

## Chairman's statement.

### The results for the year were very satisfactory and reflect three main factors:

- Outperformance, increased turnover and efficiency gains for UK water activities.
- The sale of our 46% interest in Waste Recycling Group (WRG).
- The continuing management and performance advantages of our water industry focus.



**JOHN NAPIER** Chairman

Group profit before tax benefited from the net exceptional gain of £14.6 million made from the sale of our WRG interests. If you disregard exceptional gains, profit before taxation of £191.6 million is 9.4% ahead of last year. The main drivers of profit increase were increased UK turnover, continuing improvement from operations and reduced interest costs. These benefits were partially offset by a reduced US contribution due to the translation of the weaker US dollar. In total there was an increase in EPS excluding exceptional gains and deferred tax to 46.2p, 9% up on the prior year.

The sale of our WRG interests, and cessation of our Timco timber operations in the US and subsequent sale of its assets, completed our disposal programme supporting our water and waste water focus strategy. The smaller non-regulated service operations in the US, KeyLand property, Loop business process services and contract operations in the UK now leverage from, support and are sustained by our core businesses. The proceeds of the WRG sale of £142.7 million were applied to reducing debt and a share buyback programme, which was completed prior to year end.

Yorkshire Water Services (YWS) went from strength to strength. It improved overall service levels and had outstanding operational performance achieving three 'band A' ratings in the regulator's January 2004 assessment of water and waste water activities. It has continued to outperform expectations in operational and capital efficiencies. Within the period of the current price determination to date it has led UK operational performance in achieving a 12% reduction in costs in real terms over a four year period. At the same time it has continued to drive forward and improve service standards, water quality and compliance obligations.

The performance of YWS in the year is particularly commendable as it was achieved against the background of a challenge of severe water shortages. Supplies were maintained without restriction or special drought orders. This was achieved by a combination of a regional supply network, active water resource management and measurement and close liaison and co-operation with regulatory agencies, especially the Environment Agency, who work

actively with the company. It was also helped by our continuing investment in advancing telemetry and business systems. The company won the National Customer Service Awards for the 'best use of technology in customer services'.

The other UK operations had mixed results. Contract operations won one of the largest contracts awarded in recent times: the contract with the Ministry of Defence (MoD) will earn revenues of £1 billion over the next 25 years for supplying water services to MoD sites in the Midlands, Wales and South West region. This complements previous wins in Scotland. The MoD contract is performing on plan to date. KeyLand had an on plan year. The business support services operation Loop performed below last year due to unrecovered costs on a third party contract upon which Loop has given notice to terminate since the year end.

The performance of the US operations remains satisfactory. They have successfully completed the integration of the New England operations of American Water Works acquired in April 2002. However for the second successive year the business experienced unusual supply and demand conditions. Last year sales were down due to water restrictions because of drought, and in this year sales were down due to excess rainfall and well below average temperatures, which reduced demand.

A new Aquarion Chief Executive, Chuck Firlotte has been appointed, as part of a planned succession, having completed a three year period as director of UK water operations. The objective will be to accelerate the management, operational and cultural integration of the US business which is currently in its rate review cycle. The regulatory base of price determination in the US is an expected rate of return on assets. Aquarion is involved in the process in its major regions. It is complex, as it involves a number of different regulatory regional bodies.

The waste water activity continues to develop with a successful start up and above planned performance of Aquarion's first major waste water contract, awarded in Bridgeport in April 2003. The challenge of successful growth by revenue improvement and the organic growth of water service and waste water operations is being actively progressed.

In the wider field of corporate performance the company continues to progress in environmental, social and corporate compliance areas. All

## Chairman's statement continued...

activities of the company have an environmental purpose. Apart from the direct provision of drinking water and waste water services the related actions of improving drinking and river water qualities, improved waste water treatment standards and enhanced recreational and bathing water and beach standards, constitute major environmental improvements. The company also has extensive environmental interaction with national bodies and local communities on the best methods of enhancing and protecting significant natural assets, especially moorlands, water catchment and reservoir areas. At the same time it seeks to meet the challenge of affording the maximum recreational use of these facilities. It is also active in encouraging tenant farmers to adopt agri-environmental best practice approaches.

In the social spheres we have led developments to supply cool drinking water to primary schools to deal with the issues of dehydration and acknowledge issues of improving diet and health. The company also works actively with Business in the Community focusing on the Right to Read and other schemes to support local education. These involved up to 25% of our staff working on a voluntary basis. There are also active community schemes and programmes in the US focused on community support, education, deprived groups and enhanced environmental behaviours.

The board has been further strengthened over the last year. On the non-executive front the appointment of Christopher Fisher brought significant banking experience, whilst the continuation of Richard Schmidt, after retirement as Chief Executive Officer in the US, allowed for maximum continuity and an easy transition in management. The requirements of the revised combined code have also meant a higher proportion of non-executives, to avoid too much duplication in the membership of committees. On the executive side the new Finance Director, Martin Towers, appointed in March 2003 has settled in well and formed a strong team with your Chief Executive, Kevin Whiteman, who has produced his first full year results following his appointment to that post in September 2002. The board conducted its first full formal evaluation process in the year and will continue to review its own and the company's effectiveness.

The immediate outlook for 2004/05 is reasonably predictable and improvement is expected. The year however will be dominated by the publication of the first draft response by the regulator as part of the price determination process. This will largely determine the UK water industry

and Kelda prospects for the period 2005/10. To date that process has been transparent and there has been clear identification of the investment needs required to support environmental improvements. This investment remains significant.

In an incentive based regulatory regime we are well placed due to our excellent service and operational records. The macro factors support an increasing rate regime and the importance of sound and sustainable low risk capital structures to keep borrowing costs to a minimum. All this is known to regulator, government, industry and to capital providers, shareholders and lenders. It is not expected, and would be a major disappointment and damaging to the prospects of the industry, if a more arbitrary price approach were now to be applied.

Generally the industry has been very successful in meeting service, drinking water quality, waste water, river quality and other environmental standards. It has required and will continue to require the confidence and support of capital providers. It is fundamentally an efficient provider of relatively low cost, high consumer value, essential water and environmental services. We expect the future of the industry to be maintained if not encouraged in the next determination.

The process of transforming Kelda has been an interesting and exciting programme which could not have been carried through without the active support of the board and management. Equally importantly the programme has gained the support of employees and their representatives at all levels, despite some difficult issues having had to be addressed. There will undoubtedly be future challenges ahead, but this report is an opportunity to thank all employees on behalf of the shareholders for the progress the company has achieved to date.



**JOHN NAPIER** Chairman Kelda Group plc