

Report and Accounts
2001/2002

Glas Cymru Cyfyngedig

Company Number: 03975719



Directors' Report

Principal Activity and Review of the Year

Glas Cymru is a company limited by guarantee established for the sole purpose of acquiring Dŵr Cymru Cyfyngedig ("Welsh Water").

Its constitution requires that all financial surpluses generated by the company are retained and reinvested for the benefit of Welsh Water and its customers. The company cannot diversify into unrelated commercial activities.

The acquisition of Welsh Water was completed on 11 May 2001, pursuant to a sale and purchase agreement dated 5 February 2001, when the entire ordinary share capital of Welsh Water's immediate holding company, Dŵr Cymru (Holdings) Limited ("Holdings"), was acquired by Glas Cymru (Securities) Cyfyngedig - a wholly owned subsidiary established for the purpose of acquiring and owning Welsh Water.

Immediately prior to acquiring Welsh Water, Dŵr Cymru (Financing) Limited ("Financing") a wholly owned subsidiary of Holdings completed a £1,910 million asset backed bond issue, the proceeds of which were loaned to Welsh Water under an inter company loan agreement. The purpose of the bond issue was to facilitate the refinancing of Welsh Water and the future financing of its operating and capital requirements.

On 19 March 2002 Welsh Water announced a successful £120 million lease finance transaction, the terms of which compare very favourably with Welsh Water's existing sources of funding.

During the year the Board appointed 48 individuals as Members of Glas Cymru, bringing the total number of Members to 57. The process for the appointment of Members is set out on pages 22 to 23, together with the names and brief details of individuals appointed.

The performance of the Company during 2001/2002 is described in the Chairman's Statement, the Annual Review and the Financial Review on pages 1 to 19. These, together with the financial statements on pages 37 to 64, confirm that the financial performance of the business is generally ahead of the projections reported in the Information Memorandum dated 4 May 2001 issued by Financing in connection with the above described bond issue, and that the company is on track to deliver the planned customer rebates in 2003/04 and 2004/05 announced by Glas Cymru at its annual general meeting on 7 July 2001.

Directors

The names and a short biography of each director is set out on pages 20 to 21. There were no changes in Directors during the financial year. No director is or has been party to, or has any interest in, any significant contract with the Company (other than

directors' service contracts).

Chris Jones, Nigel Annett and Lord Burns (being the directors longest in office) will retire by rotation and submit themselves for re-appointment at the Annual General Meeting on 5 July 2002, in accordance with Article 46 of the Articles of Association.

Details of the remuneration of individual directors and of the remuneration strategy approved by the Board are included in the Remuneration Report for the year ended 31 March 2002 set out on pages 28 to 31.

A resolution will be proposed at the Annual General meeting to receive and adopt this report.

Employees

Company policy is to treat employees without discrimination and to operate equal opportunity employment practices. At the financial year end Welsh Water employed 130 people and further information on the company's approach to managing staff relations is set out on page 16. Other than the directors of the Company, Glas Cymru Cyfyngedig itself has no employees.

On 1 April 2001 Welsh Water implemented an outsourced procurement strategy under which over 1,600 staff transferred to contracting partners following a competitive bid process. This fundamentally changed the manner in which our services are delivered to customers and made it an imperative that we develop effective two-way communications with all staff involved in service delivery. We have achieved this in two ways. First by the development of a number of "alliances" in which partner contractors are encouraged to work with Welsh Water and develop a "one-team" approach in the delivery of Welsh Water's business plan. Second, all key contractor staff have access to our company Intranet as the primary source of key business and performance information, and during the year the alliance working to deliver a large part of Welsh Water's capital investment programme launched its own intranet service.

Environment

Details of the company's approach to managing its impact on the environment are set out on pages 14 to 15. Later this year we will publish additional information on this important area, especially our work to meet our commitment to further conservation, protect our heritage and promote access and recreation.

Directors' Report

Research and development

All expenditure on research and development is incurred by Welsh Water, which continues to monitor and selectively participate in water industry R&D initiatives (most notably through membership of UK Water Industry Research Limited) with a view to maintaining the company's achievements in improving operational efficiency, and to ensure continued compliance with appropriate national and international standards for potable water, sewage effluent and sludge treatment.

Payment to suppliers

Company policy is to comply with terms of payment negotiated with suppliers. A copy of the Company's published Procurement Policy is available on request from the Company Secretary and may be obtained from Welsh Water's website [www.dwrcymru.com].

The average payment in the period was 96 days (2001: 116 days). Regulations require that in calculating this we include within trade creditors monies retained under contract in respect of capital investment projects. This accordingly varies from year to year and adversely affects the average payment for the year.

Contributions for charitable and political purposes

During the year charitable donations amounted to £16,000 (2001: £nil). Company policy is to target any donations on conservation and education, and to community projects connected with Welsh Water's capital investment programme. No payments were made, directly or indirectly, for political purposes, save in respect of nominal value relating to members of staff who have been permitted time off to undertake duties as local councillors.

Welsh language policy

The company welcomes dealing with customers and other stakeholders in Welsh or English and aims to provide an equally effective standard of service in both languages.

Regulatory accounts

The regulatory accounts that Welsh Water is required to produce under Condition F of its Instrument of Appointment will be available from the Company Secretary after 31 July 2002.

Auditors

A resolution to re-appoint PricewaterhouseCoopers as auditors of the company and to authorise the directors to agree their fees will be proposed at the Annual General Meeting.

Annual General Meeting

The Annual General Meeting will be held at The Orangery, Margam Country Park, Port Talbot at 11.00 am on Friday 5 July 2002. The Notice of Annual General Meeting (including Agenda and Explanatory Notes) is set out in a separate document.

The business of the AGM includes the receipt of Directors' Report and Financial Statements for the year ended 31 March 2002, the re-appointment of three Directors who retire by rotation and offer themselves for re-appointment, and the re-appointment of PricewaterhouseCoopers as auditors to the Company. There are also resolutions which deal with the receipt of the Remuneration Report of the Directors and to allow the company to comply with the Political Parties, Elections and Referendums Act 2000. All resolutions are matters of "ordinary business" for the Annual General Meeting that will be addressed each year. There are no items of special business which require approval by Members.

Post balance sheet events

On 31 May 2002, Welsh Water completed a further £100 million lease finance transaction on terms substantially the same as the facility announced on 19 March 2002.

By order of the Board



R. G. Curtis LLB ACIS

Company Secretary

12 June 2002

Directors' Report on Remuneration

The Board is pleased to submit its first Report on Remuneration for approval by Members at the 2002 Annual General Meeting.

Remuneration Committee

The role of the Remuneration Committee is to approve and implement the remuneration policy and specifically:

- To review annually and agree with the Board the broad policy and framework for the remuneration of executive management;
- To agree the terms of executive director's service contracts and remuneration; and
- To determine the nature and scale of short and longer term incentive performance arrangements that encourage enhanced performance and reward individuals in a fair and responsible manner for their contribution to the success of the company.

The committee is chaired by Alison Carnwath and comprises all the non-executive directors and meets as required, but at least twice in any financial year. In this first year the Committee met on 5 occasions. All members of the Committee are independent of management and save for their directors' fees have no financial interest in the Company. Executive directors attend meetings of the Committee only by invitation of the chairman.

In its work the Committee considers the Principles of Good Governance and Code of Best Practice (the Combined Code) and takes advice as necessary from within and outside the Company. The principal professional advisors to the Committee are William M Mercer (SCA Consulting), Barnett Waddingham and Linklaters & Alliance.

Responsibility for determining the fees of the Chairman and of the Non-Executive Directors sits with the Board.

Remuneration Policy

The objective of the company's remuneration policy is to attract, retain and motivate directors and managers of the required calibre in a competitive market place and to implement remuneration arrangements which align as closely as practicable the interests of the individual with the interests of the customers of Welsh Water. Accordingly a high proportion of the maximum remuneration of executive directors is "at risk".

Specifically, the remuneration policy:

- Sets base salaries initially below market levels (assessed against a comparator group of companies of similar nature and complexity), typically at or around lower quartile; and

- Sets incentive bonuses across a broad range of performance measures relevant to customers.

The comparator group of companies used are the UK water companies listed on The London Stock Exchange and selected other companies. The Remuneration Committee assesses the appropriateness of the comparator group of companies used in determining remuneration policy on an annual basis.

Scope of remuneration arrangements for executive directors

The remuneration of each executive director comprises a basic salary (together with pension arrangements and other pensionable benefits in kind), a potential annual performance related bonus and a potential separate long-term performance related bonus. The performance related bonus arrangements are designed to align any executive bonuses with improved customer service and the financial performance of the business.

Salary

Salaries are reviewed annually. The basic salary of each executive director was previously stated in the Interim Statement of Remuneration Policy published by the Company at the Annual General Meeting in July 2001. These have not changed and are:

Mike Brooker	£175,000
Nigel Annett	£125,000
Chris Jones	£125,000

Performance Related Bonus

Executive directors may earn an annual bonus of up to 80% of basic salary of which up to 50% is assessed against delivery of customer service performance targets and up to 30% is assessed against the annual financial performance of the Company. Annual bonus payments are non pensionable.

The customer service performance element of the annual bonus is measured by reference to an overall service assessment published by OFWAT. The extent to which awards will be earned under this element of the bonus will depend on the relative ranking of Welsh Water compared to the other water and sewerage companies. Both absolute ranking and improvement in ranking will be rewarded, and a fall in the Company's ranking will be penalised. The Remuneration Committee has reserved the discretionary power to modify this element of the scheme to reflect any revision by OFWAT of its service performance measures.

Directors' Report on Remuneration

Included within the overall service assessment are non-financial performance measures for:

- **Water supply:** interruptions to supply, restrictions on supply and drinking water compliance
- **Sewerage measures:** sewage flooding incidents and quality of effluent discharges to the environment
- **Customer service performance:** speed of response to telephone and written billing enquiries and handling of written complaints.

The financial performance element of the annual bonus is measured against pre-capital expenditure cash-flow targets, after net interest payable. Cash-flow is the clearest single measure of financial performance that captures the short-term drivers of the business. Each year the Remuneration Committee determines appropriate cash-flow targets and the level at which maximum bonus should be paid, and the level below which no bonus would be paid.

Long term performance related bonus

This scheme has been established for executive directors and is linked to the long-term financial performance of the Company, determined on the basis of two measures: (i) the increases in the Company's level of reserves; and (ii) changes in the rating of each class of the Company's bonds.

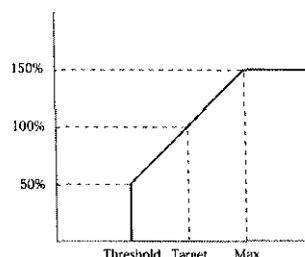
Growth in reserves captures the fundamental dynamics on which the objectives of Glas Cymru were founded. Improved performance and efficiency in the way the business is financed and operated will all be captured by growth in financial reserves, the main use of which will, over time, be to deliver lower bills to the customers of Welsh Water. This therefore aligns the financial interests of directors and senior managers in a direct and simple way with those of customers.

The level of accumulated financial reserves represents the best measure of the Company's long-term financial success. The scheme operates over a four-year period to 31 March 2005. The assessment of performance will be taken as the average of the balance of reserves at six month-ends – three either side of March 2005.

As in the case of the annual bonus scheme, vesting of any award will occur on a sliding scale against 'threshold' and 'maximum' level of performance targets set by the Remuneration Committee.

The award based on the level of reserves will then be adjusted (up or down) according to the credit rating change over the period on each class of bonds (providing that awards could never fall below zero). The schedule of awards is shown in the diagram below.

Reserves - Based Bonus



Ratings - Based Adjustment

Improvement	Award
+4 points or more	+50%
+3 points	+35%
+2 points	+20%
+1 point	+10%
No change	0%
-1 point	-10%
-2 points	-20%
-3 points	-30%
-4 points or fewer	-50%

Half of any award earned under the long-term bonus scheme will be payable in July 2005 (i.e. at the end of the performance period in the month following publication of the Company's audited financial results). The remaining half will be deferred for two years and be paid on the second anniversary of the award with no further performance conditions. If a director were to leave the company before that date (other than for retirement, redundancy, or reasons of ill health) the unpaid part of any award would be forfeited.

Directors' Report on Remuneration

Directors' emoluments excluding pension benefits

The following emoluments were earned by the Directors in respect of the financial year ended 31 March 2002.

2001/2002	Lord Burns	MP Brooker	NC Annett	CA Jones	JM Bryant	A Carnwath	GT Davies	DJ Hine	AJ Hobson	Total
Salary	-	£158,933	£118,167	£118,167	-	-	-	-	-	£395,267
Bonus	-	£54,250	£38,750	£38,750	-	-	-	-	-	£131,750
Fees	£140,000	-	-	-	£35,000	£35,000	£35,000	£35,000	£35,000	£315,000
Benefits in kind	-	£7,517	£12,265	£7,105	-	-	-	-	-	£26,887
Total	£140,000	£220,700	£169,182	£164,022	£35,000	£35,000	£35,000	£35,000	£35,000	£868,904

The following emoluments were earned by the Directors in respect of the financial year ended 31 March 2001.

2000/2001	Lord Burns	MP Brooker	NC Annett	CA Jones	JM Bryant	A Carnwath	GT Davies	DJ Hine	AJ Hobson	Total
Salary	-	-	£34,444	£34,444	-	-	-	-	-	£68,888
Bonus	-	-	£100,000	£100,000	-	-	-	-	-	£200,000
Fees	£98,333	-	-	-	£2,917	£29,583	£39,583	£2,917	£2,917	£176,250
Benefits in kind	-	-	-	-	-	-	-	-	-	-
Total	£98,333	-	£134,444	£134,444	£2,917	£29,583	£39,583	£2,917	£2,917	£445,138

Notes

- (1) The highest paid director is MP Brooker - Aggregate emoluments: £220,700
- (2) Benefits in kind relate to receipt of car and fuel benefits, private medical insurance and life insurance.
- (3) MP Brooker and CA Jones received a non-pensionable salary supplement in lieu of receiving a company car for part of 2001/2002.
- (4) The financial statements for the year ended 31 March 2002 include a provision of £131,750 (31% of basic salary) for bonus potentially payable to executive directors for performance in the financial year 2001/2002. The bonus is payable under the terms of the performance related bonus scheme described on page 28. However, the amount to be paid to each director cannot be determined until OFWAT publishes comparative performance data for 2001/2002 for the water and sewerage companies of England and Wales.
- (5) Accordingly the combined emoluments of the directors paid in the financial year ended 31 March 2002 for their services as directors of the company and its subsidiaries are:

	2002	2001
Fees	£315,000	£176,250
Salaries (including benefits in kind)	£422,154	£68,888
Performance related bonus	£131,750	£200,000
	£868,904	£445,138

- (6) In 2001 CA Jones and NC Annett were each awarded £100,000 bonus for the financial year ended 31 March 2001 which predated the Company's acquisition of Welsh Water. £50,000 was paid in 2001/2002 with £25,000 being deferred and payable in each of 2002/2003 and 2003/2004.

Pensions and Benefits

It is company policy to make provision for pensions for executive directors in respect of their basic salaries, but not in respect of annual bonuses or benefits.

The Welsh Water Pension Scheme is a final salary occupational scheme and is fully funded and subject to Inland Revenue limits. The Company will make a provision for liabilities arising from contractual commitments to executive directors over the Inland Revenue "earnings cap".

The normal retirement age for Directors under the Welsh Water Pension Scheme is 60 and benefits

accrue at 1/45th of salary per year of pensionable service, subject to an overall pension at normal retirement age of two-thirds of final pensionable salary. The scheme also provides life cover of four times pensionable pay for death in service, a pension payable in the event of ill health and a spouses pension payable on death.

Executive directors have the use of an expensed company car (or receive a salary supplement in lieu of a company car), and participate in a private health and medical insurance scheme.

Director's Report on Remuneration

Directors pension benefits - 2001/2002

	Accrued Pension (per annum)	Increase in accrued pension over year	Transfer value equivalent of increase	Contributions paid by director	Contributions paid by company
MP Brooker	£87,517	£15,739	£204,000	£10,600	£21,200
NC Annett	£926	£926	£7,120	£7,500	£15,000
CA Jones	£926	£926	£5,590	£7,500	£15,000

Notes

- (1) The Welsh Water Pension Scheme was established on 1 December 2001.
- (2) Accrued pension for MP Brooker reflects contributions made in the year under the Hydar Water Pension Scheme. NC Annett and CA Jones ceased to make contributions to this scheme in the previous financial year (2000/2001). Each Director is currently a Deferred Member of the Hydar Water Pension Scheme.

Service Contracts

The executive directors have service contracts that are subject to one year's notice. If it became necessary to recruit a new executive director, the Remuneration Committee would, in exceptional circumstances to secure the services of an individual of the right calibre, consider an appointment terminable on longer notice, but would require that this reduce to one year's notice, or less, after an initial period.

Directors' service contracts do not provide for compensation to be payable in the event of early termination by the Company. The policy of the Remuneration Committee in the event of termination is to mitigate compensation payments.

External appointments

At 31 March 2002 no Executive Director had any external fee paying appointments. However, the Company recognises the benefit of broadened experience that might be achieved through involvement in external activities. Any such appointments will be subject to annual approval by the Remuneration Committee and, subject to the Committee's agreement, an individual director may retain any fees.

Remuneration Policy for non-executive directors

The fees payable to the Chairman and the Non-Executive Directors were fixed in May 2001 for two years, as below.

Chairman	£140,000
Non-Executive Directors	£35,000

Non-Executive Directors receive no additional fees for membership of Board committees or the undertaking of any special responsibilities, nor do they receive any benefits in kind.

The Chairman and the non-executive directors are appointed under letters of appointment, which may be terminated on six months notice. No other compensation is payable on termination of appointment by the Company.

Compliance with the Combined Code

The Directors confirm that the Company has complied with the provisions of the Combined Code relating to directors remuneration throughout the financial year ended 31 March 2002.



Alison Carnwath
Chair - Remuneration Committee
12 June 2002

Corporate Governance

Introduction

Glas Cymru is committed to high standards of corporate governance. This has been, and remains, critical to establishing the company's credentials as an efficient, low-risk provider of an essential public service in the eyes of Welsh Water customers and its regulators, and the company's bondholders and other stakeholders.

The Company has complied throughout the year with the Principles of Good Governance and Best Practice as annexed to the Listing Rules of the United Kingdom Listing Authority (the "Combined Code"), except in respect of the formal appointment of a senior independent director which is referred to below.

Compliance with the Combined Code is monitored by the Members of the company and by Ofwat, Welsh Water's economic regulator, as compliance is a regulatory obligation enshrined in the Licence of Welsh Water. In addition bondholders and other stakeholders use compliance with the Combined Code, alongside the company's financial performance, as critical tests of the performance of the Board.

The Board

The role of the Board is to set the strategic direction of the company and to review its operating and financial performance. The Board meets monthly.

The Board has adopted a formal schedule of matters reserved to the Board, which can only be amended by the Board and which is reviewed annually.

Appointments to the Board are the responsibility of the full Board on recommendation from the Nominations Committee. New directors have a formal induction programme. All directors submit themselves for re-election at the annual general meeting at least once every three years.

The Board is comprised of a majority of independent non executive directors with a wide and relevant business experience and whose remuneration consists only of fees. They have access to all information relating to the Group; the advice and services of the company secretary; and, as required, independent external advice at the expense of the company.

There is a clear division of responsibility between the chairman and the managing director whose roles, with those of the executive directors, are clearly defined so as to give no individual unfettered powers of decision. The managing director is responsible for the day-to-day management of the business and for implementation of policies and procedures adopted by the Board.

All Members of the Company have regular opportunity to meet with and question directors and, accordingly, the Board has concluded that nomination of a senior independent director would not improve governance and have not appointed one.

In addition to the formal committees of the Board (described below) the Board has also designated "special responsibilities" to a number of non-executive directors, covering important areas such as procurement, communications and government and regulation.

The Board receives a rolling programme of presentations and meetings with senior managers to ensure they become suitably familiar with the significant aspects of the company's business. External training for directors is provided where appropriate.

Together these arrangements enable the Board to exercise control over all significant aspects of the company's business.

The Directors

Brief biographical details of each of the current directors can be found on pages 20 to 21 of the annual report, including respective dates of appointment as directors.

At the annual general meeting three directors, C. A. Jones, N. C. Annett and Lord Burns will retire and seek re-election in accordance with the company's articles of association. All of the directors are required to stand for re-election at least every three years.

Each of the executive directors has a written service contract subject to termination on twelve months notice.

Corporate Governance

The Members

The role of the members of Glas Cymru is to ensure the company remains focused on its primary purpose of providing high quality water and sewerage services at least cost to the communities served by Welsh Water. In doing this members carry out an important corporate governance role.

Members are appointed by the Board under the company's published Membership Policy on the advice of an independent membership selection panel. No individual can be appointed a member without having first been recommended by the panel. The role of the panel is to recommend for membership individuals who in a written application have shown they have the skills, experience and interests to be effective members of the company. In addition the panel is required to ensure the company establishes and maintains a balanced and diverse membership, which is as far as possible broadly reflective of the range of customer and other stakeholder interests served by Welsh Water.

Membership of the company is personal. Members are not appointed to represent any particular group or stakeholder interest.

Details of the membership policy and the members of Glas Cymru can be obtained from the company secretary or from the company's website.

Other stakeholders

Like all the other water businesses in England and Wales, Welsh Water operates within a regulatory framework prescribed by the Water Industry Act 1991. The economic regulator is Ofwat, which is responsible for setting the limits on the prices that Welsh Water can charge, and overseeing Welsh Water's overall performance.

The regulator with responsibility for drinking water quality is the Drinking Water Inspectorate, which is part of the Department of the Environment Food and Rural Affairs and acts on behalf of the National Assembly for Wales in respect of Welsh Water.

The Environment Agency oversees the company's environmental performance, especially with regard to the way in which it abstracts water from rivers and reservoirs, and then disposes of wastewater after it has been treated. All aspects of Welsh Water's water and wastewater operations are subject to extensive performance monitoring against targets set by regulators and Government.

Each year the regulators publish reports commenting on and comparing the performance of water companies across a full range of measures, including cost efficiency, customer service, water quality and environmental quality.

The National Assembly for Wales has a key role in determining the priorities for water quality and environmental quality standards and improvements, as well as setting the framework for other public policy matters such as social considerations arising from water tariff structure, metering and competition.

All of these regulators have strong powers at their disposal that can be used in the event that Welsh Water's performance is not up to standard.

Committees of the Board

There are four formal committees of the Board each of which has written terms of reference, which define the role and responsibilities of the committee, and which are reviewed annually. These are the Audit Committee, the Remuneration Committee, the Nominations Committee and the Quality and Environment Committee. Membership of the various committees is set out on pages 20 to 21 of the annual report. The minutes of all committees are submitted to the following meeting of the Board.

The Audit Committee comprises three non-executive directors and is chaired by Tony Hobson. It meets four times a year to:

- Review and advise the Board on the Group's interim and annual financial statements, its accounting policies and on the control of its financial and business risks;
- Review the nature and scope of the work to be performed by the external auditors and outsourced internal audit function, the results of audit work and of the response of management;
- Make recommendations on the appointment and remuneration of external auditors; and
- To review the non-audit services provided to the Group by the external auditors to ensure the independence of the auditors is not compromised.

The Audit Committee meets with executive directors and management, as well as privately with both external and internal auditors. The terms of reference of the Audit Committee include all matters indicated by the Combined Code.

The role of the Remuneration Committee is to determine and agree with the Board the broad policy and framework for the remuneration of executive directors and senior managers, and to determine the nature and scale of incentive performance arrangements that encourage enhanced performance and which reward individuals in a fair and responsible manner for their contribution to the success of the company. The committee is chaired by Alison Carnwath and consists of all the non-executive directors, and meets as required, but at least twice in any financial year.

The role of the Nominations Committee is to review the size, structure and composition of the Board and to make recommendations to the Board on any appointments that may be deemed necessary. This committee is chaired by the Chairman of the Board and meets as required. All the directors are members of this committee, although the chairman of any meeting must be a non-executive director and there must be a majority of non-executive directors at all meetings of the committee.

The role of the Quality and Environment Committee, which is chaired by Dame Deirdre Hine and meets each month, is to advise the Board on any issue relating to operational policy and practice in relation to compliance with drinking water regulations and environmental laws and regulations. This committee also reviews the performance of Welsh Water against agreed key performance indicators, with particular regard to matters of public health, health and safety and environmental impact.

The Quality and Environment Committee was established in recognition that where a large proportion of the services of the company are provided by specialist contractors, that additional attention should be paid to the assessment and handling of hazard and risk. Members of this committee include two non-executive directors (including the chairman of the committee) and two executive directors. Two independent experts on the public health and operational aspects of water supply and environmental management attend all meetings of the committee.

The findings of the Quality and Environment Committee will be attached to Welsh Water's annual report to the Drinking Water Inspectorate and Environment Agency (the "Quality Regulators"). The Board is required to notify the Quality Regulators at once if it does not implement any recommendation made by this committee. The operation of the committee is also subject to review by Welsh Water's Reporter (the independent

consultant appointed by Welsh Water with the approval of Ofwat) who will report to Ofwat and the Quality Regulators on the effectiveness of Welsh Water's systems of internal control.

Internal control

The Board has overall responsibility for the system of internal control and for monitoring its effectiveness. The implementation and maintenance of the internal control systems are the responsibility of executive directors and senior management.

The Company's internal control systems are designed to manage, rather than eliminate, the risk of failure to meet business objectives and can only provide reasonable, and not absolute, assurance against material misstatement or loss. In assessing what constitutes reasonable assurance, the board has regard to materiality and to the relationship between the cost of and the benefit from the internal control systems.

Key features of the system of internal control include:

- An organisation with clearly defined lines of authority and accountability and established policies and procedures, reviewed annually, for all significant aspects of the company's business;
- A clear business process for the identification, evaluation and mitigation of hazard and risk, including regular reporting to the Board (and to the Audit Committee and the Quality and Environment Committee) and routine external verification through audit and similar quality management system procedures;
- A comprehensive annual budget and business plan and a clear process of monthly reporting of all aspects of the business's performance against that plan. Revised financial forecasts are prepared quarterly.
- Clear policies for the approval and control of major items of capital expenditure and for the acquisition and disposal of material assets or entering into of any arrangement that gives rise to, or could give rise to, a material liability for the company; and
- Effective arrangements for an internal audit function to carry out reviews of information systems and business and contract management control procedures, under a broadly based programme of activity approved by the Audit Committee.

Corporate Governance

The managing director chairs a risk management group, which includes senior managers from all parts of the company's business. Under a risk management strategy approved by the Board, the role of the risk management group is to review and challenge the robustness of risk management procedures within the business, including that of Welsh Water's contracting partners. Internal procedures encourage all staff (and contracting partners) to participate in open two-way dialogue so as to ensure that risk is captured and managed early and effectively, to learn from our own experience and the experience of others to promote best practice and to improve the quality of service delivered to the customers of Welsh Water. Through the managing director, this group reports to the Board and to the Audit and Quality and Environment Committees of the Board every six months.

The results from the ongoing monitoring of financial, operational and compliance controls and the risk management process have been reported to the Board. The Board has consequently reviewed the effectiveness of the internal control systems over the course of the year.

Internal audit

It is the role of internal audit to provide independent and objective assurance to the Board that the process by which significant risks are identified, assessed and managed, and by which material exceptions to such process is reported to the Board and subsequently addressed, are appropriate and effectively applied. During the financial year 2001-2002 the conduct, but not the management, of internal audit activity was outsourced to Grant Thornton. The Audit Committee approves the annual plan for internal audit, which cover the scope, authority and resources of such activity.

Going concern

Having made due enquiry the Board has concluded that there is a reasonable expectation that the Company and the Group has adequate resources to continue as a going concern for the foreseeable future. Accordingly, the financial statements for the year ended 31 March 2002 have been prepared on a going concern basis.

Directors' responsibilities for the financial statements

The directors are required by the Companies Act 1985 to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and group as at the end of the financial year and of the profit or loss of the company and group for the year. In preparing the financial statements, the directors ensure that appropriate accounting policies have been adopted and applied consistently, and that reasonable and prudent judgements have been made. The directors also confirm 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 group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board



R Curtis LLB ACIS
Company Secretary
12 June 2002

Auditors' report to the members of Glas Cymru Cyfyngedig

We have audited the financial statements which, comprise the profit and loss account, the balance sheet, the cash flow statement and the related notes which have been prepared under the historical cost convention and the accounting policies set out in the statement of accounting policies.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the annual report and the financial statements in accordance with applicable United Kingdom law and accounting standards 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 United Kingdom Auditing Standards issued by the Auditing Practices Board.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if 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 transactions is not disclosed.

We read the other information contained in the annual report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. The other information comprises only the directors' report, the chairman's statement, the annual and financial review and the corporate governance statement.

We also, at the request of the directors (because the company applies the Financial Services Authority Listing Rules as if it were a listed company), review whether the corporate governance statement reflects the company's compliance with the seven provisions of the Combined Code specified by the Financial Services Authority for review by auditors of listed companies, and we

report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or to form an opinion on the effectiveness of the company's or group's corporate governance procedures or its risk and control procedures.

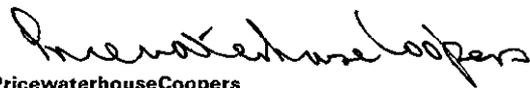
Basis of audit opinion

We conducted our audit in accordance with auditing standards 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 judgements 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 of the state of affairs of the company and the group at 31 March 2002 and of the profit and cash flows of the group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.



PricewaterhouseCoopers

Chartered Accountants and

Registered Auditors

Cardiff

12 June 2002

Notes:

- (a) The maintenance and integrity of the Dŵr Cymru website is the responsibility of the directors; 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 report since it was initially presented on the website.
- (b) Legislation in the United Kingdom governing the preparation and dissemination of financial information may differ from legislation in other jurisdictions.

Accounting policies

A summary of the Group's principal accounting policies are set out below, which have been consistently applied, except as noted in respect of deferred taxation:

Basis of accounting

The financial statements are prepared in accordance with the historical cost convention and with applicable accounting standards in the UK and, except for the treatment of certain capital contributions, comply with the Companies Act 1985. An explanation of this departure from the requirements of the Companies Act 1985 is given in the "Grants and customer contributions" section below and note 10(b).

Basis of consolidation

The consolidated financial statements include the financial statements of the company and all of its subsidiaries. The results of companies and businesses acquired during the year are dealt with in the consolidated financial statements from the date of acquisition. Intra-group transactions and profits are eliminated on consolidation.

Turnover

Turnover represents the income receivable in the ordinary course of business for services provided and excludes value added tax.

Goodwill

Negative goodwill arising on the acquisition of subsidiary undertakings and businesses, represents the difference between the fair value of the consideration given over the fair value of all the identifiable assets and liabilities acquired. Negative goodwill is included in the balance sheet and is amortised to the profit and loss account over its expected useful economic life.

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

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 depreciation charge for infrastructure assets is the estimated level of annual expenditure required to maintain the operating capability of the network which is based on the company's independently certified asset management plan.

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	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.

The carrying value of tangible fixed assets is reviewed for impairment if circumstances dictate that they may not be recoverable.

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 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(b)). 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.

Accounting policies

Pension costs

The majority of the Group's employees belong to pension schemes, which are funded by both employers' and employees' contributions and which are of the defined benefit type. Contributions are charged to the profit and loss account so as to spread the cost of pensions over employees' working lives with the company. Contribution rates are based on the advice of a professionally qualified actuary. Any difference between the charge to the profit and loss account and contributions paid is shown as an asset or liability in the balance sheet.

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

Financial instruments

Derivative instruments utilised by the group 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. Currency swap agreements and currency forward exchange contracts are translated at the rates ruling in the agreements and contracts.

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. The new accounting standard FRS19 "Deferred Tax" has been adopted. This requires full provision to be made for deferred tax arising from timing differences between the recognition of gains and losses in the financial statements and their recognition in tax computations where future payment or receipt is more likely than not to occur. Previously, provision was made for deferred tax on all material timing differences to the extent that it was probable that a liability or asset would crystallise. In adopting FRS19, the Group has chosen to discount deferred tax assets and liabilities.

Provision for insurance liabilities

Provision is made for all known and estimated liabilities arising from uninsured claims against the group where there is a present obligation that will result in transfer of economic benefits.

Consolidated profit and loss account for the year ended 31 March 2002

	Note	2002 £m	2001 £m
Turnover	2	406.1	-
Net operating costs	4	(223.2)	-
Operating profit		182.9	-
Profit on disposal of fixed assets		0.8	-
Profit on ordinary activities before interest		183.7	-
Net interest payable	7	(110.4)	-
Profit on ordinary activities before taxation		73.3	-
Taxation on profit on ordinary activities	8	(0.8)	-
Profit on ordinary activities after taxation being retained profit for the year	23	72.5	-

All operations are continuing.

The group has no recognised gains and losses other than shown above, and therefore no separate statement of total recognised gains and losses has been presented.

The comparative period relates to the activity of the holding company, as the acquisition of Dŵr Cymru Cyfyngedig was completed on 11 May 2001.

Profit before taxation for the year was £24.1m excluding the amortisation of negative goodwill and the release of fair value provisions (see Note 3).

Consolidated Balance sheet at 31 March 2002

Group	Note	2002 £m	2001 £m
Fixed assets			
Negative goodwill	9	(138.0)	-
Tangible assets	10	2,358.1	-
Investments	11	0.2	-
		<u>2,220.3</u>	-
Current assets			
Debtors	12	64.0	0.5
Current asset investments	13	383.2	-
		<u>447.2</u>	0.5
Current liabilities			
Creditors: amounts falling due within one year	14	(247.8)	(0.5)
Net current assets		<u>199.4</u>	-
Total assets less current liabilities		<u>2,419.7</u>	-
Creditors: amounts falling due after more than one year			
Provisions for liabilities and charges	21	(129.1)	-
Deferred income	22	(38.6)	-
Net assets		<u>72.5</u>	-
Reserves			
Profit and loss account	23	72.5	-
Total reserves		<u>72.5</u>	-

The financial statements on pages 37 to 64 were approved by the Board of directors on 12 June 2002 and were signed on its behalf by:



Lord Burns
Chairman



M P Brooker
Managing Director



C A Jones
Finance Director

Balance sheet at 31 March 2002

Company	Note	2002 £m	2001 £m
Fixed assets			
Investments	11	-	-
		-	-
Current assets			
Debtors - due within one year	12	-	0.5
Debtors - due after one year	12	5.2	-
		5.2	0.5
Current liabilities			
Creditors: amounts falling due within one year	14	(5.2)	(0.5)
Net current assets		-	-
Reserves			
Profit and loss account		-	-
Total reserves		-	-

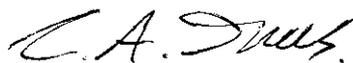
The financial statements on pages 37 to 64 were approved by the Board of directors on 12 June 2002 and were signed on its behalf by:



Lord Burns
Chairman



M P Brooker
Managing Director



C A Jones
Finance Director

Consolidated cashflow statement for the year ended 31 March 2002

	Note	2002 £m	2001 £m
Cash inflow/(outflow) from operating activities	24	249.4	(0.2)
Returns on investments and servicing of finance			
Interest received		11.2	-
Interest paid		(57.6)	-
Interest element of finance lease rental payments		(9.0)	-
		(55.4)	-
Capital expenditure and financial investment			
Purchase of tangible fixed assets		(187.5)	-
Sale of tangible fixed assets		3.1	-
Grants and contributions received		7.4	-
		(177.0)	-
Acquisitions			
Purchase of subsidiary undertaking		(4.2)	-
Cash balances acquired with subsidiary undertaking		49.5	-
		45.3	-
Cash inflow/(outflow) before use of liquid resources and financing		62.3	(0.2)
Management of liquid resources			
Purchase of commercial paper		(96.7)	-
Sale of commercial paper		98.0	-
Net increase in deposits		(179.2)	-
		(177.9)	-
Cash outflow before financing		(115.6)	-
Financing			
Long term loans received		115.7	-
Loan repayments		(15.4)	-
		100.3	-
Decrease in cash in the year	26	(15.3)	(0.2)

Reconciliation of movements in reserves for the year ended 31 March 2002

	2002	2001
	£m	£m
At 1 April 2001	-	-
Profit for the year transferred to reserves	72.5	-
At 31 March 2002	72.5	-

Notes to the financial statements

1 Company profit and loss account

As permitted by section 230 of the Companies Act 1985, the parent company's profit and loss account has not been included in these financial statements. The parent company's retained loss for the year is £27,142 (2001 £Nil).

2 Segmental analysis by class of business

	2002 £m
(a) Turnover	
Regulated water and sewerage activities	401.0
Non-regulated activities	5.1
	<u>406.1</u>
(b) Profit on ordinary activities before taxation	
2002 £m	
Regulated water and sewerage activities	
Operating profit	182.7
Profit on disposal of fixed assets	1.4
Net interest payable	(111.2)
	<u>72.9</u>
Non-regulated activities	
Operating profit	0.2
Loss on disposal of fixed assets	(0.6)
Interest receivable	0.8
	<u>0.4</u>
(c) Net assets	
2002 £m	
Regulated water and sewerage activities	72.1
Non-regulated activities	0.4
	<u>72.5</u>

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

Notes to the financial statements

3 Profit before taxation

The profit before taxation is stated after crediting:	2002 £m
Amortisation of negative goodwill	40.8
Amortisation of acquisition fair value provisions	8.4
	<u>49.2</u>

Excluding these items, the profit before taxation for the year was £24.1m.

4 Net operating costs

	Note	2002 Total £m	2001 Total £m
Staff costs	5(b)	5.5	-
Amortisation of fair value provisions		(8.4)	-
Research and development		0.1	-
Rentals under operating leases:			
- Hire of plant and equipment		-	-
- Other		0.2	-
Fees paid to auditors:	6		
- Audit services (Company £3,000, 2001:£2,000)		0.2	-
- Other services		-	-
Amortisation of grants and contributions	22	(1.3)	-
Own work capitalised		(3.2)	-
Net rents payable		1.6	-
Other operating charges		189.1	-
		<u>183.8</u>	-
Depreciation (including infrastructure assets):			
- Own assets		67.2	-
- Assets held under finance leases		13.0	-
Goodwill amortisation		(40.8)	-
		<u>223.2</u>	-

Notes to the financial statements

5 Directors and employees

(a) Directors' emoluments

Detailed disclosures of directors' individual emoluments are given in the Remuneration Committee report on pages 28 to 31. These disclosures are part of the financial statements.

(b) Staff costs	2002 £m
Wages and salaries	4.8
Social security costs	0.1
Pension costs (see Note 31)	0.6
	<u>5.5</u>

Of the above, £2.0m has been charged to capital.

(c) Average monthly number of employees during the year (including executive directors)	2002 Number
Regulated water and sewerage activities	<u>136</u>

6 Auditors' remuneration

Auditors during the year were PricewaterhouseCoopers. They were used primarily for audit related services, costing £181,000, including regulatory audit services carried out to meet Ofwat reporting requirements. Non-audit professional services during the period amounted to £4,000.

The Board has adopted a formal policy with respect to accounting services. The external auditor will not be used for internal audit services and all non-audit work above a material threshold will be subject to prior competitive tendering.

7 Net interest payable

	2002 £m	2001 £m
Interest receivable	12.9	-
Interest payable:		
On loans	(114.6)	-
On finance leases	(8.7)	-
Net interest payable	<u>(110.4)</u>	-

Notes to the financial statements

8 Taxation

(a) Analysis of (charge)/credit in year	Note	2002 £m	2001 £m
Current tax:			
Adjustments in respect of previous periods		-	-
Total current tax	8(b)	-	-
Deferred Tax:			
Origination and reversal of timing differences		(5.7)	-
Increase in discount		4.9	-
Total deferred tax		(0.8)	-
Tax on profit on ordinary activities		(0.8)	-

(b) Factors affecting current tax charge for year	2002 £m
Profit on ordinary activities before tax	73.3
Profit on ordinary activities multiplied by the corporation tax rate in the UK of 30%	22.0
Effects of:	
Expenses not deductible for tax purposes	1.9
Capital allowances in excess of depreciation	(9.7)
Other timing differences	1.2
Income not chargeable for tax purposes	(14.8)
Tax losses utilised	(0.6)
Current tax charge for year	-

9 Intangible fixed assets – negative goodwill

	Note	2002 £m
Cost:		
At 1 April 2001		-
Additions	27	(178.8)
At 31 March 2002		(178.8)
Amortisation		
At 1 April 2001		-
Released in the year		40.8
At 31 March 2002		40.8
Net Book Value		
At 31 March 2002		(138.0)
At 31 March 2001		-

Negative goodwill is being released to the profit and loss account on a straight line basis over the period from acquisition of the relevant subsidiary to 31 March 2005.

Notes to the financial statements

10 Tangible fixed assets - Group

(a) Analysis by type

Group	Freehold land and buildings £m	Infrastructure assets £m	Operational structures £m	Vehicles, plant, equipment and computer hardware and software £m	Total £m
Cost					
At 1 April 2001	-	-	-	-	-
Assets acquired on acquisition of subsidiary	44.6	1,301.8	1,584.9	185.7	3,117.0
Additions	0.7	99.2	80.0	10.0	189.9
Grants and contributions	-	(6.6)	-	-	(6.6)
Disposals	(4.4)	(1.0)	(0.1)	-	(5.5)
At 31 March 2002	40.9	1,393.4	1,664.8	195.7	3,294.8
Accumulated depreciation					
At 1 April 2001	-	-	-	-	-
Accumulated depreciation acquired on acquisition of subsidiary	19.2	314.4	392.7	133.4	859.7
Charge for the year	0.9	30.5	40.6	8.2	80.2
Eliminated on disposals	(2.2)	(1.0)	-	-	(3.2)
At 31 March 2002	17.9	343.9	433.3	141.6	936.7
Net book value					
At 31 March 2002	23.0	1,049.5	1,231.5	54.1	2,358.1
At 31 March 2001	-	-	-	-	-
Analysis of net book value at 31 March 2002					
Owned	23.0	1,049.5	849.1	54.1	1,975.7
Held under finance leases	-	-	382.4	-	382.4
23.0	1,049.5	1,231.5	54.1	2,358.1	

Tangible fixed assets at 31 March 2002 include £158.4m of assets in the course of construction, which are not depreciated until commissioned.

(b) The accounting treatment for grants and customer contributions in respect of infrastructure assets is described in the principal accounting policies on page 37. This treatment is not in accordance with Schedule 4 to the Companies Act 1985, which requires 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 has been adopted in accordance with section 227(6) of the Companies Act 1985 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 £169.8m lower than it would have been had grants and contributions been treated as deferred income indefinitely.

Notes to the financial statements

11 Fixed asset investments

a) Group

Cost and net book value	2002 £m
At 1 April 2001	-
On acquisition	0.2
At 31 March 2002	0.2

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 group holds 5% Convertible Unsecured Loan Stock 2014 at a cost of £23,326 in Water Research Centre (1989) Plc.

50% interest is held in the following unlisted company:-

	Nature of Business	Country of Incorporation	Description of Holding
Garwnant Visitors Centre	Recreation and Education	Great Britain	Ordinary Shares of £1

The purpose of this investment is to operate retail, recreational and educational facilities.

b) Company

Cost and net book value	2002 £m
At 1 April 2001	-
Additions	-
At 31 March 2002	-

Principal group companies:-

The Company has a £1 investment in Glas Cymru (Securities) Cyfyngedig and has direct or indirect investments in the following subsidiary undertakings:-

	Principal Activity	Country of Incorporation	Holding
Glas Cymru (Securities) Cyfyngedig	Holding company	England and Wales	100%
Dŵr Cymru (Holdings) Limited*	Holding company	England and Wales	100%
Dŵr Cymru Cyfyngedig*	Water and sewerage	England and Wales	100%
Dŵr Cymru (Financing) Limited*	Raising finance	Cayman Islands	100%
Welsh Water Utilities Finance Plc*	Raising finance	England and Wales	100%

* Indirect Holdings

Notes to the financial statements

12 Debtors

Group	2002 £m	2001 £m
(a) Amounts falling due within one year:		
Trade debtors	26.5	-
Other debtors	4.9	0.4
Prepayments and accrued income	32.4	0.1
	63.8	0.5
(b) Amounts falling due after more than one year:		
Other debtors	0.2	-
	64.0	0.5
Company	2002 £m	2001 £m
(a) Amounts falling due within one year:		
Amounts owed by subsidiary undertakings	-	0.1
Other debtors	-	0.4
	-	0.5
(b) Amounts falling due after more than one year:		
Amounts owed by subsidiary undertakings	5.2	-
	5.2	0.5

13 Current asset investments - Group

Management of liquid resources	2002 £m	2001 £m
Investments in:		
Fixed term and call deposits - due within one year	376.2	-
Fixed term and call deposits - due after one year	7.0	-
	383.2	-

Cash generated from operating activities and from long-term borrowings in advance of future capital expenditure obligations is invested. These investments include long-term deposits, government securities and corporate bonds.

Notes to the financial statements

14 Creditors

Group	Note	2002 £m	2001 £m
(a) Amounts falling due within one year:			
Bank overdrafts		15.5	0.2
Other loans	15	0.6	-
Finance leases	16	1.1	-
Trade creditors		104.0	0.1
Other taxation and social security		2.8	-
Other creditors		123.8	0.2
		247.8	0.5
(b) Amounts falling due after more than one year			
Other loans	15	1,891.8	-
Obligations under finance leases	16	287.5	-
Other creditors - between one and five years		0.2	-
		2,179.5	-
(c) Loan reconciliation			
Original bond issue		1,910.0	-
Add: Local authority loans		5.4	-
Less: Loan repurchase		(15.0)	-
Less: Bond issue costs unamortised		(12.5)	-
Add: Bond indexation		4.5	-
Loans as above		1,892.4	-
Company		2002 £m	2001 £m
Amounts falling due within one year:			
Bank loans and overdrafts		-	0.2
Amounts owed to subsidiary undertaking		5.2	0.1
Other creditors		-	0.2
		5.2	0.5

Notes to the financial statements

15 Other loans

Group	2002 £m
Loans are repayable as follows:	
Within one year	0.6
Between one and two years	0.6
Between two and five years	1.6
After more than five years	1,889.6
	<u>1,892.4</u>
Repayable wholly within five years	-
Repayable wholly after five years	1,887.0
Repayable by instalments of which some repayments are after five years	5.4
	<u>1,892.4</u>

Interest rates on these loans ranged between 3.54% (index-linked) and 11.45%.

On 10 May 2001 Dŵr Cymru (Financing) Limited, a subsidiary company, completed a £1,910 million asset-backed bond issue, the proceeds of which were lent to Dŵr Cymru Cyfyngedig under an inter-company loan agreement. The costs directly attributable to issuing the bonds have been capitalised in accordance with FRS4 and are being amortised to the profit and loss account over the life of the bonds.

16 Finance leases

Group	2002 £m	2001 £m
Amounts due under finance leases within one year	1.1	-
Amounts due under finance leases between two and five years inclusive	11.2	-
Amounts due under finance leases after more than five years	276.3	-
	<u>288.6</u>	-

A long dated interest rate swap was arranged on 1 April 1994 which has the effect of fixing the rate of interest at 7.8% on floating rate sterling finance lease obligations of £55.3m. This obligation reduces over a term of 12 years.

17 Maturity of gross borrowings for group

The expected maturity profile of the group's gross borrowings, before unamortised bond issue costs of £12.5million, excluding bank overdrafts, was as follows:

	Expected maturity £m
In less than one year	1.7
In more than one year but not more than two years	2.3
In more than two years but not more than five years	96.1
In more than five years	2,080.9
	<u>2,181.0</u>

18 Financial instruments and risk management

(a) Treasury 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 does not envisage the use of complex financial instruments. We use financial instruments, including derivatives, to raise finance and manage risk from our operations.

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.

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 group minimises exposure to currency risk in respect of foreign currency denominated borrowing by using appropriate derivative instruments to hedge these liabilities into sterling obligations.

The group hedges at least 85% of its total outstanding liabilities into either index-linked or fixed rate obligations. 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 exposes the group to inflation risk. Subject to market constraints and Board approval the group therefore seeks to raise new debt through index-linked instruments or by entering into appropriate hedging transactions.

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.

We maintain committed banking facilities in order to provide flexibility in the management of the group'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 Common Terms Agreement. This facility is renewable on an annual basis.

(b) Short-term debtors and creditors

These have been excluded from the financial instrument disclosures set out in the following paragraphs.

(c) Interest rate and currency swaps

The group has entered into swap agreements in order to manage the interest rate and currency exposure of its financial liabilities and not for trading or speculative purposes.

At 31 March 2002 the notional principal amounts outstanding of the group's interest rate swap arrangements were £680.3m with termination dates ranging from March 2008 to March 2031 and interest rates ranging from 5.67% to 7.80%.

At 31 March 2002 the notional principal amount outstanding of the group's currency swap agreement was £200m (US\$ 286m), with the termination date being March 2008.

Notes to the financial statements

18 Financial instruments and risk management

(d) Interest rate profile of financial liabilities

After taking into account the interest rate and currency swaps outlined above, the fixed, index-linked and floating interest rate profile of the group's financial liabilities is:

	Fixed £m	Index-Linked £m	Floating £m	Total £m
Bank overdraft	-	-	15.5	15.5
Bonds	1,410.0	489.5	-	1,899.5
Finance leases	55.3	-	233.3	288.6
Other loans	-	-	5.4	5.4
	1,465.3	489.5	254.2	2,209.0
Unamortised bond issue costs				(12.5)
				2,196.5

As at 31 March 2002 all the floating rate liabilities were hedged through floating rate cash balances.

The bank overdraft represents uncleared bank balances and therefore does not attract interest.

The floating rate interest liabilities on the finance leases are based on agreed margins to LIBOR and will therefore fluctuate from year to year. Interest rates on the other loans of £5.4m have varied from 6.4% to 7.8% during the year.

The bonds were issued by our subsidiary company, Dŵr Cymru (Financing) Limited. The finance leases and other loans are obligations of Dŵr Cymru Cyfyngedig.

The weighted average interest rates and expected maturities for fixed rate obligations are:-

	Weighted average interest rate	Weighted average expected maturity
Bonds	7.06%	14.90 yrs
Finance leases	7.80%	12.00 yrs

(e) Interest rate profile of financial assets

	Fixed £m	Floating £m	Total £m
Short-term deposits	350.5	-	350.5
Call deposit account	-	32.7	32.7
	350.5	32.7	383.2

The sterling money market deposits above comprise deposits placed on money markets from overnight to thirteen months. All deposits are at fixed interest rates. The weighted average interest rate on commercial paper and money market deposits held during the year was 4.74% and the weighted average length of deposit held was 43 days.

The interest rate applied to the call deposit account is variable, and is calculated in accordance with market convention.

Notes to the financial statements

18 Financial instruments and risk management

(f) Committed borrowing facilities available

The group has various undrawn committed borrowing facilities. The facilities available at 31 March 2002 were as follows:

	Note	£m
Authorised loan facilities		150.0
Overdraft		20.0
Liquidity facility	18a	150.0
		320.0

The authorised loan facility expires on 31 March 2006. The overdraft facilities are repayable on demand.

(g) Fair values of financial instruments

In the table below, the fair value of short-term borrowings, current investments, cash at bank and in hand and bank loans and overdraft approximates to book values due to the short maturity of these instruments.

Fair value is the amount at which a financial instrument could be exchanged in an arms length transaction between informed and willing parties, other than a forced liquidation or sale.

The fair value of long-term borrowings has been determined by reference to prices available from the financial markets on which these borrowings are traded.

	Book value £m	Fair value £m
Non - derivatives:		
Assets		
Current asset investments	383.2	383.2
Liabilities:		
Borrowings less than one year	(1.7)	(1.7)
Fixed rate borrowings over one year	(800.0)	(839.4)
Index - linked borrowings over one year	(485.0)	(551.6)
Floating rate borrowings over one year	(917.3)	(917.3)
Bank overdraft	(15.5)	(15.5)
Derivative financial instruments held to manage the interest rate and currency profile and matched by primary financial instruments		
Interest rate swap	-	(40.3)
Currency swaps	-	0.8

As at 31 March 2002 there were no unmatched derivative financial instruments.

Notes to the financial statements

18 Financial instruments and risk management

Gains and Losses on hedges

Changes in the fair value of instruments used as hedges are not recognised in the financial statements until the hedged position matures. An analysis of these unrecognised gains and losses is as follows:

	Gains £m	Losses £m	Total net gains/ (losses) £m
Unrecognised gains/(losses) on hedges at 31 March 2002	0.8	(40.3)	(39.5)
Of which:			
Gains/(losses) expected to be recognised in the year ended 31 March 2003	(3.3)	(8.2)	(11.5)
Gains/(losses) expected to be recognised after the year ended 31 March 2003	4.1	(32.1)	(28.0)

19 Capital commitments

Group	2002 £m	2001 £m
Contracted for but not provided in the financial statements	77.8	-

In order to meet additional quality and service standards, together with growth and new demands, the group has capital investment obligations over the next three years amounting to approximately £740m at current prices in the regulated water and sewerage business.

The company has no expenditure contracted for but not provided in the financial statements at 31 March 2002.

20 Leasing commitments

Group	Land and buildings		Other	
	2002 £m	2001 £m	2002 £m	2001 £m
At 31 March 2002 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:				
within one year	-	-	-	-
between one and two years	-	-	-	-
between two and five years	-	-	-	-
after five years	0.4	-	-	-
	0.4	-	-	-

The company has no lease commitments.

Notes to the financial statements

21 Provisions for liabilities and charges

Group	Note	2002 £m	2001 £m
Deferred taxation	(a)	76.4	-
Restructuring provision	(b)	5.1	-
Contract management provision	(c)	0.9	-
Provision for uninsured losses	(d)	4.0	-
Provision for loss on swap closure	(e)	20.0	-
Provision for contract for difference	(f)	22.7	-
		129.1	-

(a) Deferred taxation

	2002 £m	2001 £m
Tax effect of timing differences		
Excess of tax allowances over depreciation	335.8	-
Other timing differences	(4.6)	-
Undiscounted provision for deferred tax	331.2	-
Discount	(254.8)	-
Discounted provision for deferred tax	76.4	-
Provision at 1 April 2001	-	-
On acquisition of subsidiary	75.6	-
Deferred tax charge on profit and loss account for period	0.8	-
Provision at 31 March 2002	76.4	-

(b) Restructuring provision

This provision at 31 March 2002 is in respect of payments to be made relating to surplus property. The provision will be utilised over the next six years.

	2002 £m Severance	2002 £m Property	2002 £m Other	2002 £m Total
At 1 April 2001	-	-	-	-
Provision at date of acquisition	0.5	5.1	0.1	5.7
Charge to the profit and loss account	0.2	0.6	-	0.8
Utilised in the year	(0.7)	(0.6)	(0.1)	(1.4)
At 31 March 2002	-	5.1	-	5.1

(c) Management contract provision

This provision is in respect of expected costs of terminating sewerage management contracts on 31 March 2001 and the TUPE arrangements of the employees within that contract. It is anticipated that the provision will be utilised over the next twelve months.

	2002 £m
At 1 April 2001	-
Provision arising on acquisition of subsidiary	1.6
Utilised in the year	(0.7)
At 31 March 2002	0.9

Notes to the financial statements

2002-2003

21 Provisions for liabilities and charges

(d) Provision for uninsured losses

This provision is in respect of uninsured losses and its utilisation period is uncertain due to the nature of insurance claims.

	2002 £m
At 1 April 2001	-
Provision arising on acquisition of subsidiary	1.5
Charge to profit and loss account	3.4
Utilised in the year	(0.9)
At 31 March 2002	4.0

(e) Provision for loss on swap closure

£9.8m of this provision is the unamortised balance of a fair value of the provision relating to an acquired subsidiary's swap. The balance of £10.2m is in respect of a liability that arose on the cancellation on 2 May 2001 of certain swap contracts and the revision of an existing swap arrangement on 23 May 2001, which incorporated the liability on the early redemption of these cancelled swaps. It is anticipated that the provision will be utilised over the life of the revised swap, which expires on 31 March 2031.

	2002 £m
At 1 April 2001	-
Provision as at date of acquisition	22.2
Utilised in the year	(2.2)
At 31 March 2002	20.0

(f) Provision for fair value on contract for difference

On 14 March 2001, a subsidiary company Dŵr Cymru Cyfyngedig, entered into a swap contract with WPD Finance Limited, the Contract for Difference (CfD). This contract fixed the price of the operations and customer outsourcing contracts before the contracts were awarded. The outsourcing of the contracts were in total below the CfD price and consequently Dŵr Cymru Cyfyngedig will have to make payments to cover the shortfall. The CfD contract is therefore onerous and a fair value provision, on acquisition of Dŵr Cymru Cyfyngedig, was required. The above provision will be amortised until the contract ends on 31 March 2005.

	2002 £m
At 1 April 2001	-
Provision arising on acquisition of subsidiary	30.0
Charge to profit & loss account	-
Utilised in the year	(7.3)
At 31 March 2002	22.7

Notes to the financial statements

22 Deferred Income - Group

Deferred income relates to grants and other customer contributions received and receivable in respect of operational fixed assets and will be credited to the profit and loss account over the lifetime of those assets.

	2002 £m
At 1 April 2001	-
Deferred income arising on acquisition of subsidiary	39.3
Received and receivable during the year	0.6
Released to profit and loss account	(1.3)
At 31 March 2002	38.6

23 Reserves

	Group Profit and Loss Account £m	Company Profit and Loss Account £m
At 1 April 2001	-	-
Profit retained for the year	72.5	-
At 31 March 2002	72.5	-

24 Cash flow from operating activities

	2002 £m	2001 £m
Operating profit	182.9	-
Depreciation of tangible fixed assets	80.2	-
Amortisation of goodwill	(40.8)	-
Decrease/(increase) in debtors	43.7	(0.5)
(Decrease)/increase in creditors	(10.5)	0.3
(Decrease)/increase in restructuring provisions	(6.1)	-
Cash flow from operating activities	249.4	(0.2)

Notes to the financial statements

25 Reconciliation of net cash flow to movement in net debt

	2002 £m	2001 £m
Decrease in cash in the year	(15.3)	-
Debt acquired with purchase of subsidiary	(2,075.1)	-
Bank deposits and commercial paper acquired with purchase of subsidiary	205.3	-
Movements in bank deposits and commercial paper during the year	177.9	-
Increase in loans during the year	(113.9)	-
Bond issue costs	13.6	-
Write-off of unamortised bond issue costs	(1.1)	-
Indexation of index-linked debt	(4.5)	-
	(1,813.1)	-
Net debt at 1 April 2001	(0.2)	-
	<u>(1,813.3)</u>	-

26 Analysis of net debt

	At 1 April 2001 £m	On acquisition £m	Cash Flow £m	Non-Cash Items £m	At 31 March 2002 £m
Net cash:					
Bank overdraft	(0.2)	-	(15.3)	-	(15.5)
	<u>(0.2)</u>	<u>-</u>	<u>(15.3)</u>	<u>-</u>	<u>(15.5)</u>
Liquid resources:					
Current asset investments	-	205.3	177.9	-	383.2
Finance leases	-	(172.9)	(115.7)	-	(288.6)
Debts falling due within one year	-	(0.6)	-	-	(0.6)
Debts falling due after one year	-	(1,901.6)	1.8	-	(1,899.8)
	-	<u>(2,075.1)</u>	<u>(113.9)</u>	<u>-</u>	<u>(2,189.0)</u>
Bond issue costs capitalised	-	-	13.6	(1.1)	12.5
Bond indexation	-	-	-	(4.5)	(4.5)
	-	<u>(2,075.1)</u>	<u>(100.3)</u>	<u>(5.6)</u>	<u>(2,181.0)</u>
Net debt	<u>(0.2)</u>	<u>(1,869.8)</u>	<u>62.3</u>	<u>(5.6)</u>	<u>(1,813.3)</u>

Notes to the financial statements

27 Acquisition of subsidiary undertakings

On 11 May 2001 Glas Cymru (Securities) Cyfyngedig, a 100% owned subsidiary of Glas Cymru Cyfyngedig, acquired the entire issued share capital of Dŵr Cymru (Holdings) Limited, the parent company of Dŵr Cymru Cyfyngedig, Dŵr Cymru (Financing) Limited and Welsh Water Utilities Finance Plc. The following table sets out the book values of the identifiable assets and liabilities acquired and their fair value to the group:

	Book Value £m	Fair Value Adjustments £m	Fair Value £m
Fixed assets			
Tangible	2,257.3		2,257.3
Investments	0.2		0.2
Current assets			
Debtors	107.5		107.5
Cash	49.5		49.5
Current assets investments	205.3		205.3
Total assets	2,619.8		2,619.8
Creditors			
Bonds	1,896.4		1,896.4
Finance leases	172.9		172.9
Other loans	5.8		5.8
Trade creditors	149.4		149.4
Other creditors	49.9	(4.0)	45.9
Accruals	1.0		1.0
Provisions			
Deferred income	38.8		38.8
Reorganisation provision	7.1		7.1
Deferred taxation	75.6		75.6
Other	1.5	42.4	43.9
Total liabilities	2,398.4	38.4	2,436.8
Net Assets	221.4	(38.4)	183.0
Negative goodwill			(178.8)
Purchase consideration			4.2

Details of the fair value adjustments are as follows:

	Note	£m
Provision for Onerous Contracts		
Provision for swap fair value	21(e)	11.3
Provision for Contract for Difference	21(f)	30.0
Provision for contract with United Utilities Green Environment		1.1
		42.4
Other creditors not required		(4.0)
		38.4

The above fair value adjustments are provisional.

Notes to the financial statements

27 Acquisition of subsidiary undertakings

On 11 May 2002, the group acquired Dŵr Cymru (Holdings) Limited, an investment holding company, which does not trade. The principal trading subsidiary in the group which was acquired was Dŵr Cymru Cyfyngedig.

A summarised profit and loss account of Dŵr Cymru Cyfyngedig for the period from 1 April 2001 up to 10 May 2001 and from 11 May 2001 to 31 March 2002 is set out below:

	1 April 2001 to 10 May 2001	11 May 2001 to 31 March 2002
	£m	£m
Turnover	52.6	406.1
Operating profit	21.2	133.9
Exceptional items	2.6	-
(Loss)/profit before taxation	(2.1)	43.8
Taxation credit/(charge)	0.2	(0.5)
(Loss)/profit after taxation	(1.9)	43.3

The profit after taxation in respect of Dŵr Cymru Cyfyngedig for the year ended 31 March 2001 was £46.9m

28 Directors' and officers' loans and transactions

No loans or credit transactions with any directors, officers or connected persons subsisted during the year or were outstanding at the end of the year.

29 Elan aqueduct

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, has been 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 £1.2m in respect of Elan Valley Trust Fund.

30 Related party transactions

In accordance with the exemption afforded by Financial Reporting Standard 8 there is no disclosure in these financial statements of transactions with entities that are part of the Glas Cymru Cyfyngedig group.

Notes to the financial statements

31 Pensions

Current arrangements

Following the acquisition of Dŵr Cymru Cyfyngedig by Glas Cymru Cyfyngedig, a new pension scheme for current employees was introduced with effect from 1 December 2001. All existing staff joined the new scheme on 1 December 2001. As a consequence, these staff have now become deferred members in the predecessor Hydr Limited schemes referred to later in this note. Under the new arrangements, employees will have the right to transfer their past service and benefits to the new scheme in the course of the next twelve months, pending finalisation of the transfer values under the predecessor schemes. As at 31 March 2002 and up to the date of approval of these accounts, these transfer values had not been determined nor had any employee formally elected to transfer.

The first formal valuation of the new scheme is due at 31 March 2003. The current company contribution is 12% per annum. The contribution rate will be revisited at the valuation date. The pension cost in the period from 1 December 2001 to 31 March 2002 was £300,000.

Additional disclosures regarding the defined benefit pension scheme are required under the transitional provisions of FRS 17 "Retirement benefits" and these are set out below. The disclosures relate to the first year of the transitional provisions. They provide information which will be necessary for the full implementation of FRS 17 in the year ending 31 March 2004.

An informal actuarial valuation of the new scheme at 31 March 2002 has been performed by a qualified actuary using revised assumptions that are consistent with the requirements of FRS 17. Investments have been valued, for this purpose, at fair value. The major assumptions used by the actuary were:

	%
Rate of increase in salaries	4.46
Rate of increase in pensions payment	2.96
Discount rate	5.92
Inflation assumption	2.96

The fair value of the assets, and the present value of the liabilities in the scheme, at the balance sheet date were:

	2002 Long term rate of return expected	2002 £'000
Equities	7%	-
Bonds	5%	-
Cash	4%	258.4
Total market value of the assets		258.4
Present value of scheme liabilities		243.1
Surplus in the scheme		15.3
Related deferred tax asset		(5.0)
Net pension asset		10.3

Notes to the financial statements

31 Pensions

	2002 £m
Balance Sheet	
Net assets excluding pension asset	72.5
Pension asset*	-
Net assets including pension asset	72.5
Reserves	
Profit and loss reserve excluding pension asset	72.5
Pension asset*	-
Profit and loss reserve including pension asset	72.5

*The net assets and profit and loss reserve of the company would increase by £10,300.

As the scheme has only been operative for four months the assets have been placed on deposit but will be invested in bonds and equities in line with the direction of the Trustees during the year ended 31 March 2003.

Previous arrangements

Until 30 November 2001, the company participated in a number of pension schemes in the UK. The assets of each pension scheme are held separately from the assets of the group and are administered by trustees. The principal schemes are defined benefit schemes in the UK - the Hyder Water Pension Scheme (HWPS), and the Water Mirror Image Pension Scheme (WMIS).

Under the terms of the Purchase and Sale Agreement by which Glas Cymru Cyfyngedig acquired Dŵr Cymru Cyfyngedig, the company will have no ongoing pension liabilities or the ability to use the surplus arising in respect of those employees who have transferred to the new service providers or in respect of the remaining employees who are now deferred members of the schemes.

The total pension cost for the period up to 30 November 2001 was £0.3m (2001: £8.8m). Payments are in accordance with actuarial guidance.

32 Status of the company

The company is limited by guarantee and does not have any share capital. In the event of the company being wound up, the liability of the members is limited to £1 each.