Operating and financial review

Financial review The group's key financial ratios are sound. Interest cover improved to 2.6 times and balance sheet gearing was unchanged with the benefit of the US land sale receipts.

Group operating profit

Turnover from the group's continuing operations increased 4.2% to £658.2m (2001: £631.9m). Following the completion of the group's disposal programme, operating profit from the continuing operations increased 8.1% to £250.0m (2001: £231.3m) of which 46% (2001: 47%) accrued in the second half year. The group's share of associates' operating profit added £20.3m (2001: £16.5m), the increase reflecting WRG's results following their acquisition of the Hanson waste management interests in January 2001. The overall group operating profit (including share of associates) increased 11.1% to £265.3m (2001: £238.9m after exceptional costs of £11.8m).

The group's activities and associates other than the UK regulated water business accounted for nearly 17% (2001: 15%) of the group operating profit before unallocated costs. Unallocated costs, which include corporate and business development costs, reduced substantially to £5.2m (2001: £7.9m). Strategy review costs of £5.8m were also incurred in the prior year.

Group profit before taxation

Two non operating exceptional items have made a significant impact on the group's 2001/02 results. In the US, the major land sale realised a profit before tax of £60.3m. The disposal of the renewable energy business resulted in a loss on disposal of £25.9m. The exceptional profit of £15.9m in the prior year arose from previous non core business disposals.

In 2001/02, the group benefited from the previous year's business disposals and lower interest rates. The group's interest charge (excluding share of associates) reduced to £93.5m (2001: £95.2m) of which £64.1m (2001: £56.9m) relates to the Yorkshire Water UK regulated business. The share of associates' interest increased to £9.3m (2001: £3.6m) as a consequence of the debt funded acquisitions by WRG. The key interest cover ratio (expressed as the ratio between operating profit and interest costs) improved to 2.6 (2001: 2.4).

Headline group profit before taxation was £197.1m (2001: £156.4m). Before the non operating exceptional items, profit before taxation increased 15.8% to £162.7m (2001: £140.5m).

Taxation

The overall group tax charge was £45.8m (2001: £35.6m). This includes deferred tax of £14.8m (2001: £12.0m) following the introduction of FRS 19 and £19.0m in respect of the US land sale. The underlying effective tax rate on the group's activities (calculated as the current tax charge as a percentage of profit before tax and non operating exceptional items) was 7.4% (2001: 14.2%). An increase in the allowable tax deductions because of the nature of the work now being undertaken in Yorkshire Water's investment programme is largely responsible for the reduction. This increase in tax allowances is not fully offset by deferred tax because of the adoption of discounting as permitted by FRS 19. The effective tax rate will continue to be sensitive to both the scale and nature of the Yorkshire Water capital investment programme.

Earnings per share and dividends

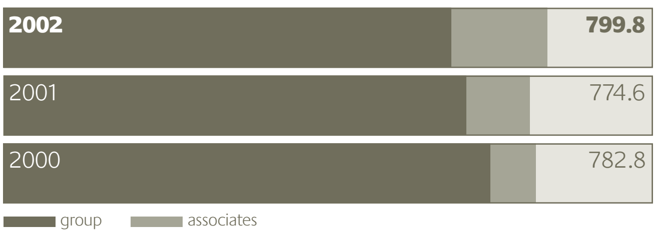
The FRS 3 earnings per share increase of 24.0% is distorted by the inclusion of exceptional items. Earnings per share, adjusted to exclude non operating exceptional items and the exceptional operating costs in the prior year increased 11.7% to 35.3p (2001: 31.6p).

The board is recommending a final dividend of 17.8p (2001: 17.3p) per share. With the interim dividend of 7.7p (2001: 7.5p), this represents an increase of 2.8% in the total dividend for the year to 25.5p (2001: 24.8p).

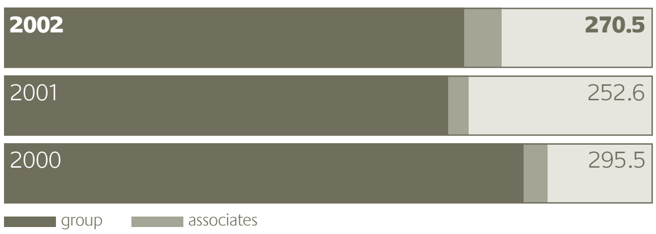
Cash flow

Cash flow from operating activities (principally the UK and US water businesses) was £387.8m (2001: £375.3m restated). The Yorkshire Water regulated investment programme and Aquarion's capital expenditure absorbed most of this cash inflow. Net interest payments on the group's debt were £83.7m (2001: £81.3m) and the group's total capital expenditure

Turnover: group and share of associates (£m)



Operating profit: group and share of associates before unallocated costs (£m)



on fixed assets was £323.6m (2001: £325.1m). The net receipts from the US land sale were £57.2m. Dividend payments during the year were £96.3m (2001: £93.6m).

Group balance sheet

Group net debt at 31 March 2002 was £1,436.5m (2001: £1,395.1m) after the receipts from the US land sale. The Yorkshire Water UK regulated business accounted for £1,042.0m (2001: £960.7m) of the group total. Balance sheet gearing (expressed as the relationship between net debt and net debt plus shareholders' funds) was unchanged at 46%.

Post balance sheet event

On 25 April 2002, the company announced the completion of the acquisition, by its US subsidiary Aquarion, of five American Water Works subsidiaries in Connecticut, Massachusetts, New Hampshire and New York. The consideration was $120m plus the assumption of $104m of debt.

Accounting policies

The group accounts have been prepared in accordance with the accounting policies described in note 1 to the accounts. In accordance with FRS 18 'Accounting Policies', the directors have reviewed the group's accounting policies and consider them to be the most appropriate to the group's operations.

FRS 19 'Deferred Tax' was implemented during the year resulting in the creation of a significant provision for deferred tax at 31 March 2002 of £149.9m (2001: £138.1m). The prior year comparative figures have been restated accordingly. FRS 19 generally requires full provision to be made for deferred tax arising from timing differences between the recognition of gains and losses in the accounts and their recognition in the tax computation. As permitted by FRS 19, a policy of discounting has been adopted. The implementation of the new standard will have no effect on the group's cash or borrowing position.

Aquarion prepares accounts in accordance with Generally Accepted Accounting Principles in the US (US GAAP). Where material, adjustments are made to the results of the US operations to align US GAAP with the group's accounting policies.

Pensions

The first disclosures in accordance with the phased implementation requirements of FRS 17 'Retirement Benefits' have been made in the group's accounts for the year ended 31 March 2002. FRS 17 will change fundamentally the calculation and reporting of the cost of retirement benefits. It does not directly affect the funding position of the group's pension schemes or, therefore, the group's cash or borrowing position. The Kelda group's pension liabilities are carefully managed and the new disclosures confirm that position.

Treasury policy

Treasury strategy is controlled centrally in accordance with approved board policies, guidelines and procedures. The strategy is designed to manage the group's exposure to fluctuations in interest and currency exchange rates, preclude speculation and to source and structure the group's borrowing requirements. Note 20 to the accounts shows details of the financial instruments held by the group for these purposes.

The group uses a combination of fixed capital, retained profits, long term loans and finance leases, bank borrowings and commercial paper to finance its operations. Any funding required is raised by the group treasury department in the name of the holding company or operating company as appropriate, and supported by guarantees as necessary. Funds raised by the holding company may be on lent to operating subsidiaries at commercial rates of interest. Cash surplus to operating requirements is invested in short term instruments with institutions rated at least A1 or P1 by Standard & Poor's and Moody's.

Shareholder value

The company's mid market share price at the close of business on 28 March 2002, the last trading day before the end of the financial year, was 389.5p (2001: 349.0p). The yield on the company's shares at that date, based on the recommended final dividend, was 6.5% (2001: 7.1%).

Going concern

After making enquiries, the directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.

J. O'Kane

John O'Kane
Group Finance Director

Group profit before taxation and non operating exceptional items (£m)

Adjusted earnings per share (p)

*Not restated to reflect the adoption of FRS 19