through the use of borrowings across a range of currencies, instruments, type and maturities. Our policy is to ensure that the maturity profile does not impose an excessive strain on our ability to repay loans. Under this policy, no more than 20% of the principal of group borrowings can fall due in any twenty-four month period.

Banking facilities

We maintain committed banking facilities in order to provide flexibility in the management of the Company's liquidity.

There is also a special liquidity facility, which we are required to maintain in order to meet certain interest and other obligations that cannot be funded through operating cashflow in the event of a standstill being declared by the Security Trustee, following an event of default under the group's debt financing covenants.

Critical Accounting Estimates

The preparation of financial statements to conform with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results ultimately may differ from those estimates.

Allowance for doubtful debts

Individual impairment losses on customer debts are calculated based on an individual assessment of the cash flows that are expected. Collective impairment losses on receivables with similar credit risk are calculated using a statistical model. The key assumption in the model is the probability of a failure to recover amounts when they fall into arrears. The probability of failing to recover is determined by past experience, adjusted for changes in external factors. The accuracy of the impairment calculation would therefore be affected by unexpected changes to the economic situation, and to changes in customer behaviour. To the extent that the failure to recover debts in arrears alters by +/-5%, the bad debt allowance would increase or decrease by £3.6 million.

Pension benefits

The present value of the pension obligations is dependent on the actuarial calculation, which includes a number of assumptions. These assumptions include the discount rate, which is used to calculate the present value of the estimated future cash outflows that will be required to meet the pension obligations. In determining the discount rate to use, the Group considers market yields of high quality corporate bonds, denominated in sterling, that have times to maturity approximating the terms of the pension liability. Were this discount rate to reduce or increase by 0.1%, the carrying value of the pension obligations would increase or reduce by £0.9 million.

Measured income accrual

Revenue includes an estimation of charges unbilled at the period end. The accrual is estimated using a defined methodology based upon the weighted average water consumption by tariff, which is calculated based upon historical billing information, adjusted for changes in external factors, such as weather. A 5% change in actual consumption from that estimated would have the effect of increasing/decreasing the accrual by £2.2 million.

Notes to the financial statements

2. Segmental information

The Directors consider that there is only one reporting segment being the operation of water and sewerage business in the UK. Therefore the disclosures for the primary segment have already been given in these financial statements.

The secondary reporting format is by geographical analysis by origin and destination. As the Company has virtually only domestic activities there is only one geographical segment. Therefore the disclosures for the secondary segment have also already been given in these financial statements.

3. Financing costs

3a). Net interest before fair value losses on financial instruments

	2006	2005
	£m	£m
Interest payable on loans	**(124.7)**	(148.3)
Interest payable on finance leases	**(31.9)**	(22.3)
Termination profit on closure of finance lease	**-**	6.1
Amortisation of bond issue costs	**(2.9)**	(1.3)
Total interest payable	**(159.5)**	(165.8)
Interest receivable	**9.7**	23.5
Net interest payable before fair value adjustments	**(149.8)**	(142.3)

Included within interest payable on loans are amounts payable to group undertakings of £117.3m (2005: £141.9m).

3b). Fair value (losses)/gains on financial instruments

Whilst the group employs an economically effective policy using interest rate and currency swaps, this policy does not satisfy the stringent hedge accounting criteria of IAS39. Consequently, the Company's interest rate and currency swaps are fair valued at each balance sheet date with the movement (gains or losses) disclosed in the income statement. Over the life of these swaps, providing that there is an effective match, these fair value adjustments will reverse and reduce to zero. (See note 14 for balance sheet note in respect of derivative financial instruments).

	2006	2005
	£m	£m
Fair value losses on index linked swaps	**(3.5)**	-
Tax effect of fair value losses on financial instruments	**1.1**	-
Net of tax impact of fair value losses on financial instruments	**(2.4)**	-

4. Profit before taxation

The following items have been included in arriving at profit before taxation:

	2006 £m	2005 £m
Operating charges from outsourced activities:		
- Operating services agreement	**107.7**	89.9
- Customer services agreement	**19.4**	19.3
- Laboratories and analytical services	**7.3**	7.5
- Other contracts	**11.7**	28.4
	146.1	145.1
Employee costs (note 21)		
- Wages and salaries	**7.2**	8.2
- Social security	**0.7**	0.8
- Severance programme and other termination costs	**0.4**	2.7
- Net actuarial gain (note 22)	**(1.5)**	-
- Pension costs (excluding actuarial gain / loss)	**2.6**	1.7
Research and development expenditure	**0.4**	0.2
Trade receivables impairment	**7.6**	8.0
Rates	**18.8**	17.6
Environment agency charges	**13.0**	12.6
Fees paid to auditors (see below)	**0.2**	0.3
Own work capitalised	**(7.3)**	(4.3)
Net rents payable	**0.5**	0.2
Other operating charges	**24.5**	25.8
	213.2	218.9
Depreciation of property, plant and equipment:		
- Owned assets	**60.1**	58.9
- Under finance leases	**33.6**	27.3
Amortisation of intangible assets	**3.8**	3.6
Infrastructure renewals expenditure	**48.8**	3.0
Profit on disposal of fixed assets	**(0.8)**	(4.3)
	358.7	347.4

4. Profit before taxation cont'd

Services provided by the company's auditor

During the year the Company obtained the following services from the Company's auditor as detailed below:

	2006	2005
	£'000	£'000
Audit Services		
- Statutory audit	**99**	99
- Regulatory reporting	**32**	25
- Periodic review reporting	**-**	50
Further assurance services		
- IFRS transition	**48**	47
- Interim review	**25**	26
- Grant applications	**6**	8
- Financial modelling	**12**	-
Tax advisory services	**10**	19
	232	274

Annual regulatory audit services includes work on the Regulatory Accounts, June Return and Principal Statement. In addition to the above services, PricewaterhouseCoopers LLP acted as auditor to the Welsh Water 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 £7,000 (2005: £7,000).

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. Taxation

Analysis of charge in the year

	2006	2005
	£m	£m
Current tax – continuing operations		
- Current year movements	**(2.3)**	-
- Adjustment in respect of prior years	**(1.4)**	-
Deferred tax		
- current year movements	**(8.6)**	7.6
- Adjustment in respect of prior years	**5.3**	-
Taxation (charge)/credit	**(7.0)**	7.6

Notes to the financial statements cont'd

5. Taxation cont'd

The tax for the year is lower (2005: lower) than the standard rate of corporation tax in the UK (30%). The differences are explained below:

	2006 £m	2005 £m
Profit before tax	41.5)	4.4)
Profit before tax multiplied by the corporation tax rate in the UK of 30% (2005: 30%)	12.5)	1.3)
Effects of:		
Adjustments to tax in respect of prior years	(3.9)	-
Expenses not deductible for tax purposes	0.2)	0.1)
Other permanent differences	(1.8)	(9.0)
Total taxation charge/(credit)	7.0)	(7.6)

6. Intangible fixed assets

Intangible fixed assets comprise computer software and related system developments.

	Cost	Depreciation	Net book value
Current Year	**£m**	**£m**	**£m**
At 1 April 2005	**49.6**	**(45.2)**	**4.4**
Additions	**3.8**	**-**	**3.8**
Charge for the year	**-**	**(3.8)**	**(3.8)**
At 31 March 2006	**53.4**	**(49.0)**	**4.4**

	Cost	Depreciation	Net book value
Prior Year	**£m**	**£m**	**£m**
At 1 April 2004	48.6	(41.6)	7.0
Additions	1.0	-	1.0
Charge for the year	-	(3.6)	(3.6)
At 31 March 2005	49.6	(45.2)	4.4

Notes to the financial statements cont'd

7. Property, plant and equipment

Current year	Freehold land & buildings £m	Infrastructure assets £m	Operational structures £m	Plant equipment, computer hardware £m	Total £m
Cost					
At 1 April 2005	32.8	1,310.6	1,959.6	184.8	3,487.8
Additions net of grants and contributions	-	64.6	95.4	8.4	168.4
Disposals	(0.1)	-	-	-	(0.1)
At 31 March 2006	32.7	1,375.2	2,055.0	193.2	3,656.1
Accumulated depreciation					
At 1 April 2005	14.8	18.8	589.1	144.2	766.9
Charge for the year	0.8	21.0	65.5	6.4	93.7
Disposals	(0.1)	-	-	-	(0.1)
At 31 March 2006	15.5	39.8	654.6	150.6	860.5
Net book value					
At 31 March 2006	17.2	1,335.4	1,400.4	42.6	2,795.6

Prior year	Freehold land & buildings £m	Infrastructure assets £m	Operational structures £m	Plant equipment, computer hardware £m	Total £m
Cost					
At 1 April 2004	32.8	1,236.4	1,860.4	174.9	3,304.5
Additions net of grants and contributions	-	74.2	99.2	9.9	183.3
At 31 March 2005	32.8	1,310.6	1,959.6	184.8	3,487.8
Accumulated depreciation					
At 1 April 2004	14.4	0.0	533.0	133.3	680.7
Charge for the year	0.4	18.8	56.1	10.9	86.2
At 31 March 2005	14.8	18.8	589.1	144.2	766.9
Net book value					
At 31 March 2005	18.0	1,291.8	1,370.5	40.6	2,720.9

Assets held under finance leases	2006 £m	2005 £m
Cost	1,091.7	958.8
Aggregate depreciation	(156.1)	(122.5)
	935.6	836.3

Included in assets held under finance leases are infrastructure assets, with a net book value of £498.3m (2005: £402.0m) and operational structures with a net book value of £437.3m (2005: £434.3m).

Included within fixed assets is an amount £99.9m in respect of assets in the course of construction (2005: £91.1m).

8. Fixed asset investments

Cost and net book value	2006 £m	2005 £m
At 1 April and 31 March	**0.1**	0.1

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

	Nature of Business	Country of Incorporation	Description of Holding
Water Research Centre (1989) plc	Water Research	Great Britain	"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.

In addition, the Company holds Ordinary shares of £1 each in the following subsidiary

	Principal Activity	Country of Incorporation	Holding
Welsh Water Utilities Finance Plc	Raising finance	England and Wales	100%

9. Trade and other receivables

	2006 £m	2005 £m
(a) Amounts falling due within one year:		
Trade receivables	**77.0**	70.5
Less provision for impairment of receivables	**(49.6)**	(49.1)
Trade receivables - net	**27.4**	21.4
Amounts owed by group undertakings	**0.1**	0.1
Other receivables	**9.8**	7.6
Prepayments and accrued income	**49.5**	36.8
	86.8	65.9
(b) Amounts falling due after more than one year:		
Amounts owed by group undertakings	**370.5**	371.3
Other receivables	**-**	0.1
	370.5	371.4
	457.3	437.3

10. Held to maturity investments

	2006 £m	2005 £m
Investments in:		
Fixed term deposits - due within one year	**-**	89.1

The effective interest rate on held to maturity investments as at 31 March 2005 was 5.2% and those investments had an average maturity of 283 days.

Notes to the financial statements cont'd

11. Cash and cash equivalents

	2006 £m	2005 £m
Cash at bank and in hand	3.8	3.7
Short-term bank deposits	10.1	231.2
	13.9	234.9

The effective interest rate on short-term deposits as at 31 March 2006 was 4.7% (2005: 4.9%) and these deposits have an average maturity of 82 days (2005: 65 days).

12. Trade and other payables

	2006 £m	2005 £m
Trade payables	26.8	38.3
Capital creditors	45.3	39.0
Amounts due to group undertakings	3.8	3.7
Other taxation and social security costs	0.3	0.5
Other creditors	46.0	47.2
	122.2	128.7

13. Financial liabilities – borrowings

Current	2006 £m	2005 £m
Interest accruals	0.3	7.6
Loans due to group undertakings	120.3	100.0
Other unsecured loans	0.4	0.4
Finance lease obligations	3.7	3.0
	124.7	111.0

Non-current	2006 £m	2005 £m
Interest accruals	18.7	10.5
Loans due to group undertakings	1,488.8	1,866.6
Other unsecured loans	3.3	3.7
Finance lease obligations	736.4	628.5
	2,247.2	2,509.3

A security package was granted by Dŵr Cymru Cyfyngedig (DCC), as part of the group's bond programme for the benefit of holders of senior bonds, finance lessors and other senior financial creditors.

The obligations of DCC are guaranteed by the Company, Glas Cymru (Securities) Cyfyngedig and Dŵr Cymru (Holdings) Limited. The main elements of the security package are:

i) a first fixed and floating security over all of DCC's assets and undertaking, to the extent permitted by the Water Industry Act, other applicable law and its licence and

ii) a fixed and floating security given by the guarantors referred to above which are accrued on each of these company's assets including, in the case of Dŵr Cymru (Holdings) Limited, a first fixed charge over its shares in DCC.

14. Derivative financial instruments

All derivative financial instruments are held for economic hedging purposes although they do not qualify as accounting hedges under IAS 39. As such, movements in their fair values are taken to the Income Statement (see note 3b). Fair values are obtained by reference to actual market transactions

2006	Fair Values	
	Assets	Liabilities
	£m	£m
Current		
Index linked swaps	4.2	-
Non-Current		
Index linked swaps	6.3	(14.0)
	10.5	(14.0)

There were no derivative financial instruments in 2005. The notional value of the indexed linked swaps is £587m (2005: £nil).
In accordance with IAS 39, 'Financial instruments: Recognition and measurement', Dŵr Cymru Cyfyngedig has reviewed all contracts for embedded derivatives that are required to be separately accounted if they do not meet certain requirements set out in the standard. Dŵr Cymru Cyfyngedig has no embedded derivatives as per IAS 39.

Indexed-linked swaps

The indexed-linked swaps have the effect of fixing the interest rate on £637 million of finance lease liabilities by reference to the retail price index ("RPI") with effect from March 2006.

The notional amount of the swaps as at 31 March 2006 is £587 million, representing the average balance on the finance leases subject to floating interest rates for the year to 31 March 2007. The notional amount amortises over the life of the swaps to match the average floating rate balances of the leases.

All the indexed-linked swaps were entered into during the year and the principal terms are as follows:

Notional Amount:	£587 million (amortising)
Average swap maturity:	26 years
Average interest rate:	1.60% (fixed) plus RPI.

15. Financial risk management

The policies of the Company in respect of financial risk management are included in the accounting policies note on page 18. The numerical financial instrument disclosures as required by IAS 32 are set out below

a) Interest rate risk

The effective interest rates at the balance sheet dates were as follows:

	2006	2005
Assets:		
Cash and cash equivalents	**4.7%**	4.9%
Financial assets held to maturity	-	5.2%
Amounts owed by group undertakings	**12.0%**	12.0%
Liabilities:		
Inter-company loans	**5.6%**	5.6%
Finance leases	**4.5%**	4.7%
Other Unsecured loans	**6.2%**	6.2%

Trade and other receivables and payables are not interest bearing.
The effective interest rates ignore the effect of the index-linked swaps set out in note 14.

Notes to the financial statements cont'd

15. Financial risk management cont'd

b) Liquidity risk

2006	Within 1yr £m	1-2 years £m	2-5 years £m	> 5 years £m	Total £m
Assets:					
Cash and cash equivalents	13.9	-	-	-	13.9
Trade and other receivables	86.8	-	-	370.5	457.3
	100.7	-	-	370.5	471.2
Liabilities:					
Trade and other payables	122.2	-	-	-	122.2
Inter-company loan	120.3	4.4	15.4	1,469.0	1,609.1
Other unsecured loans	0.4	0.3	1.1	1.9	3.7
Finance leases	3.7	4.6	21.0	710.8	740.1
	246.6	9.3	37.5	2,181.7	2,475.1

2005	Within 1yr £m	1-2 years £m	2-5 years £m	> 5 years £m	Total £m
Assets:					
Cash and cash equivalents	234.9	-	-	-	234.9
Financial assets held to maturity	89.1	-	-	-	89.1
Trade and other receivables	65.9	0.1	-	371.3	437.3
	389.9	0.1	-	371.3	761.3
Liabilities:					
Trade and other payables	128.7	-	-	-	128.7
Inter-company loan	100.0	-	13.1	1,853.5	1,966.6
Local Authority loans	0.4	0.3	1.2	2.2	4.1
Finance leases	3.0	3.5	16.7	608.3	631.5
	232.1	3.8	31.0	2,464.0	2,730.9

The minimum lease payments under finance leases fall due as follows:

	2006 £m	2005 £m
Not later than one year	31.1	31.7
Later than one year but not more than five	147.0	128.8
More than five years	1,289.4	1,139.5
	1,467.5	1,300.0
Future finance charges on finance leases	(708.4)	(650.8)
Present value of finance lease liabilities	759.1	649.2

c) Fair values

The fair values of the Company's derivative financial instruments are set out in note 14

The fair value of the intercompany loan is £1,950.4m (2005: £2,220.0m). The fair value of the Company's other non-derivative financial instruments are the same as the book values.

15. Financial risk management cont'd

d) Borrowing facilities

The company has the following undrawn committed borrowing facilities available at 31 March in respect of which all conditions precedent had been met at that date:

	2006	2005
	£m	£m
Expiring within 1 year:		
Revolving credit facilities	**-**	30.0
Inter-company revolving credit facilities	**259.8**	120.0
Inter-company loan facility	**75.0**	-
	334.8	150.0

A fellow subsidiary, Dŵr Cymru Financing Limited also has a special liquidity facility of £150 million, which it is required to maintain in order to meet certain group interest and other obligations that cannot be funded through operating cashflow of the group, in the event of a standstill being declared by the Security Trustee. A standstill would arise in the event that Dŵr Cymru Cyfyngedig defaults on its debt financing covenants. Dŵr Cymru Cyfyngedig also has a £20 million overdraft facility. Both of these facilities are renewable on an annual basis.

The above facilities are at floating rates of interest.

16. Provisions

	Restructuring provision	**Uninsured loss provision**	**Provision for loss on swap closure**	**Total**
	£m	**£m**	**£m**	**£m**
At 1 April 2005	4.9	4.9	8.1	17.9
Charged to Income Statement	1.1	0.9	-	2.0
Utilised in year	(0.7)	(1.3)	(0.6)	(2.6)
At 31 March 2006	5.3	4.5	7.5	17.3

Restructuring provision
This provision is in respect of payments to be made relating to surplus property, and estimated dilapidation costs which will be utilised over the next three years.

Provision for uninsured losses
This provision is in respect of uninsured losses and where insurance cover does not cover a deductible amount. The utilisation period is uncertain due to the nature of insurance claims but is estimated to be five years.

Provision for loss on swap closure
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 loss arising on redemption was settled by setting a higher rate on another swap contract. This provision is being released to the Income Statement over the life of the revised swap, which expires on 31 March 2031.

Notes to the financial statements cont'd

17. Deferred tax

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 30% (2005: 30%)

The movement in the deferred tax provision is as shown below

	2006	2005
	£m	£m
At 1 April	**308.3**	315.9
Income Statement charge / (credit)	3.3	(7.6)
At 31 March	**311.6**	308.3

Deferred tax assets have been recognised in respect of all tax losses and other temporary differences giving rise to deferred tax assets because it is probable that these assets will be recovered.

	2006	2005
	£m	£m
Effect of tax allowances over depreciation	**307.06**	318.3
Other tax differences	**4.6**	(10.0)
Provision for deferred tax	**311.6**	308.3

18. Called up share capital

		Preference share capital £m	Ordinary share capital £m	Total share capital £m
2006	Authorised:			
	501,050,000 ordinary shares of £1 each	-	**501.1**	**501.1**
		-	**501.1**	**501.1**
	Allotted, called up and fully paid:			
	309,876,374 ordinary shares of £1 each	-	**309.9**	**309.0**
		-	**309.9**	**309.0**
2005				
	Authorised:			
	301,050,000 ordinary shares of £1 each	-	301.1	301.1
	200,000,000 7% preference shares of £1 each	200.0	-	200.0
		200.0	301.1	501.1
	Allotted, called up and fully paid:			
	109,876,374 ordinary shares of £1 each	-	109.9	109.9
	200,000,000 7% preference shares of £1 each	200.0	-	200.0
		200.0	109.9	309.9

With effect from the 31 March 2006 the entire authorised and allotted preference share capital, comprising 200,000,000 7% cumulative preference shares, was reclassified as 200,000,000 ordinary shares of £1 each.

The 7% cumulative preference shares carried a fixed cumulative preference dividend at the rate of 7% per *annum, payable ½ yearly in arrears* on 31 March and 30 September. The shares had no redemption entitlement and were held by a fellow subsidiary undertaking. On a winding up, the holders had priority before all other classes of shares to receive repayment of capital plus any arrears of dividend. The holders had no voting rights unless the dividend was in arrears by 6 months or more.

Notes to the financial statements cont'd

19. Cash generated from operations

Reconciliation of operating profit to cash generated from operations:

	2006 £m	2005 £m
Operating profit	**194.8**	146.7
Adjustments for:		
Depreciation and amortisation	**97.5**	89.8
Profit on disposals of fixed assets	**(0.8)**	(4.3)
Changes in working capital:		
Increase in trade and other receivables	**(17.9)**	(5.0)
(Decrease)/ Increase in trade and other payables	**(12.5)**	5.1
Decrease in pension deficit	**(1.2)**	-
Decrease in provisions	**(0.6)**	(4.0)
Cash generated from operations	**259.3**	228.3

20. Analysis and reconciliation of net debt

a) Net debt at the balance sheet date may be analysed as:	**2006**	2005
	£m	£m
Cash and cash equivalents	**13.9**	234.9
Financial assets	**-**	89.1
	13.9	324.0
Debt owed by parent company after one year	**370.5**	371.3
Debt due after one year	**(1,489.8)**	(1,870.3)
Debt due within one year	**(120.7)**	(100.4)
Finance leases	**(740.1)**	(631.5)
Accrued interest	**(19.0)**	(18.1)
	(2,369.6)	(2,620.3)
Net debt	**(1,985.2)**	(1925.0)

20. Analysis and reconciliation of net debt cont'd

b) The movement in net debt during the period may be summarised as:	**2006 £m**	2005 £m
Net debt at start period	**(1,925.0)**	(1,776.8)
(Decrease)/Increase in net cash	**(221.0)**	92.3
(Decrease)/increase in group receivables	**(0.8)**	(21.2)
(Decrease)/increase in financial assets	**(89.1)**	(84.8)
Decrease/(increase) in debt	**271.6**	(125.9)
Increase in net debt arising from cashflows	**(39.3)**	(139.6)
Non cash movement on group debt	**(20.0)**	(18.6)
Movement in accrued interest	**(0.9)**	10.0
Movement in net debt during the period	**(60.2)**	(148.2)
Net debt at end of period	**(1,985.2)**	(1,925.0)

21. Employees and directors

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:

	2006 £'000	2005 Restated £'000
Salary (including benefits in kind)	**731**	849
Fees	**389**	362
	1,120	1,211
Long term incentive plan	**214**	758
Highest paid Director: (2006: NC Annett; 2005: MP Brooker)		
Aggregate emoluments	**332**	323
Accrued pension under defined benefit scheme	**51**	124
Long term incentive plan	**97**	312

Retirement benefits are accruing to two Directors (2005 – three) under defined benefit schemes. Benefits are accruing to one Director (2005 – nil) under a defined contribution scheme.

i) The financial statements for the year ended 31 March 2006 include a provision of £241,833 (2005: £287,870) for bonus potentially payable to Executive Directors for performance in the financial year 2005/06. The final amount to be paid to each Director will be determined when Ofwat publishes it's Overall Performance Assessment (OPA) results for 2005/06 in the Autumn of 2006 and could be higher or lower. An amount of £213,844 (2005: £757,552) has also been provided under the terms of the Executive Directors' Long Term Incentive Plan.

ii) The comparatives have been restated to reflect the final performance bonus for 2004/05. The actual performance bonus in respect of 2004/05 was paid in September 2005 following the publication of Ofwat's OPA report for 2004/05, and amounted to £365,993 compared to the amount accrued at 31 March 2005

21. Employees and directors cont'd

of £287,870. The aggregate emoluments of the highest paid Director increased by £32,169 to £355,039 and total emoluments increased by £78,123 to £1,243,593.

iii) The comparatives have also been restated to reflect an under payment of salary of £13,457 to one of the Directors This was paid in the financial year 2005/06 but related to the period 1 January to 31 March 2005.

b) Staff costs during the year	**2006**	2005
	£m	£m
Wages and salaries	**7.2**	8.2
Severance programme and termination costs	**0.4**	2.7
Social security costs	**0.7**	0.8
Other pension costs (note 22)	**1.1**	1.7
	9.4	13.4

Average monthly number of people (including executive directors) employed by the company	**2006**	2005
	Number	Number
Regulated water and sewerage activities	**136**	146

Of the above, £3.7 million (2005: £2.5 million) has been charged to capital. The severance programme and termination costs include £0.4m (2005: £2.2 million) in respect of pension costs. Other pension costs includes £0.5m (2005: £nil) in respect of the Directors' unfunded pension liabilities.

22. Pension commitments

Following the acquisition of Dŵr Cymru Cyfyngedig by Glas Cymru Cyfyngedig, a new funded defined benefit pension scheme for current employees (based on *final pensionable salary and pensionable service*) was introduced on 1 December 2001, 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 the 31 December 2005 and a new defined *contribution scheme*, the Dŵr Cymru Defined Contribution Scheme, was introduced from the 1 January 2006.

Pension costs for the defined contribution scheme are as follows:

	2006	2005
	£'000	£'000
Defined contribution scheme	**24**	-

Defined benefit scheme

A full actuarial valuation of the scheme was undertaken as at 31 March 2003 by Barnett Waddingham, an independent, professionally qualified actuary, using the *projected unit method*. *This valuation was updated* at 31 March 2006 and the principal assumptions made by the actuaries were:

	2006	2005
Rate of increase in pensionable salaries	**3.75%**	3.75%
Rate of increase in pensions in payment	**2.75%**	2.75%
Discount rate	**5.10%**	5.40%
Inflation assumption	**2.75%**	2.75%

The major categories of plan assets, as a percentage of total assets and the expected rates of return thereon, were as follows:

22. Pension commitments cont'd

	2006		2005	
	Expected long term return	**Percentage of total assets**	Expected long term return	Percentage of total assets
Equities	**6.50%**	**55%**	6.70%	56%
Bonds	**5.00%**	**35%**	5.40%	44%
Other	**4.50%**	**10%**	4.75%	-

Pensions and other post-retirement obligations

The amounts recognised in the balance sheet are determined as follows:

	2006 £'000	2005 £'000
Present value of funded obligations	**(37,197)**	(32,406)
Fair value of plan assets	**30,561**	24,637
Net liability recognised in the balance sheet	**(6,636)**	(7,769)

The amounts recognised in the income statement are as follows:

	2006 £'000	2005 £'000
Current service cost (excluding members contribution)	**1,271**	1,348
Interest cost	**1,779**	1,558
Expected return on plan assets	**(1,502)**	(1,191)
Net actuarial gains recognised in year	**(1,497)**	(6)
Past service cost	**899**	2,202
Total included within staff costs (note 21)	**950**	3,911

The total charge of £0.950m (2005: £3.911m) is included within operating costs.

Changes in the present value of the defined benefit obligation are as follows:

	2006 £'000	2005 £'000
At 1 April	**32,406**	26,710
Current service cost (including members contribution)	**1,612**	1,701
Past service cost	**899**	2,202
Interest cost	**1,779**	1,558
Benefits paid	**(1,452)**	(679)
Actuarial losses	**1,953**	914
31 March	**37,197**	32,406

Changes in the fair value of plan assets are as follows:

	2006 £'000	2005 £'000
At 1 April	**24,637**	18,873
Expected return on plan assets	**1,502**	1,191
Contributions (including members contribution)	**2,424**	2,132
Benefits paid	**(1,452)**	(679)
Special contribution	**-**	2,200
Actuarial gain on plan assets	**3,450**	920
31 March	**30,561**	24,637

22. Pension commitments cont'd

Analysis of the movement in the balance sheet liability:

	2006 £'000	2005 £'000
At 1 April	**7,769**	7,837
Total expense as above	**950**	3,911
Contributions paid (excluding members contribution)	**(2,083)**	(1,779)
Special contribution accrued at year end	**-**	(2,200)
31 March	**6,636**	7,769

	2006 £'000	2005 £'000
Expected return on plan assets	**1,502**	1,191
Actuarial gain on plan assets	**3,450**	920
Actual return on plan assets	**4,952**	2,111

Cumulative actuarial gains and losses recognised in equity:

	2006	2005	2004	2003
Experience adjustments arising on scheme assets:				
Amount (£m)	**3.5**	0.9	2.0	(0.2)
Percentage of scheme assets	**11%**	4%	11%	(1%)
Experience adjustments arising on scheme liabilities:				
Amount (£m)	**0.3**	(0.3)	-	2.7
Percentage of the present value of scheme liabilities	**1%**	(1%)	0%	11%
Present value of scheme liabilities (£m)	**37.2**	32.4	26.7	24.1
Fair value of scheme assets (£m)	**30.6**	24.6	18.9	14.8
Deficit (£m)	**(6.6)**	(7.8)	(7.8)	(9.3)

The contribution expected to be paid during the financial year ended 31 March 2007 amounts to £1.5m.

23. Operating lease commitments – minimum lease payments

	Land and buildings	
	2006 £m	2005 £m
At 31 March 2006 there were revenue commitments, in the ordinary course of business in the next year for the payment of rentals on non cancellable operating leases expiring:		
After five years	**0.4**	0.4

24. Contingent liabilities

The Company is liable under its inter-company loan arrangements with Dŵr Cymru (Financing) Limited ("Financing") for any cash liabilities that may arise in Financing to the extent that such cash liabilities are not already included in fixed interest rates under the tranches of the inter-company loan. An amount equal to any such cash liabilities is recharged by Financing as fees under these inter-company loan arrangements.

On 10 May 2001, Financing had entered into £625 million notional of interest rate swaps. The purpose of these interest rates swaps was to fix the interest rate on an equivalent amount of floating rate bonds of Financing. The floating rate borrowings and the interest rate swaps were matched and re-charged as fixed interest tranches of the inter-company loan of the same date.

24. Contingent liabilities cont'd

Financing's floating rate bonds, and the related fixed interest rate tranches of the inter-company loan, were repaid on 31 March 2005 (£100 m), 30 June 2005 (£425 m) and 31 March 2006 (£100 m). Financing's interest rate swaps remain in place to hedge other floating rate liabilities of the Company, in accordance with the Group's hedging strategy.

Accordingly, the Company will be liable for any future cash liabilities under these interest rate swaps under these inter-company loan arrangements. As at 31 March 2006 the mark to market value of these interest rate swaps was £98 million (2005: £68 million). The average interest rate and maturity of these swaps is 5.73% and 20 years respectively (2005: 5.73% and 21 years).

25. Capital and other financial commitments

The Company's business plan at 31 March 2006 shows net capital expenditure of £280m (2005: £216m) 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.

26. Related party transactions

The Company had the following transactions with other companies that are part of the Glas Cymru Cyfyngedig group:

Interest payable on intercompany loans to Dŵr Cymru Financing Limited - £117.3m

Interest receivable from Dŵr Cymru Financing Limited on bonds owned - £3.0m

27. Immediate and ultimate holding company

The immediate parent company is Dŵr Cymru (Holdings) Limited and the ultimate holding company and controlling party is Glas Cymru Cyfyngedig, both of which are registered in England and Wales. The largest and smallest group within which the results of the Company are consolidated is that headed by Glas Cymru Cyfyngedig, whose consolidated financial statements can be obtained from the Company Secretary at Pentwyn Road, Nelson, Treharris, Mid Glamorgan, CF46 6LY.

28. Directors' and officers' loans and transactions

No loans or credit transactions with any Directors, officers or connected persons existed during the year or were outstanding at the balance sheet date.

29. 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 £31.7 million, 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 £2.1 million (200: £2.4 million) in respect of the Elan Valley Trust Fund.

30. Reconciliations between IFRS and UK GAAP

a) Reconciliation of net income for the year ended 31 March 2005

	UK GAAP	IAS16	IAS39	IAS19	IAS12	IFRS
	£m	£m	£m	£m	£m	£m
Note		I	II	III	IV	
Revenue	494.1					494.1
Operating costs :						
- Operational costs	(218.5)			(0.4)		(218.9)
- Infrastructure renewals *expenditure*	-	(43.0)				(43.0)
- Depreciation	(118.1)	28.3				(89.8)
Profit on disposal of fixed assets	4.3					4.3
Operating profit	161.8	(14.7)		(0.4)		146.7
Interest payable and similar charges	(165.8)					(165.8)
Interest receivable	23.5					23.5
Profit before taxation	19.5	(14.7)		(0.4)		4.4
Taxation	10.0				(2.4)	7.6
Profit for the year	29.5	(14.7)		(0.4)	(2.4)	12.0

b) Reconciliation of net assets at 1 April 2004

	UK GAAP	IAS16	IAS39	IAS19	IAS12	IFRS
	£m	£m	£m	£m	£m	£m
Note		I	II	III	IV	
Assets						
Non-current assets						
Property, plant & equipment	2,636.7	(12.9)				2,623.8
Intangibles	-	7.0				7.0
Investments	0.1					0.1
Trade and other receivables	392.6					392.6
	3,029.4	(5.9)				3,023.5
Current assets						
Trade and other receivables	61.9					61.9
Financial assets:						
- held to maturity investments	173.9					173.9
Cash and cash equivalents	142.6					142.6
	378.4					378.4
Liabilities						
Current liabilities						
Financial liabilities:						
- borrowings	(22.1)					(22.1)
Trade and other payables	(148.0)	(1.1)		0.6		(148.5)
	(170.1)	(1.1)		0.6		(170.6)
Net current assets	208.3	(1.1)		0.6		207.8
Non-current liabilities						
Financial liabilities:						
- borrowings	(2,480.0)					(2,480.0)
Retirement benefit obligations	-			(7.8)		(7.8)
Provisions	(21.9)					(21.9)
Deferred Income	(35.9)	35.9				-
	(2,537.8)	35.9		(7.8)		(2,509.7)
Net assets before deferred tax	699.9					721.6
Deferred tax	(82.9)				(233.0)	(315.9)
Net assets	617.0	28.9		(7.2)	(233.0)	405.7

30. Reconciliations between IFRS and UK GAAP cont'd

c) Reconciliation of net assets at 31 March 2005

Note	UK GAAP £m	IAS16 £m I	IAS39 £m II	IAS19 £m III	IAS12 £m IV	IFRS £m
Assets						
Non-current assets						
Property, plant & equipment	2,744.7	(23.8)				2,720.9
Intangible assets	-	4.4				4.4
Investments	0.1					0.1
Trade and other receivables	371.4					371.4
	3,116.2	(19.4)				3,096.8
Current assets						
Trade and other receivables	65.9					65.9
Financial assets:						
- held to maturity investments	89.1					89.1
Cash and cash equivalents	234.9					234.9
	389.9					389.9
Liabilities						
Current liabilities						
Financial liabilities:						
- borrowings	(111.0)					(111.0)
Trade and other payables	(128.9)			0.2		(128.7)
	(239.9)			0.2		(239.7)
Net current assets	150.0			0.2		150.2
Non-current liabilities						
Financial liabilities:						
- borrowings	(2,509.3)					(2,509.3)
- derivative financial instruments	-					-
Retirement benefit obligations	-			(7.8)		(7.8)
Provisions	(17.9)					(17.9)
Deferred Income	(33.6)	33.6				-
	(2,560.8)	33.6		(7.8)		(2,535.0)
Net assets before deferred tax	705.4	14.2		(7.6)		712.0
Deferred tax	(72.9)				(235.4)	(308.3)
Net assets	632.5	14.2		(7.6)	(235.4)	403.7

d) Notes to reconciliations of income and net assets

I. IAS16 – Property, plant & equipment

The most significant impact of IAS16 relates to infrastructure assets. In accordance with UK GAAP (FRS15), infrastructure assets are treated as a single homogenous asset, which is subject to renewals accounting. Under renewals accounting, capital expenditure to maintain the asset (infrastructure renewals expenditure) is treated as an addition to fixed assets and the depreciation charge (infrastructure renewals charge) is the estimated level of annual expenditure required to maintain the operating capability of the network. No other depreciation was applied to the infrastructure network.

Under IAS16, infrastructure renewals accounting is not permitted and infrastructure assets are now depreciated over the estimated useful lives of identified components of the network. In addition, infrastructure renewals expenditure is now capitalised only if it represents a material replacement of a network component. If not, it is charged separately to operating expenditure rather than being treated as depreciation. As a result, there is a significant expenditure classification change, which impacts EBITDA.

In addition, rather than applying IAS16 retrospectively, a deemed cost has been established for the infrastructure assets at 1 April 2004 based on fair value in accordance with IFRS1.

30. Reconciliations between IFRS and UK GAAP cont'd

Finally, there are two classification changes following implementation of IAS16. These are:

a) Software development costs are now classified as intangible assets rather than being included as part of property, plant and equipment;

(b) Grants and customer contributions of a capital nature are now deducted from the cost of property, plant and equipment. Previously, capital grants relating to non-infrastructure assets were separately identified within creditors as deferred income.

The impact of the new accounting policy is to reduce the depreciation charge for the year ended 31 March 2005 by some £28 million and to increase operating expenditure by some £43 million. The net effect of IAS16 is to reduce operating profit by some £15 million and increase net assets at 31 March 2005 by some £14 million, but will not impact on operating cashflows for the purposes of covenanted interest cover ratios.

The accounting policies applied under UK GAAP for all other fixed assets are compliant with IFRS and continue to be appropriate.

II. IAS32/39 – Financial instruments

The group hedges at least 85% of its total outstanding financial liabilities into either index-linked or fixed rate obligations. For this purpose interest rate liabilities on floating rate liabilities are hedged through a combination of derivative instruments and cash balances.

Under UK GAAP, the Company recognised the effect of derivatives by adjusting the interest charge on the underlying liabilities to the fixed rate hedge. The fair value of the derivative instrument was not recognised.

Whilst the group employs an effective commercial hedging policy using interest rate and currency swaps, this policy does not satisfy the stringent hedge accounting criteria of IAS39. Consequently, under IFRS, the Company's interest rate and cross-currency swaps are fair valued at each balance sheet date with the movement (profit or loss) disclosed in the income statement.

IAS39 has been retrospectively adopted and, looking forward, charging the movement in fair values of financial derivatives between balance sheet dates to the income statement will increase the volatility of reported results, but will not impact on the group's cash based covenanted financial ratios.

III. IAS12 – Deferred tax

Deferred tax under IAS12 is based on "temporary differences" between the carrying value and tax base of the Company's assets and liabilities. Under UK GAAP, deferred tax is provided on "timing differences" that originated but had not reversed before the balance sheet date. Furthermore, IAS12, unlike UK GAAP does not permit the discounting of deferred tax liabilities.

As a result of the implementation of IAS12, an additional deferred tax liability of £235 million has been provided at 31 March 2005 and the tax credit for 2004/05 has decreased by some £2 million.

IV. IAS19 – Pension schemes

Under UK GAAP, the measurement and recognition requirements of SSAP24 were applied to pensions for the 2004/05 report and accounts with FRS17 transitional disclosures provided in the notes.

IAS19 takes a balance sheet approach to accounting for defined benefit schemes, similar to FRS17. Therefore, under IFRS, a deficit of £7.8 million the same as that previously disclosed under FRS17 is recognised in the balance sheet at 31 March 2005, and the impact on operating profit for 2004/05 is a reduction of £0.4 million.

As permitted by the amendment to IAS19, all cumulative actuarial gains and losses at as 1 April 2004, the date of transition to IFRS, were recognised in full. Going forward, we are not electing to apply the "corridor" treatment under IAS19 and as such, all future actuarial gains and losses will be charged in full to the income statement.