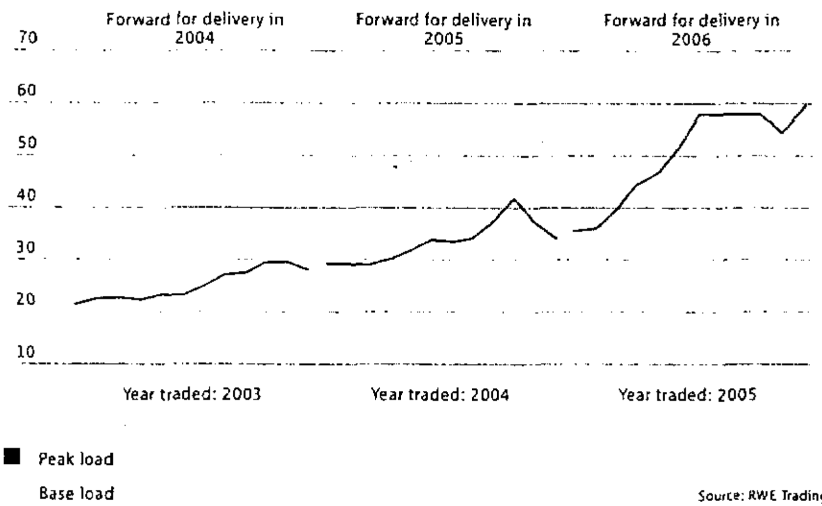
Accordingly, UK forward prices were far higher than the European average. Averaged for the year, one-year forward contracts traded at £42.5 (€62.5) per MWh of base-load power and at £50.6 (€74.4) per MWh of peak-load power. Compared with the same type of contracts in the prior year, their price rose by 50% and 51% respectively.

Development of one year forward wholesale electricity prices in the UK
in £ / MWh



Source: RWE Trading.

The UK wholesale price trend had a trickle-down effect on the end customer business. Averaged for the year, electricity prices for household and commercial customers were up about 10%. Price adjustments made for industrial and small corporate customers were even more significant. Nevertheless, one cannot assume that utilities were able to fully pass on the rise in electricity procurement costs to their end customers.

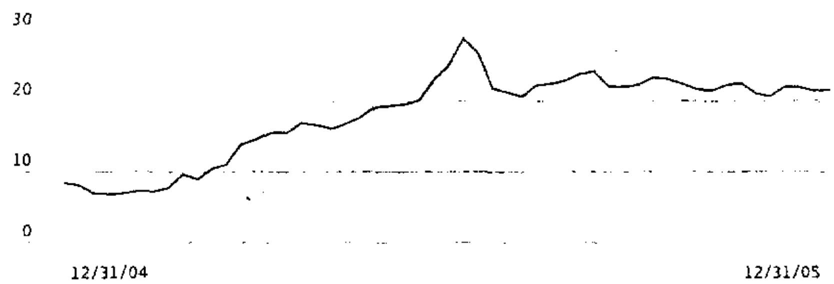
Electricity prices also advanced on our Central Eastern European markets. End customers in Hungary had to pay an average of 10% more. End consumer electricity prices in Poland and Slovakia were up 3% and 4% respectively.

Emissions trading has a direct impact on electricity prices in EU markets. Prices for CO_2 certificates have risen considerably compared with the beginning of 2005.

Introduction of emissions trading affects electricity price trend. As explained before, price developments on Europe's electricity markets were influenced by the emissions trading system which started on January 1, 2005. Prices for CO_2 certificates for the first allocation period (2005–2007) advanced considerably until the middle of the year. After starting at €7–8 in January, they posted record highs of nearly €30 per metric ton of CO_2 in early July. Over the course of the year, the price leveled off to between €20–24. The increase in the price of emissions certificates is partially due to the steep climb in gas prices in the UK, triggering a fuel switch in the electricity generation sector to hard coal, which caused higher emissions. The dry spell in Spain resulted in a similar effect, since this curtailed the

CO_2-free production of electricity in hydroelectric power stations in favour of power stations running on fossil fuels. Market participants thus expected CO_2 certificates to become increasingly scarce. In addition, they saw their fears confirmed by the EU's restraint in approving the UK, Polish and Czech national allocation plans.

Development of CO_2 certificate prices traded in 2005
in € / metric ton



Source: RWE Trading.

The steep climb in oil prices caused gas prices to rise significantly as well. This contributed to the increase in electricity prices.

Oil and gas prices achieve new record highs. Due to the influence it has on the gas market, the price trend on the world crude oil market also caused electricity prices to increase. Crude oil became much more expensive in 2005. In August a barrel* of Brent crude fetched record prices exceeding US$ 67 in day trading. On average, Brent crude cost US$ 54.5 per barrel last year. This is a 43 % increase over the corresponding period in 2004 and more than twice as much as the last ten-year average. The substantial price increase was principally due to the rise in demand in China, India and the US, while available production capacities in oil-producing countries was tight. Geopolitical factors also contributed to the price increase.

* 184

Gas prices on the Continental European market track the price of oil with an average lag of six months. Cross-border prices of natural gas in Germany rose over the course of the year. On average, they were 35 % up on the level achieved in 2004. This trend was reflected in end customer prices. German private households saw prices advance by 11 %, while industrial customers experienced a 17 % rise. An independent regulator is in charge of determining gas prices in the Czech Republic. The regulatory authority largely looks to prices quoted on the world's oil markets and major exchange rates when setting prices. Prices paid by Czech household customers increased by 13 % averaged over the year.

Prices on the UK gas spot market were more than 40 % higher than in 2004. This is due to the fact that domestic gas reserves are dwindling. Moreover, because this region is becoming more dependent on imports, UK gas prices are increasingly affected by the fact that in Continental Europe, gas prices track oil prices. Furthermore, there was a rise in imports of high-priced liquefied natural gas (LNG*). Gas prices charged to UK households were up by approximately 14 %. Price adjustments made in the major corporate customer segment were even more significant.

* 185

Europe's and North America's regulated water markets posted stable growth.

Growth in the regulated water market through investment in infrastructure. The market for regulated water and wastewater services is basically very stable. RWE's core water regions of Europe and North America generally have low susceptibility to economic cycles. Demand, however, sometimes fluctuates for weather-related reasons and water consumption in large parts of the US was thus higher than the low level achieved in the previous year. The key driver of growth in the water business is investment in the infrastructure, which is financed through tariff increases approved by regulators. The UK's new five-year regulatory period started on April 1, 2005. In line with conditions agreed with regulators, investments of £3.1 billion (€4.4 billion) will be made. They aim to improve the quality, security and environmental friendliness of the water supply system. The investment figure is quoted in 2002 / 2003 money terms, and must be adjusted by annual inflation. To pay for the investments, tariff increases of 22 % plus annual inflation will be implemented over the entire regulatory period. The lion's share of the tariff increases (14.9 % real; 18.3 % nominal) came into effect at the beginning of the new regulatory period. Privatization of the state water supply and wastewater management systems in most of the countries in Continental Europe is still in its nascent phase. Private sector involvement has so far been limited to the construction or expansion of plants as well as the operation and maintenance of network infrastructure.

Change in political environment

The political environment is a key factor for our business. Far-reaching energy policy measures were taken in 2005, altering our room for manoeuvre as a power utility and presenting us with new challenges. Milestones were the introduction of the EU-wide CO_2 emissions trading system as of January 1, 2005 and the new German Energy Act (EnWG) that entered into force in July.

July 2005 saw the enactment of the new German Energy Act. The key issue is the introduction of electricity and gas grid regulators.

German energy law undergoes fundamental reform. After more than a year of lengthy procedures, the second amendment to the German Energy Act was passed in summer 2005. It establishes the statutory framework for the German energy supply sector and is designed to increase transparency and competition on the electricity and gas markets. The key issue in the act relates to the introduction of regulatory authorities responsible for monitoring grid access and electricity and gas grid fees.

Germany's central regulatory authority is the Federal Network Agency for Electricity, Gas, Telecommunications, Post and Railways ("Bundesnetzagentur"). Network operators with fewer than 100,000 customers working within a single state are subject to the supervision of individual state regulatory authorities, which have transferred this responsibility to the Federal Network Agency in some cases. Grid fees must be approved based on new grid fee regulations before they are charged (ex ante).

* 185
* 185

The new regulations include certain changes to the calculation rules used in the association agreements so far. In the future, grid fees are to be calculated using the regulatory current cost accounting* method only for existing plants. Investments in new facilities will be subject to inflation-adjusted historic cost accounting* from 2006 onwards. Most of the approvals for new grid fees are expected to be granted in April 2006 (electricity) and July 2006 (gas). The current cost-oriented calculation method is to be supplemented by incentive-based regulation in 2007. To this end, the Federal Network Agency is to submit a proposal to the parliament by the middle of this year, which will subsequently be translated into a directive. From July 2007 onwards, changes in electricity prices for household customers as well as small commercial clients will no longer need approval. Instead, they will be subject to the forces of competition. Basic supply will then be supervised by the German Federal Cartel Office.

Moreover, the new German Energy Act envisions a simplification of the gas grid access model. Detailed requirements to be met by the new system are likely to be established by the middle of 2006. Additional regulations relate to unbundling, i.e. the separation of grid operations from generation, sales and trading. Transmission network operators are already obliged to fulfil all unbundling requirements. Distribution network operators are obliged to implement the new rules gradually by no later than July 1, 2007, depending on their size.

The new Energy Act stipulates the incentive-based regulation of electricity and gas grids from 2007 onwards. The impact this may have on our earnings cannot be predicted at present.

We expect the new German Energy Act (EnWG) to have an adverse effect on our grid business. Unlike the emissions trading scheme, however, in light of the envisioned deadlines for the first approvals of grid fees, the Act did not have a major impact on the development of our business in 2005. The requirement to unbundle operations necessitated operational changes, but we had addressed these needs in our Group reorganization, which was initiated in 2003. We anticipate that the first negative effects on revenue from grid fees will occur this year. We intend to largely offset this by taking additional measures to reduce costs and enhance efficiency throughout the RWE Energy Group. Naturally, however, there is still some uncertainty as regards the impact of regulation. It is impossible to forecast the impact this will have on earnings in 2007. This will depend, to a considerable degree, on the incentive-based regulation system, for which details will be provided during the course of 2006.

European CO_2 emissions trading system introduced. Fiscal 2005 saw the beginning of the European CO_2 emissions trading scheme. State emissions certificates have been mandatory for the operation of large-scale industrial furnaces with a thermal rating in excess of 20 MW* since January 1, 2005. These certificates are distributed by the government via national allocation plans (NAPs) and are free of charge during the first trading period (2005–2007).

* 185

ropean emissions trading is an additional cost factor in the generation of electricity. We had to buy a large number of CO_2 certificates for our power plants in both Germany and the UK.

Germany's energy and industrial sectors must reduce CO_2 emissions in the first trading period by 2 million metric tons per annum to 503 million metric tons per annum compared with the reference period (2000–2002). The cap for the second trading period (2008–2012) is 495 million metric tons per annum. Free certificates were allocated based on a complex distribution key, including numerous exemptions. In light of the unexpectedly high degree to which these exemptions were made use of, German industry applied for far more certificates than required to cover emissions envisaged in the NAP. Therefore, the emissions trading office responsible reduced allocations to facilities that do not benefit from the exemptions more than initially expected. For these plants, the average shortfall is 7.4 percentage points compared with the reference period. Our power plants emitted 120 million metric tons of CO_2 in Germany in fiscal 2005. We were allocated certificates for about 115 million metric tons. The current shortfall thus amounts to approximately 5 million metric tons.

The UK, our second key market, is awaiting a final decision on its national allocation plan (NAP). The UK government submitted a revised NAP to the EU Commission in February of 2005. It envisions a free allocation in the first trading period of 252 million metric tons of CO_2 per annum. This is nearly 7 million metric tons more than in the first draft of the UK NAP. However, the Commission rejected the increase. The UK government took the matter to court, and was successful. The court now requires the Commission to reconsider the UK's amended plan and to make a fresh decision on it. According to the original NAP, RWE npower would have received an allocation for 14.9 million metric tons of CO_2 per year. Furthermore, in the year under review, we purchased a UK gas power station including the CO_2 certificates it was allocated. Therefore, RWE npower had a total of 15.3 million metric tons of CO_2 in emissions allowances allocated free of charge. In 2005, 22.7 million metric tons of carbon dioxide were emitted. RWE npower thus has a shortfall of 7.4 million metric tons in CO_2 certificates.

The energy policy of the grand coalition in Germany. The coalition agreement signed by the new incumbent parties (CDU, CSU and SPD) in November 2005 does not appear to include a fundamental change in energy policy. In particular, the parties failed to reach an agreement on the extension of nuclear power plant lifetimes. Renewables will continue to be subsidized to the same extent as before. Furthermore, shaping the NAP for the second trading period is on the agenda for 2006. It must be submitted to Brussels by the middle of the year. Pursuant to the coalition agreement, costs incurred by industry owing to emissions trading will be reduced, and the allocation system will be made more transparent and less bureaucratic. No specific suggestions have been put forth so far. Therefore, it is impossible to predict the impact the intended measures will have on our business.

Major events

In the year being reviewed, we continued to focus on our core businesses and streamlined our portfolio by selling non-core activities. The decision to sell substantial portions of our water business was of great strategic importance. Furthermore, 2005 was marked by the replacement and expansion of our German and UK power plants. These events and all of the other major activities (including early 2006) are described below.

Sale of UK and North American water operations announced – rise in dividend payout ratios planned for 2006 and 2007.* On November 4, 2005, we announced that we intend to sell the water operations of RWE Thames Water and American Water in the UK and US respectively. We decided to take this step in order to focus even more on Europe's convergent electricity and gas markets in the future. RWE Thames Water's Continental European water business will be integrated into RWE Energy, owing to the synergies it has with our regional energy operations. This does not apply to Spanish-based Pridesa, which is also up for sale.

Depending on the progress of the sale of RWE Thames Water and American Water, we want to increase the dividend for fiscal 2006 and 2007. To this end, we intend to lift the payout ratio to 70–80%.

As a first step, we are weighing the options we have to sell the activities in order to exit the North American water business. A public offering is likely at present. As soon as this process has been initiated successfully, we will start the process of selling the UK water business. Here, our preferred options are to sell the activity to financial investors with long-term strategies or via the stock market. The North American and UK transactions are both subject to approval from national regulators and the Supervisory Board of RWE AG. We aim to have completed both divestments by 2007. We also want RWE investors to benefit from this. Depending on the progress of the planned sale of American Water and RWE Thames Water, we intend to increase the dividend payout ratio for fiscal 2006 and 2007 to between 70% and 80% of our recurrent net income. Following these two exceptional increases, we will review the regular payout ratio for 2008 onwards. The 50% target envisioned for 2006 so far is to serve as the lower limit. Moreover, we do not plan to refinance most of the financial liabilities that come due in 2006 and 2007. These comprise approximately €5 billion in bonds and bank debt.

RWE Umwelt sold. In February 2005 the German Federal Cartel Office approved the sale of 70% of RWE Umwelt's consolidated business volume to Rethmann (now known as Remondis). We thus successfully concluded the transaction, which was initiated in the previous year. At the beginning of October 2005 we concluded the sale of the waste management operations in the West, Westphalia, Hesse, East and Mecklenburg-Western Pomerania regions, which had been left out of the previous transaction to comply with antitrust regulations. The majority interests in the five regions mentioned above generate combined annual revenues of approximately €530 million. Revenue earned by the corresponding minority interests is of a similar order.

Restructuring of RWE Solutions. As of April 1, 2005, RWE Solutions' energy business with key industrial accounts was transferred to the newly established RWE Key Account GmbH, an RWE Energy subsidiary. Since our core competency is the operation, and not the construction, of power generation plants, we also shed a number of investments of RWE Solutions. In January we divested the industrial engineering operations for uninterrupted power supply. In May we sold the electro-mechanical systems and components activities. Furthermore, in September we sold the 50 % stake in solar plant specialist RWE SCHOTT Solar to our partner SCHOTT. RWE Solutions' remaining activities are up for sale as well.

Realignment of Harpen. In November, we announced that we would integrate Harpen's renewables-based electricity generation into RWE Power's power station portfolio. The distributed power production operations will be transferred to RWE Energy, since this company has the customer contacts required for this business. Following the spin-out of the aforementioned operations, Harpen will be a pure-play real estate firm. Since real estate is not one of the RWE Group's core businesses, we intend to sell Harpen.

* 185

RWE Trading divests SSM Coal. RWE Trading focuses its coal activities on procurement of hard coal for our power generation companies and proprietary trading*. Therefore, in December, the company sold its 100 % stake in the Dutch-based coal trading company SSM Coal.

We will reduce CO_2 emissions by nearly 9 million metric tons through two new large-scale power stations.

Power plant construction in Germany. In September we decided to build a new 2,100 MW lignite-fired power plant with optimized plant technology in Neurath, which is in the vicinity of Cologne. Due to its €2.2 billion budget, it is one of the largest power plant projects ever carried out in RWE's history. The facility is scheduled to go online in 2010. In the middle of November, RWE Power fired the starting shot for the next major project. At our Hamm power plant site, we intend to construct a dual-block hard coal power station with a total capacity of about 1,500 MW. According to our estimates, the investment will total € 1.3 billion. The new power plant is scheduled to go on stream in 2011 / 2012. In common with the lignite-fired power plant in Neurath, the Hamm dual block will replace outdated facilities, which have much lower efficiency. These two projects will reduce RWE's CO_2 emissions by nearly 9 million metric tons per annum.

RWE npower acquires modern gas power station in the UK. In November RWE npower purchased the Great Yarmouth Power Ltd power plant company from BP UK Power Holdings. Great Yarmouth Power owns a combined cycle gas turbine (CCGT) power station with an installed capacity of 420 MW on the eastern coast of England. The CCGT facility was commissioned in 2002, making it one of the most modern of its kind in the UK. Included in the acquisition of the power plant was a 43-kilometre-long pipeline connecting the plant to one of the UK's largest gas terminals, Bacton. The purchase price was €227 million.

RWE Energy simplifies gas transmission grid usage. In April 2005 we introduced RWE EESy, a new entry-exit system* for our 7,200-kilometre-long gas transmission grid in Germany. RWE EESy replaces the customized, distance-dependent point-to-point contracts, providing customers with transparent grid access at a low transaction cost. By making use of new gas trading products, the system is flexible with regard to balancing zones. This will make it more attractive to traders and expand the range of products and services offered to gas customers such as industrial clients and municipal utilities.

* 183

Alwin Fitting is RWE AG's new labour director. In June the Supervisory Board of RWE AG appointed Mr. Fitting to its Executive Board as the company's new labour director. Alwin Fitting was RWE Power's labour director before his new post. He has been in charge of RWE AG's personnel operations since August 1, 2005. Fitting took over this post from Jan Zilius, who was appointed Chairman of the Executive Board of RWE Power. Mr. Zilius stays on as Executive Vice-President of RWE AG.

Power outages in northwestern Germany. On November 25, 2005, extreme weather conditions in the Netherlands and Belgium as well as in our supply area in the northwestern part of Germany severely curtailed power supplies. The combination of sleet, freezing temperatures and strong winds formed unusually thick layers of snow and ice on aerial lines and pylons. This caused pylons to collapse, and cut power to large parts of these regions. According to estimates, damages suffered by RWE exceed €50 million. To assist customers who were especially hard hit, RWE set up a voluntary €5 million aid fund, without any legal obligation to do so. In addition, we commissioned an independent appraiser to conduct an in-depth investigation of the causes for the blackouts. By the middle of February 2006, more than half of the damaged pylons had already been replaced.

Event after the close of the fiscal year: Exit from the Chilean water business. On February 10, 2006, we reached a binding agreement on the sale of majority stakes in the Chilean water utilities ESSBIO S.A. (51%) and ANSM S.A. (100%). The sale is part of the divestment programme involving the sale of RWE Thames Water's peripheral activities.

Notes on reporting

We adjusted our reporting structure at the beginning of the 2005 financial year. In so doing, we are taking into account completed and pending divestments, among other things. The adjustments address the following issues:

- RWE Trading is no longer presented separately in our financial reporting. Instead, RWE Trading is now subsumed under RWE Power's Power Generation Business Unit. The rationale for this change lies in the fact that, as an integral component of the energy value chain, RWE Trading's primary function is to contribute to sustaining the value of our power production operations. The change in our reporting structure does not affect our operations.

- Harpen, which specializes in renewables-based and distributed power generation, has been assigned to the Power Generation Business Unit.

- At the end of February 2005, we sold 70 % of RWE Umwelt's business volume. The sale of the remaining 30 % was completed in early October. In the financial statements for 2005, we have classified the environmental services activities as "discontinued operations." The environmental services business is thus no longer included in revenue, EBITDA, the operating result, capital expenditure or the workforce. These items exclusively relate to our continuing operations.

- On January 1, 2005 we started disclosing some of RWE Thames Water's peripheral activities as "assets / liabilities held for sale." This applies to our activities in Chile, the United Arab Emirates, China, Thailand and Australia. Some of them were sold during the fiscal year.

Business performance

Production and sales

Power plant capacity by primary energy source as of 12/31/2005 MW	RWE Power[1]		RWE npower	RWE Group[2]	
	Total	Germany		Total	Germany
Hard coal	9,485	9,485	4,415	13,995	9,580
Lignite	10,849	10,135	–	10,849	10,135
Nuclear	6,308	6,308	–	6,308	6,308
Gas	3,905	3,904	2,962	7,096	4,133
Hydro, oil, other	3,117	2,895	1,537[3]	5,021	3,262
Total	**33,664**	**32,727**	**8,914**	**43,269**	**33,418**

1 Figures for RWE Power also include capacities of power stations not owned by RWE that we can deploy at our discretion on the basis of long-term agreements, totaling 6,487 MW (hard coal), and 2,261 MW (hydro, oil, other).
2 Including RWE Energy's capacity in Germany amounting to 691 MW.
3 This does not take into account the fact that RWE npower has a 33 % share in a joint venture that had 268 MW of installed wind power capacity in the year under review.

Our German electricity production decreased primarily due to an outage at one of our power plants and the rise in costs following the start of EU-wide emissions trading. Conversely, our UK generation was up.

Power generation declines by 8 %. In the fiscal year that just ended, the RWE Group produced 219.5 billion kWh of electricity. This corresponds to an 8 % decline compared with 2004. In-house generation and procured volumes total 317.8 billion kWh in output.

RWE Power generated 183.2 billion kWh of electricity, accounting for more than 80 % of the RWE Group's total output. This includes electricity generated from power plants not owned by RWE that we can deploy at our discretion on the basis of long-term agreements. The amount of electricity produced by RWE Power was 10 % lower than in 2004. This was in part due to the deconsolidation of our Portuguese power plant activities Turbogas / Portugen as well as the fact that we produced less energy from hard coal and lignite compared with last year owing to high CO_2 costs. In addition, Block B of the Biblis nuclear power plant was taken offline for several months for maintenance.

As of December 31, 2005, RWE Power had 33,664 MW in generation capacity at its disposal. This was 1,239 MW less than in the previous year, in part due to the sale of Turbogas / Portugen and the shutdown of an oil-fired power plant block. Lignite is the major source of energy used by RWE Power, accounting for 32 % of installed capacity, followed by hard coal at 28 %, nuclear at 19 %, gas at 12 %, and renewables at 3 %.

RWE npower recorded a 3% rise in electricity generated to 33.4 billion kWh. Unlike RWE Power, our UK business produced more electricity from hard coal as margins were attractive. Gas-based power generation was on par with the year-earlier level despite the substantial increase in fuel prices. As mentioned earlier, we acquired the Great Yarmouth gas power station in November 2005.

At the end of 2005 RWE npower had a total of 8,914 MW in generation capacity. Hard coal accounts for 50%, with gas, oil and renewables representing shares of 33%, 16% and 1%. This does not include 268 MW of installed wind capacity in plants in which RWE npower holds a 33% stake through a joint venture.

RWE Energy made a small contribution of 2.9 billion kWh to total power produced. This output is largely attributable to German regional companies.

Electricity production by primary energy source Billion kWh	RWE Power[1]		RWE npower		RWE Group[2]	
	2005	2004	**2005**	2004	**2005**	2004
In-house generation	183.2	202.6	33.4	32.5	219.5	237.5
Lignite	76.0	78.0	–	–	76.0	78.0
Nuclear	45.1	48.2	–	–	45.1	48.2
Hard coal	45.4	54.6	17.8	17.4	64.0	72.5
Gas	11.3	16.3	14.8	14.8	27.3	32.3
Hydro, oil, other	5.4	5.5	0.8	0.3	7.1	6.5
Electricity purchased from third parties	–	–	25.6[3]	27.0[3]	98.3	91.8
Total	**183.2**	**202.6**	**59.0**	**59.5**	**317.8**	**329.3**

1 Figures for RWE Power include electricity procured from power plants not owned by RWE that we can deploy at our discretion on the basis of long-term agreements. In 2005 they break down into 29.5 billion kWh (hard coal) and 2.5 billion kWh (hydro, oil, other).
2 Including generation and electricity purchases of RWE Energy's regional companies.
3 Electricity purchased by RWE npower largely via RWE Trading.

In light of the growth in demand for oil and gas, we are increasingly benefiting from RWE Dea's upstream activities.

Gas production rises, oil production drops. RWE Dea, the upstream company subsumed under the RWE Power Division, produced 2,353 million m^3 of gas in the year under review. This figure was 9% up year on year. The rise is due to the fact that we commenced production in a concession area in the UK North Sea in September 2005. Furthermore, we stepped up German production to cover increased demand. Conversely, RWE Dea posted a decline in oil production. It dropped by 18% to 4.6 million m^3. A Norwegian North Sea oil production platform experienced a stoppage in November 2004 and was only gradually able to resume production. Furthermore, we reduced our share in the production of a joint venture in Kazakhstan, as planned. Moreover, we recorded declines in production caused by the gradual reduction in reserves.

Electricity sales volume down 5% on previous year. RWE's external electricity sales totaled 299.1 billion kWh. They are typically somewhat lower than the amount of power generated (317.8 billion kWh). This is due to grid losses as well as our in-house consumption by lignite production and hydro-storage power plants. Electricity sales volumes were down 5 % on 2004.

External power sales generated by the RWE Power Division amounted to 93.1 billion kWh and were thus 6 % lower than in the previous year. This reflects the divestment of Turbogas / Portugen, our Portuguese power plant activities. RWE Trading accounted for the lion's share of the sales volume (78.5 billion kWh). These figures were achieved largely from the sale of in-house electricity production on the wholesale market. They do not include sales from trading with purchased electricity.

External electricity sales volume by customer segment	RWE Power[1]		RWE Energy		RWE npower		RWE Group	
Billion kWh	**2005**	2004	**2005**	2004	**2005**	2004	**2005**	2004
Private and commercial customers	0.5	0.5	39.0	38.9	22.3	22.5	61.9	62.0
Industrial and corporate customers	7.8	6.8	59.9	65.4	32.6	37.0	100.3	109.2
Distributors	14.0	19.0	51.7	52.1	0.4	–	66.1	71.1
Electricity trading	70.8	73.1	–	–	–	–	70.8	73.1
Total	**93.1**	**99.4**	**150.6**	**156.4**	**55.3**	**59.5**	**299.1**	**315.4**

1 Including RWE Trading.

RWE Energy sold 150.6 billion kWh of electricity. This was 4 % less than in 2004. In Germany, the reduction of sales volumes is predominantly attributable to business with industrial customers and distributors. We were unable to extend all of the expired contracts. Some customers, whose consumption we used to cover completely, now purchase some of the electricity they use from other utilities. There was a rise in sales of electricity compliant with the law for the promotion of renewables-based energy (Renewable Energy Act—REA) that is fed into our grid. A change in the statement of REA amounts in our electricity statistics also had a positive impact. Electricity sales volumes at our sales companies outside Germany showed a generally stable development. Losses resulting from deregulation in Hungary were contrasted by increases in sales volumes in the fast-growing Polish market.

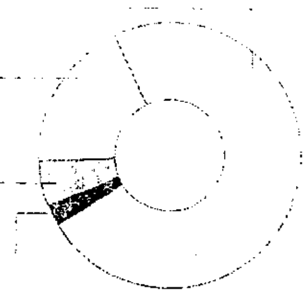
RWE Energy supplies 15.8 million customers with electricity, 11.9 million of which are in Germany.

At the end of 2005 RWE Energy and its subsidiaries served 15.8 million electricity customers. This was about 1 million fewer than in the prior year. The decline is to a considerable extent due to the sale of minority interests in Czech energy utilities. In Germany, our main market, 11.9 million customers currently buy electricity from us. In Hungary, we supply electricity to 2.1 million customers, with 0.8 million and 0.6 million served in Poland and Slovakia respectively.

In the fiscal year being reviewed, RWE npower sold 55.3 billion kWh of electricity. This was 7 % less than in the previous year. Our value-oriented sales policy led to a drop in sales to major industrial and corporate clients. In the private household segment, RWE npower roughly maintained its level of sales from the previous year.

Electricity sales volume of the RWE Group by region in 2005

	2005	2004
Germany	73.5 %	72.3 %
UK	18.5 %	18.9 %
Hungary	5.6 %	5.4 %
Others	2.4 %	3.4 %



At the end of 2005, 3.9 million household customers in the UK obtained electricity from RWE npower. This is up slightly year on year and represents a 15 % share of the market. In addition, despite supplying a lower volume of electricity overall, we actually increased the number of small commercial, industrial and corporate customer sites supplied, taking the total to 388,000.

Gas sales volume virtually unchanged. At 356.8 billion kWh, the RWE Group's gas sales volume was only slightly down on the previous year's level. The marginal decrease is attributable to RWE Energy's and RWE npower's sales operations.

External gas sales volume by customer segment Billion kWh	RWE Power[1]		RWE Energy		RWE npower		RWE Group	
	2005	2004	**2005**	2004	**2005**	2004	**2005**	2004
Private and commercial customers	–	–	73.5	75.3	39.7	38.6	113.2	113.9
Industrial and corporate customers	3.3	6.5	104.7	105.5	8.0	10.0	116.0	122.0
Distributors	17.0	13.6	110.6	111.0[2]	–	–	127.6	124.6[2]
Total	**20.3**	**20.1**	**288.8**	**291.8**	**47.7**	**48.6**	**356.8**	**360.5**

1 Including RWE Trading.
2 Including gas trading.

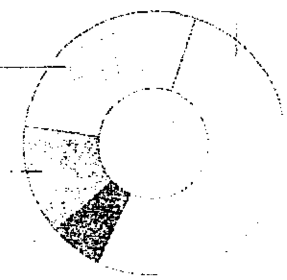
Gas sales generated by RWE Power largely correspond to the quantities RWE Dea produces and sells to distributors and end customers. These sales are supplemented by small volumes achieved by RWE Trading, which are procured from Czech-based RWE Transgas and RWE Dea and sold on the wholesale market. In sum, gas supplied by RWE Power amounted to 20.3 billion kWh, which was essentially unchanged vis-à-vis 2004.

Gas sales made by RWE Energy amounted to 288.8 billion kWh, falling just shy of the prior year's level. In Germany, mild autumn temperatures dampened private household consumption. Furthermore, the rise in prices caused consumers to be more thrifty in their use of gas. In addition, RWE Energy lost a few key accounts. Our gas sales in the Czech Republic were also down year on year. As in Germany, this was in part driven by higher gas prices. A large number of customers limited consumption or switched to alternative fuels. Gas usage declined, especially in power plants. On the Dutch gas market, considerable growth was achieved by acquiring new customers. We won new customers in Hungary and Germany as well.

At present, RWE Energy and its subsidiaries provide 8.3 million customers with gas—roughly 300,000 more than in 2004. Germany and the Czech Republic are our main markets, with 3 million customers each.

RWE npower's gas sales declined by 2% to 47.7 billion kWh. Deliveries to large industrial and corporate customers decreased, again due to our value-oriented sales policy. In contrast, RWE npower broadened its private household and small commercial customer base, enabling the company to increase sales in this segment.

Gas sales volume of the RWE Group by region in 2005		*2004*
Germany	51.7%	52.0%
Czech Republic	28.1%	28.2%
UK	13.7%	14.5%
Others	6.5%	5.3%



In total, 2.1 million customers obtained their gas supplies from RWE npower in the year under review. This represents an increase of 200,000 customers over the previous year. RWE npower has a 9% share of the UK household customer market. Approximately 1.6 million household customers purchase both electricity and gas from RWE npower. Again, this corresponds to a rise of roughly 200,000 compared with 2004. We believe the positive development in the UK can be traced back to our successful price-freeze proposition, brand and marketing strategy and improved levels of customer service.

Due to one-off effects, consolidated external revenue fell just shy of the year-earlier level. Net of one-off effects, it rose by 10%.

Revenue 10% up year on year net of one-off effects. In fiscal 2005 the RWE Group generated €41.8 billion in external revenue. This corresponds to a slight decrease from the prior-year level. Organic growth was contrasted by one-off effects that depressed revenue and principally stemmed from the following deconsolidations:

- Heidelberger Druckmaschinen is no longer included in the Group's 2005 consolidated financial statements since we divested the majority of this company in May 2004 (revenue in 2004: €1,359 million).
- Our Portuguese power plant activities Turbogas / Portugen are no longer included in our figures either, since they were deconsolidated as of September 30, 2004 (2004 revenue: €228 million).

- In 2005 RWE Umwelt is accounted for as a "discontinued operation." Therefore, this company is no longer included in the Group's revenue (2004 revenue: €1,830 million).

- RWE Solutions, a business unit of RWE Energy, shed its transformer (deconsolidated as of October 1, 2004), power conditioning (January 1, 2005) and mechatronics (April 1, 2005) operations as well as some other peripheral activities. This eliminated a total of €320 million in revenue compared to the prior year.

External revenue € million	2005	2004	+/– in %
RWE Power	**6,832**	**6,741**	**1.3**
Power Generation[1]	5,254	5,467	-3.9
RWE Dea	1,578	1,274	23.9
RWE Energy	**24,318**	**22,450**	**8.3**
German regions	14,838	13,830	7.3
International regions	4,077	3,371	20.9
Electricity & Gas Transmission	3,502	1,853	89.0
RWE Solutions	1,707	3,102	-45.0
Other, consolidation	194	294	-34.0
RWE npower	**6,382**	**5,605**	**13.9**
RWE Thames Water	**4,210**	**4,065**	**3.6**
Regulated UK business	1,905	1,680	13.4
North America	1,799	1,695	6.1
Other markets	506	690	-26.7
Other, consolidation	**77**	**3,276[2]**	**-97.6**
RWE Group	**41,819**	**42,137**	**-0.8**

1 Including RWE Trading and Harpen.
2 Including RWE Umwelt (€1,830 million) and Heidelberger Druckmaschinen (€1,359 million).

Foreign exchange fluctuations only had a slight impact on the development of revenue.

Another one-off effect results from the change in the statement of parts of the water business* on the balance sheet, subsequent to which this activity is no longer recognized in revenue (–€126 million). Fluctuations in the pound Sterling and US dollar-to-euro exchange rates in 2005 only had a slight impact (–€42 million in total). The average exchange rates were £0.68/€ (prior year: £0.68/€) and US$1.24/€ (prior year: US$1.25/€). In organic terms, i.e. net of all aforementioned one-off effects and currency exchange rate fluctuations, external revenue grew by 10%.

* 37

The following is an overview of the development of revenue by division.

External revenue posted by **RWE Power** totaled €6,832 million. This represents a moderate increase over the previous year. The Power Generation Business Unit (including RWE Trading and Harpen) experienced a 4% decline in external revenue mainly due to the deconsolidation of Turbogas/Portugen. The RWE Dea Business Unit grew revenue by 24% despite a decline in oil production. This was due to price increases on the oil and gas markets. Higher gas production also contributed to the improvement in revenue.

Our European energy sales business posted 8% revenue growth, mainly because higher procurement costs were passed through.

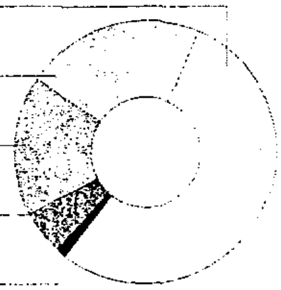
External revenue recorded by the ***RWE Energy*** Division was up 8% to €24,318 million. Electricity revenue rose 9%, because higher procurement costs were passed through to sales prices. Regulatory price adjustments were the reason in Hungary. Our gas revenue improved by 26%. This was also largely due to price increases. Analogously to the electricity market, we passed procurement cost increases on to our customers. This is because prices set in our gas purchasing and supply agreements are linked to oil prices. In the Czech Republic, the Czech regulator approved our tariff increases. In addition, there was a currency effect from the rise of the Czech koruna. Revenue earned by RWE Solutions dropped considerably. However, this is predominantly due to the aforementioned divestments.

RWE npower grew external revenue by 14% to €6,382 million. In 2004 the UK energy business increased electricity and gas prices in order to pass through to end customers the rise in procurement costs. Since this occurred during the course of the year, the impact it had on revenue was not fully felt until 2005. However, RWE npower experienced a decline in sales volume in the industrial and corporate customer segment.

External revenue generated by ***RWE Thames Water*** improved 4% to €4,210 million. This division increased revenue principally in the regulated UK business by raising water tariffs effective April 1, 2005. However, this was contrasted by one-off adverse effects on revenue, mainly owing to the change in the way we account for parts of the water business (–€126 million) and the sale of non-core activities (–€54 million). Net of these effects and the impact of foreign exchange fluctuations, the water division produced 9% organic growth in revenue. American Water also posted a 9% rise net of one-off and currency effects, in part because regulatory authorities in some of the US states approved our tariff increases. In addition, American Water benefited from a weather-induced increase in water consumption.

RWE Group revenue by region in 2005

	2005	2004
Germany	55.1%	54.8%
UK	20.7%	20.0%
Rest of Europe	17.5%	16.6%
Americas	5.4%	6.2%
Asia, Africa, Australia	1.3%	2.4%



*184

Operating result and EBITDA* clearly improved net of one-off effects. Thanks to the earning power of our Continental European energy business, we succeeded in posting another increase in the Group's operating result net of one-off effects. However, fiscal 2005 was also characterized by the aforementioned one-off effects of deconsolidations and balance sheet reclassifications.

EBITDA € million	2005	2004	+/- in %
RWE Power	**2,800**	**2,571**	**8.9**
Power Generation[1]	2,158	2,013	7.2
RWE Dea	642	558	15.1
RWE Energy	**3,142**	**2,927**	**7.3**
German regions	1,954	1,886	3.6
International regions	476	418	13.9
Electricity & Gas Transmission	621	713	-12.9
RWE Solutions	132	86	53.5
Other, consolidation	-41	-176	76.7
RWE npower	**561**	**698**	**-19.6**
RWE Thames Water	**2,045**	**1,979**	**3.3**
Regulated UK business	1,102	989	11.4
North America	744	707	5.2
Other markets	199	283	-29.7
Other, consolidation	**-224**	**225[2]**	**-199.6**
RWE Group	**8,324**	**8,400**	**-0.9**

1 Including RWE Trading and Harpen.
2 Including RWE Umwelt (€190 million) and Heidelberger Druckmaschinen (€96 million).

RWE's operating result was 4 % up on the prior year. Net of one-off effects, it was 8 % higher.

At €8,324 million, EBITDA was slightly below the year-earlier level. Conversely, the operating result was up 4 % to €6,201 million. The operating result developed better than EBITDA in part due to a decline in depreciation and write-downs, which were €235 million lower than in the previous year. This was partially because we sold RWE Umwelt and Turbogas, two asset-intensive activities. Moreover, we had €66 million more operating income from investments. Neither depreciation, nor operating income from investments are included in EBITDA.

Reconciliation of income from operating activities to EBITDA € million	2005	2004	+/- in %
Income from operating activities	**4,746**	**5,574**	**-14.9**
+ Income from investments	767	846	-9.3
- Non-operating result	688	-444	-
Operating result	**6,201**	**5,976**	**3.8**
- Operating income from investments	-478	-412	-16.0
+ Operating depreciation and write-downs	2,601	2,836	-8.3
EBITDA	**8,324**	**8,400**	**-0.9**

* 47

The aforementioned deconsolidations* had the following impact on EBITDA / the operating result:

- Heidelberger Druckmaschinen: -€96 million / -€34 million
- RWE Umwelt: -€190 million / -€76 million
- Turbogas / Portugen: -€52 million / -€36 million

A further one-off effect stems from the change in the way we report parts of our water business on our balance sheet. These activities are no longer included in EBITDA or the operating result. Fluctuations in the US dollar and pound Sterling-to-euro exchange rates had a slightly adverse effect (-€10 million / -€7 million). Net of all one-off and currency effects, EBITDA grew 5%. On a like-for-like basis, the operating result was up 8%.

Operating result € million	**2005**	2004	+/- in %
RWE Power	**2,112**	**1,846**	**14.4**
Power Generation[1]	1,667	1,489	12.0
RWE Dea	445	357	24.6
RWE Energy	**2,507**	**2,192**	**14.4**
German regions	1,609	1,483	8.5
International regions	381	322	18.3
Electricity & Gas Transmission	452	571	-20.8
RWE Solutions	113	50	126.0
Other, consolidation	-48	-234	79.5
RWE npower	**437**	**604**	**-27.6**
RWE Thames Water	**1,416**	**1,389**	**1.9**
Regulated UK business	687	612	12.3
North America	491	466	5.4
Other markets	238	311	-23.5
Other, consolidation	**-271**	**-55[2]**	**-392.7**
RWE Group	**6,201**	**5,976**	**3.8**

1 Including RWE Trading and Harpen.
2 Including RWE Umwelt (€76 million) and Heidelberger Druckmaschinen (€34 million).

In 2005 organic earnings were markedly affected by the price trend in the electricity wholesale market, tariff increases in the water business and continued efficiency enhancements in all our divisions. This was contrasted by the additional expenses incurred for fuels and power plant maintenance, among other things. Furthermore, for the first time, we incurred costs associated with the CO_2 emissions trading scheme introduced as of January 1, 2005. As explained earlier, we did not receive enough free emissions allowances from the government in 2005 to cover our CO_2 emissions. This reduced the Group's operating result by €169 million. Additional expenses arose from our share-based renumeration programmes—especially from those originating from the earlier years. This is due to the considerable rise in the share price in 2005. At the Group level, share-based renumeration programmes resulted in €310 million in staff costs (previous year: €87 million). This includes provisions for probable payments after 2005. €221 million of the total amount of €310 million is allocable to our divisions and €89 million is attributable to RWE AG and RWE Systems, which are included in the item "Other, consolidation."

The following is an overview of our operating result by division:

Net of one-off effects, RWE Power improved its operating result by 17 %. This was partially due to the wholesale electricity price trend.

RWE Power posted an operating result of €2,112 million. The division thus surpassed the year-earlier figure by 14 %. Excluding the sale of Turbogas / Portugen, RWE Power closed fiscal 2005 with an operating result that was 17 % higher than in 2004. The following is a breakdown of the operating result by business unit:

- Power Generation: This business unit, which includes RWE Trading and Harpen, increased its operating result by 12 %. Our trading activities closed the fiscal year clearly up on the prior one. Most notably, our UK trading operations experienced a successful year. In the power generation business, we benefited from the price trend on the wholesale market. However, adverse effects were felt from a decrease in output due to unscheduled power plant outages. Higher fuel prices (-€250 million) and power plant maintenance (-€120 million) also increased costs compared with 2004. The shortfall of CO_2 emissions allowances had an effect of -€40 million. The deconsolidation of Turbogas / Portugen subtracted €36 million from the operating result.

- RWE Dea: The operating result generated by this business unit was up 25 %. Our February 2005 forecast envisioned a slight decline. Developments exceeded expectations owing to the price boom on the oil and gas markets. However, RWE Dea was unable to fully benefit from this because oil prices were hedged early on. Declines in oil production also dampened the earnings trend.

RWE Energy grew its operating result by 14 %. This was due to measures taken to reduce costs and improve efficiency as well as one-off effects.

RWE Energy improved its operating result by 14 % to €2,507 million. The earnings forecast for this division ("to match the 2004 level") published in February 2005 was exceeded as well. Among other things, the forecast included anticipated earnings risks from the introduction of grid regulation in Germany, which did not arise due to delays in the legislative process. Reduced costs, improved margins and non-recurrent effects such as foreign exchange rate fluctuations contributed to the good showing. In addition, 2004 had been burdened because high provisions were built. The breakdown by business unit is as follows:

* 36

- German regions: RWE Energy's regional companies closed the fiscal year with an operating result that was 8 % higher than in the previous one. They benefited from cost cutting and efficiency enhancements. Our value-oriented sales policy is another success factor. Burdens arose from the provisions made to cover the modernization of our electricity grids and repairs to those grids which were damaged by snowstorms in our German supply area*.

- International regions: We improved the operating result of our Continental European sales business outside Germany by 18%. Drivers here were cost reductions and price-induced margin improvements in the regulated Czech gas sector. In addition, the appreciation of major Central European currencies vis-à-vis the euro produced positive currency effects.

- Electricity & Gas Transmission: This business unit oversees our German extra high-voltage electricity grid, our German gas transmission grid, and Czech-based RWE Transgas' gas transmission and gas trading operations. Furthermore, this unit now also includes the newly founded RWE Key Account GmbH, to which we transferred RWE Solutions' electricity key account business effective April 1, 2005. The operating result recorded by the Electricity & Gas Transmission Business Unit was down 21%. RWE Transgas experienced a decline in margins in business with regional distributors due to the regulatory requirements. Moreover, less income was generated from the cross-border gas transmission business, above all due to currency effects. In Germany, there was a rise in costs incurred for balancing power to compensate for short-term fluctuations of wind energy fed into the grid. Furthermore, additional costs were incurred to improve the grid infrastructure.

- RWE Solutions: Our subsidiary that specializes in energy-related services improved its operating result by €63 million to €113 million. This was due to the absence of provisions built in 2004 to cover uncertainties surrounding plant construction projects. Moreover, individual activities improved their organic earnings situation.

RWE npower closed fiscal 2005 with a 28% drop in its operating result. High CO_2 certificate and fuel costs were the main reasons. They could only partially be passed on to the market.

RWE npower saw its operating result decline by 28%. This decrease is exclusively attributable to its power generation activities. The shortfall of CO_2 emissions allowances had an adverse effect to the tune of €129 million, which was more than we anticipated. This was because the price of emissions certificates increased significantly compared with the beginning of 2005. We were thus unable to meet the earnings forecast we issued in February 2005 which envisioned a decline in earnings of no more than 20%. Furthermore, RWE npower experienced higher fuel costs. The rise in wholesale electricity prices did not offset these factors, since RWE npower had already sold forward part of 2005's electricity production at markedly lower prices in earlier years. The decline in earnings from the power generation business was contrasted by the improved earnings situation in the supply business, where we benefited from the aforementioned increases in electricity and gas prices in 2004.

RWE Thames Water posted 7% organic growth year on year, largely owing to tariff increases in the UK water business.

RWE Thames Water's operating result advanced by 2% to €1,416 million. Net of the one-off effects of balance sheet reclassification, foreign exchange rates and deconsolidations, this division's operating result was up 7%. Tariff increases in the regulated UK business were the most significant organic factor. These enabled the company to more than offset the rise in the cost of maintaining the Greater London water pipe infrastructure. The operating result posted by American Water was 6% up on the prior year, net of consolidation and currency effects. Tariff increases in the regulated business, efficiency enhancements and positive volume-related effects were the main drivers. In total, however, they lagged behind our expectations.

Key figures for value management in fiscal 2005	Operating result € million	Capital employed € million	**ROCE** %	Capital costs %	Relative value added %	**Absolute value added in 2005 € million**	Absolute value added in 2004 € million
RWE Power[1]	2,112	7,468	28.3	10.5	17.8	1,328	1,008
RWE Energy	2,507	11,962	21.0	10.0	11.0	1,311	996
RWE npower	437	6,645	6.6	10.0	-3.4	-227	-33
RWE Thames Water	1,416	19,047	7.4	7.5	-0.1	-13	-129
Other, consolidation	-271	-2,983	–	–	–	9	156[2]
RWE Group	**6,201**	**42,139**	**14.7**	**9.0**	**5.7**	**2,408**	**1,998**

1 Including RWE Trading.
2 Including RWE Umwelt (-€41 million) and Heidelberger Druckmaschinen (-€69 million).

In 2005 ROCE was 14.7%—exceeding capital costs by 5.7%. We thus surpassed our target for 2006.

ROCE target for 2006 already exceeded. We increased the value of the company considerably in 2005 again. The yardstick is the return on capital employed (ROCE). In the year being reviewed, ROCE was 14.7%, clearly surpassing the Group's capital costs of 9.0% before tax. We have thus already exceeded our ROCE target for 2006 of at least 14%.

Our strong organic performance is reflected above all in the development of absolute value added, the central control parameter for all our Group activities. The higher the value added, the more attractive the activity is to our portfolio. It is a key criterion for the assessment of investments and—alongside free cash flow—the benchmark for bonuses paid to our executives. Value added is derived by multiplying the difference between ROCE and capital costs by capital employed (€42.1 billion). It amounted to €2,408 million for the 2005 financial year. This was €410 million, or 21%, more than in 2004.

The following is an overview of the development of value added by division.

- Value added by ***RWE Power*** rose by €320 million to €1,328 million. This manifests itself especially in the improved earnings situation of our German power generation operations and of RWE Dea's upstream activities. Moreover, capital employed decreased.

- ***RWE Energy*** made a value contribution of €1,311 million. Compared to 2004, this represents an increase of €315 million, and reflects the positive organic performance achieved in the past financial year.

- In line with the negative earnings development, value added by ***RWE npower*** decreased by €194 million to -€227 million. RWE npower is expected to earn its cost of capital for the first time in 2007.

- ***RWE Thames Water*** posted a substantial improvement, increasing value added by €116 million to -€13 million. We thus essentially achieved our goal of breaking even on the capital costs of our water division in 2005. However, we had expected American Water to record a stronger improvement.

Reconciliation to net income

Despite an impairment loss in connection with the planned sale of our water business, we increased net income again.

Net income improved by 4%. The reconciliation to net income was marked by significant one-off effects, which almost entirely offset each other. Charges affected the non-operating result principally owing to an impairment loss at American Water. This was contrasted by positive effects on the financial result and taxes on income.

Non-operating result € million	**2005**	2004	+/- € million
Capital gains	326	678	-352
Impairment losses	-814	-492	-322
Restructuring, other	-200	258	-458
Non-operating result	**-688**	**444**	**-1,132**

The non-operating result declined by €1,132 million to -€688 million. Changes break down as follows:

- In 2005 capital gains totaled €326 million. They were thus €352 million down on the high level achieved in the prior year. In 2004 capital gains still included earnings contributed by the sale of shares in US hard coal producer CONSOL Energy (€220 million), Heidelberger Druckmaschinen (€200 million) as well as in Swiss-based Motor-Columbus and Atel (€136 million). The book gains achieved in 2005 principally stem from the sale of our 20% stake in Stadtwerke Düsseldorf, real estate formerly belonging to RWE Systems, and of water activities in Thailand and Australia.

- Impairment losses increased by €322 million to €814 million. An impairment loss of €759 million was recognized for American Water as a result of the impairment test performed on the goodwill carried for RWE Thames Water North America / American Water on our balance sheet in the fourth quarter of 2005. We made a downward adjustment to our growth expectations in this business in light of current developments on the market. Privatization of US water businesses is progressing more sluggishly than expected. This also applies to the outsourcing of water services by municipalities. Moreover, selling costs were included in the impairment loss in light of American Water's probable public offering. Another impairment loss was recognized for one of RWE Thames Water's peripheral activities. It amounted to €55 million.

- Despite lower provisioning than in 2004, the result disclosed under "Restructuring, other" declined by €458 million to -€200 million. This was mainly because income from the change in nuclear provisions decreased by €321 million to €396 million. Moreover, changes in the IAS 39 accounting standard mandated revaluation of RWE Trading's derivative transactions. This reduced our operating result by €62 million. Another effect was felt from long-term UK gas purchasing agreements, which are now accounted for at market value. This led to a €227 million charge. The amortization of RWE npower's customer base was virtually flat at €328 million.

The financial result improved by €800 million. We took advantage of the positive trend in equity markets by selling a large number of securities.

The financial result improved by €800 million, or 32%, to -€1,685 million. This was far more than expected, since we took advantage of the positive trend in equity markets at the end of last year to realize book gains on the sale of securities. This led to a marked improvement in the "Other financial result." Net interest rose as planned. Here the driver was the continued reduction in debt. Furthermore, the prior year's figure included non-recurrent expenses associated with a bond buyback. Another factor influencing the improvement in the financial result was the decline in interest accretion to non-current provisions. This occurred because there was a reduction in the level of provisions, which was partially due to the deconsolidation of Heidelberger Druckmaschinen and RWE Umwelt.

Financial result € million	**2005**	2004	+/- in %
Interest income	1,208	1,117	8.1
Interest expenses	-2,193	-2,247	2.4
Net interest	**-985**	**-1,130**	**12.8**
Interest accretion to non-current provisions	-1,238	-1,327	6.7
Other financial result	538	-28	-
Financial result	**-1,685**	**-2,485**	**32.2**

Income before tax from our continuing operations thus amounted to €3,828 million. This corresponds to a 3% decline compared with 2004. Our effective tax rate dropped from 39% to 32%. The decrease was mainly due to the fact that we were able to make use of tax loss carryforwards in the RWE AG tax group, for which deferred taxes have not been capitalized thus far. Furthermore, we capitalized deferred taxes for losses carried forward, which we expect to be able to make use of in the future. Impairment losses recognized for the water business had a counteracting effect, because they reduce the result, but not the tax burden. Otherwise, the effective tax rate would have decreased even more.

Income from continuing operations thus rose by 8 % to €2,607 million. Discontinued operations closed the fiscal year with a loss of €20 million.

The minority interest's share in income increased by €79 million to €356 million. This was mainly due to the improvement in earnings generated by RWE Energy companies in which third parties hold shares.

Net income generated by the RWE Group amounted to €2,231 million. This represents 4 % growth over the previous fiscal year. Corresponding earnings per share increased from €3.80 to €3.97.

Recurrent net income, the basis for our future dividend payment, rose 26 %, recording a much stronger increase than net income.

The key figure that is decisive for our future dividend policy is recurrent net income. This figure is obtained by subtracting from net income the non-operating result (which is affected by one-off effects) and non-recurrent effects on the financial result and on taxes. At €2,257 million, recurrent net income was 26 % higher than in 2004. It thus rose much more than net income. This is due to the fact that the marked decrease of the non-operating result does not affect recurrent net income.

Reconciliation to net income		**2005**	2004	+/- in %
Operating result	€ million	**6,201**	**5,976**	**3.8**
Non-operating result	€ million	-688	444	-
Financial result	€ million	-1,685	-2,485	32.2
Income from continuing operations before tax	€ million	**3,828**	**3,935**	**-2.7**
Taxes on income	€ million	-1,221	-1,521	19.7
Income from continuing operations	€ million	**2,607**	**2,414**	**8.0**
Income from discontinued operations	€ million	-20	-	-
Income	€ million	**2,587**	**2,414**	**7.2**
Income attributable to minority interest	€ million	356	277	28.5
Net income	€ million	**2,231**	**2,137**	**4.4**
Recurrent net income	€ million	**2,257**	**1,794**	**25.8**
Earnings per share	€	**3.97**	**3.80**	**4.5**
Effective tax rate	%	**32**	**39**	**-17.9**

We have achieved the interim target of our €680 million cost-cutting programme. In 2005 we realized €210 million in savings, as planned.

Cost-cutting programmes: 2005 savings target achieved. We want to reduce annual costs by €680 million within the scope of two programmes, which will end at the close of 2006.

- €500 million are allocable to measures taken by the first programme linked to the reorganization of the RWE Group, which was initiated in 2003. Here, the German energy business, the water activities, and our IT operations are the prime targets. We had already achieved €310 million in savings from this programme by the end of 2005.

- With the second programme, launched in 2002, we capitalized on synergies from the large-scale acquisitions made in the last few years. Targeted savings total €180 million. €100 million of this sum was allocable to the combining of the back office functions of our UK-based companies RWE npower and RWE Thames Water. We intend to achieve €80 million in savings at our Czech gas companies. By December 31, 2005, we had already realized a total of €140 million in synergies.

We reduced 2005 costs by €210 million through the two programmes. €230 million in savings are still pending for 2006. We uphold our goal of achieving €680 million in savings despite the planned sale of our UK and North American water activities. We want to compensate for lost synergy potential by taking additional measures.

Annual cost reduction € million	2003	2004	**2005**	2006	**Target**
Reorganization		150	160	190	500
Acquisition synergies	60	30	50	40	180
Total	**60**	**180**	**210**	**230**	**680**

Key figures by division at a glance

RWE Power[1]		**2005**	2004	+/- in %
External revenue	€ million	6,832	6,741	1.3
Intra-group revenue	€ million	6,323	5,684	11.2
Total revenue	€ million	13,155	12,425	5.9
EBITDA	€ million	2,800	2,571	8.9
Operating result	€ million	2,112	1,846	14.4
Return on capital employed (ROCE)	%	28.3	23.1	-
Weighted average cost of capital (WACC) before tax	%	10.5	10.5	-
Value added	€ million	1,328	1,008	31.7
Capital employed	€ million	7,468	7,979	-6.4
Capital expenditure	€ million	842	681	23.6
Property, plant and equipment	€ million	842	666	26.4
Financial assets	€ million	-	15	-
		12/31/05	12/31/04	
Workforce (full time equivalent)		18,702	18,792	-0.5

1 Including RWE Trading.

RWE Energy		**2005**	2004	+/- in %
External revenue	€ million	24,318	22,450	8.3
Intra-group revenue	€ million	865	706	22.5
Total revenue	€ million	25,183	23,156	8.8
EBITDA	€ million	3,142	2,927	7.3
Operating result	€ million	2,507	2,192	14.4
Return on capital employed (ROCE)	%	21.0	18.3	-
Weighted average cost of capital (WACC) before tax	%	10.0	10.0	-
Value added	€ million	1,311	996	31.6
Capital employed	€ million	11,962	11,963	-
Capital expenditure	€ million	1,238	1,024	20.9
Property, plant and equipment	€ million	1,064	947	12.4
Financial assets	€ million	174	77	126.0
		12/31/05	12/31/04	
Workforce (full time equivalent)		37,598	39,861	-5.7

RWE npower		2005	2004	+/- in %
External revenue	€ million	6,382	5,605	13.9
Intra-group revenue	€ million	3	-	-
Total revenue	€ million	6,385	5,605	13.9
EBITDA	€ million	561	698	-19.6
Operating result	€ million	437	604	-27.6
Return on capital employed (ROCE)	%	6.6	9.5	-
Weighted average cost of capital (WACC) before tax	%	10.0	10.0	-
Value added	€ million	-227	-33	-
Capital employed	€ million	6,645	6,378	4.2
Capital expenditure	€ million	542	166	226.5
Property, plant and equipment	€ million	315	150	110.0
Financial assets	€ million	227	16	-
		12/31/05	12/31/04	
Workforce (full time equivalent)		10,125	9,555	6.0

RWE Thames Water		2005	2004	+/- in %
External revenue	€ million	4,210	4,065	3.6
Intra-group revenue	€ million	4	-	-
Total revenue	€ million	4,214	4,065	3.7
EBITDA	€ million	2,045	1,979	3.3
Operating result	€ million	1,416	1,389	1.9
Return on capital employed (ROCE)	%	7.4	7.3	-
Weighted average cost of capital (WACC) before tax	%	7.5	8.0	-
Value added	€ million	-13	-129	89.9
Capital employed	€ million	19,047	18,971	0.4
Capital expenditure	€ million	1,405	1,531	-8.2
Property, plant and equipment	€ million	1,388	1,465	-5.3
Financial assets	€ million	17	66	-74.2
		12/31/05	12/31/04	
Workforce (full time equivalent)		16,306	16,051	1.6

Finance and capital expenditure

Central financing. At RWE, Group financing is handled by the corporate headquarters, RWE AG. Only in specific cases do our subsidiaries raise capital directly, e.g. if it is economically advantageous or required by regulatory authorities to make use of local credit and capital markets. Furthermore, RWE AG acts as coordinator when Group companies assume a liability by issuing warranties or signing letters of comfort. Pooling these activities is a basic prerequisite for managing and monitoring risks centrally. Moreover, this strengthens our position when negotiating with banks and other market participants.

* 184
* 184

High financial flexibility. We have flexible financing tools besides our high and stable cash flows from operating activities. We raise long-term funds on the capital market via a €20 billion debt issuance programme*. A US$ 5 billion commercial paper programme* is at our disposal to meet short-term financing needs on the money market. At the end of 2005, drawings on the debt issuance and the commercial paper programmes totaled €15.2 billion and €3.2 billion respectively. Furthermore, RWE has a €4 billion syndicated credit line, which serves as a liquidity reserve. The term is 364 days for €2 billion. The term for the other €2 billion is five years. None of our finance programmes or our credit facility contain specific financial covenants such as interest coverage, leverage or capitalization ratios that could trigger actions, such as acceleration of repayment or additional collateral. Likewise, they do not contain rating triggers.

Moody's raised our rating outlook to "stable."

* 185

Good credit rating maintained. Creditworthiness assessments by independent rating agencies have a substantial influence on a company's options to raise capital. The better the rating, the easier it is to gain access to international credit markets and the better the conditions for raising capital. Therefore, we benefit from the fact that the two leading rating agencies, Moody's and Standard & Poor's, confirm our strong creditworthiness. This is reflected in our strong Single A rating*. Moreover, Moody's improved its outlook for RWE from "negative" to "stable" in April 2005. In so doing, the agency rewarded us for our considerable debt reduction since 2003 as well as our rapidly implemented strategy to focus our business. The following table provides an overview of our current credit ratings:

	Moody's	Standard & Poor's
Long-term rating	A1 stable outlook	A+ negative outlook
Short-term rating	P-1 stable outlook	A-1 negative outlook

Rating agencies evaluate the creditworthiness of companies based on qualitative and quantitative criteria. Their assessments are also based on financial ratios that provide enough information for them to make statements on the company's earning power and liquidity. One such key figure is the ratio of EBITDA to net interest expenses. We achieved a further improvement in this figure in the year under review. The ratio of EBITDA to net interest expenses was 8.5 as compared to 8.0 in 2004.

Our strong creditworthiness has a positive impact on our interest expenses. In 2005 they amounted to 5.2 % of the RWE Group's average gross financial debt (including the interest expenses for hedges).

We reduced net debt by another €1 billion. High free cash flow and sales proceeds made this possible.

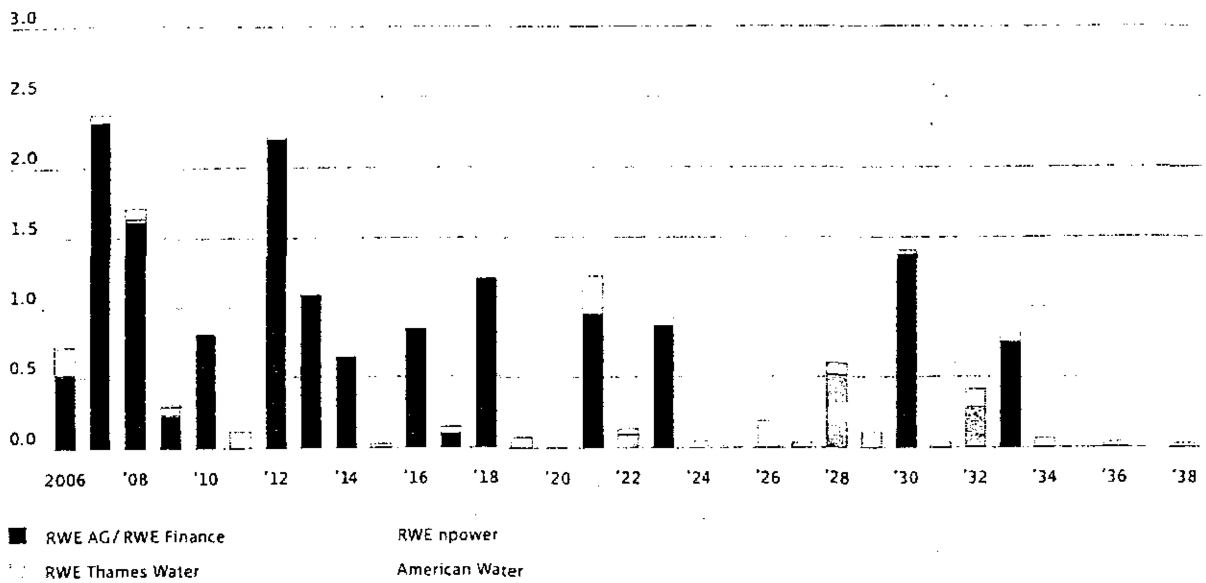
Net financial debt reduced to €11.4 billion. In fiscal 2005 we reduced our net financial debt from €12.4 billion to €11.4 billion. This decline was mainly caused by the high free cash flow (€1.6 billion). Furthermore, we received €0.9 billion in proceeds from divestments. Dividend payments made by the RWE Group (€1.1 billion) and changes in foreign exchange rates (€0.7 billion) had a debt-increasing effect. The euro lost value compared with the US dollar and pound Sterling as of the cut-off date. As of December 31, 2005, the key currency exchange rates were US$ 1.18 / € and £ 0.69 / € as compared to US$ 1.36 / € and £ 0.71 / € as of December 31, 2004. Financial derivatives, which we use to hedge liabilities against currency exchange and interest rate effects, had a market value of €1.3 billion at the end of 2005. However, derivatives are not taken into account in net financial debt.

Net financial debt € million	**12/31/05**	12/31/04	+/- in %
Cash and cash equivalents	1,431	1,526	-6.2
Marketable securities	11,356	12,049	-5.8
Other financial assets	3,603	1,423	153.2
Gross financial assets	**16,390**	**14,998**	**9.3**
Bonds, notes payable, bank debt, commercial paper	24,982	24,882	0.4
Other financial debt	2,846	2,501	13.8
Gross financial debt	**27,828**	**27,383**	**1.6**
Net financial debt	**11,438**	**12,385**	**-7.6**

In 2006 we will redeem about €700 million in bonds.

Nominal volume of RWE bonds outstanding totals €18.6 billion. The nominal volume of bonds issued by RWE companies amounted to €18.6 billion at the end of 2005. In the financial year that just ended, we repaid €1.2 billion in bonds that came due. They primarily comprise three bonds with nominal amounts of €600 million, €350 million and £100 million. €0.7 billion in bonds come due in the 2006 financial year. We will not refinance them by issuing new bonds. At the end of 2005 the weighted average remaining maturity of bonds issued by the RWE Group was eleven years.

Maturity profile of the RWE Group's capital market debt
€ billion



The RWE Group's financial debt is mirrored in our international presence. Including currency hedging effects, our debt structure by currency breaks down into 62 % in pounds Sterling, 33 % in US dollars and 5 % in euros and other currencies. As of December 31, 2005, the RWE Group's financial debt excluding other financial debt totaled €25.0 billion. Financial debt includes bonds, notes payable, bank debt and commercial paper.

In fiscal 2005 we invested additional sums predominantly in power plants and electricity grids.

Capital expenditure up 11 % year on year. Capital spending in fiscal 2005 totaled €4,143 million, or 11 % more than in 2004 (€3,737 million). Capital expenditure on property, plant and equipment and intangible assets rose by 7 % to €3,667 million. Depreciation totaled €3,762 million. In the financial year under review, we spent additional sums primarily on power plants and electricity grids. One-off effects from the deconsolidation of RWE Umwelt and Heidelberger Druckmaschinen, the change in the way parts of the water business are accounted for as well as currency exchange fluctuations had a counteracting effect. Net of all non-operating effects, capital expenditure on property, plant and equipment grew by 15 %.

Capital expenditure on property, plant and equipment € million	**2005**	2004	+/- € million
RWE Power[1]	842	666	176
RWE Energy	1,064	947	117
RWE npower	315	150	165
RWE Thames Water	1,388	1,465	-77
Other, consolidation	58	201[2]	-143
RWE Group	**3,667**	**3,429**	**238**

1 Including RWE Trading.
2 Including RWE Umwelt (€108 million) and Heidelberger Druckmaschinen (€53 million).

.ıpital expenditure on finan-
.al assets was up year on year,
but remained low.

35

Capital expenditure on financial assets totaled €476 million. This was €168 million more than in 2004. The most important projects were the acquisition of a combined cycle gas turbine plant in the UK* and increases in stakes held in subsidiaries in Central Eastern Europe. A counteractive effect was felt from the deconsolidation of RWE Umwelt and Heidelberger Druckmaschinen.

Capital expenditure on financial assets € million	**2005**	2004	+/- € million
RWE Power[1]	–	15	-15
RWE Energy	174	77	97
RWE npower	227	16	211
RWE Thames Water	17	66	-49
Other, consolidation	58	134[2]	-76
RWE Group	**476**	**308**	**168**

1 Including RWE Trading.
2 Including RWE Umwelt (€48 million) and Heidelberger Druckmaschinen (€17 million).

The following is an overview of investing activity by division:

Capital spending by ***RWE Power*** amounted to €842 million—up €161 million on the previous year. All of this money was earmarked for property, plant and equipment. This was contrasted by €787 million in depreciation. One of the investment magnets was the construction of two gas topping turbines with which we intend to improve the efficiency of the lignite-fired plant at our Weisweiler site in Germany. Furthermore, we began the construction of the 2,100 MW lignite power station in the vicinity of Cologne (Germany). In addition, we spent more capital on our opencast lignite mines. RWE Dea increased its capital expenditure on property, plant and equipment by €42 million to €290 million. Centre stage was taken by measures to develop the Mittelplate North Sea oilfield.

Capital spending at ***RWE Energy*** was up €214 million to €1,238 million. Property, plant and equipment accounted for €1,064 million. Depreciation totaled €916 million. Our investments concentrate on the expansion of our network infrastructure and the replacement of parts of the grid. This division employs about 80% of its funds for property, plant and equipment in these areas. RWE Energy also stepped up its investing activity outside Germany, with Poland leading the way.
RWE Energy spent €174 million on financial assets—€97 million more than in 2004. Of note is the increase of our stake in Polish-based STOEN from 85% to nearly 100%. Furthermore, we lifted our existing majority stakes in two regional gas distributors in the Czech Republic.

RWE npower increased its capital expenditure by €376 million to €542 million. At €315 million, capital expenditure on property, plant and equipment was more than twice as high as in 2004. The largest project was the commencement of the retrofitting of the Aberthaw power plant with a flue gas desulphurization unit. Depreciation on property, plant and equipment and intangible assets amounted to €455 million. RWE npower spent €227 million on financial assets for the acquisition of the 420 MW Great Yarmouth combined-cycle gas turbine (CCGT) power plant.

RWE Thames Water spent €1,405 million in capital. This was €126 million less than in 2004. Capital expenditure on property, plant and equipment decreased by €77 million to €1,388 million. This was largely due to the aforementioned balance sheet reclassification. Net of this one-off effect, capital spending on property, plant and equipment was roughly on par with the year-earlier level. In this division, capital expenditure focused on improving the water infrastructure in Greater London and our US supply areas. In the year under review, RWE Thames Water's depreciation of property, plant and equipment and intangible assets was €728 million.

Free cash flow improved by 9%. Cash flows from operating activities amounted to €5,304 million. We thus improved cash flows by 8%, despite the deconsolidation of Heidelberger Druckmaschinen (–€313 million) and RWE Umwelt (–€83 million). However, the previous year's figure was adversely affected by negative changes in working capital. Net cash used in investing activities totaled €2,049 million. This represents a substantial increase over the prior year. This was due to higher capital expenditure as well as the fact that we received less in proceeds from the sale of companies and asset disposals in 2005. Cash flows from financing activities totaled –€3,384 million. This is the amount by which debt repayments and dividend payments exceeded new debt. Cash and cash equivalents declined by €95 million over the course of the year.

Free cash flow was considerably higher, despite the increase in capital expenditure on property, plant and equipment.

Cash flows from operating activities, minus capital expenditure on property, plant and equipment, results in free cash flow. At €1,637 million, free cash flow was clearly higher than the dividend payments planned for the fiscal year that just ended. Compared to 2004 our free cash flow was up by €138 million, or 9%, despite the €238 million rise in capital expenditure on property, plant and equipment. The rise in free cash flow was driven by the improvement in cash flows from operating activities. Net of the deconsolidation of Heidelberger Druckmaschinen and RWE Umwelt, free cash flow advanced by 30%.

Cash flow statement[1] *€ million*	**2005**	2004	+/– in %
Cash flows from operating activities	5,304	4,928	7.6
Change in working capital	72	–623	111.6
Cash flows from investing activities	–2,049	–1,574	–30.2
Cash flows from financing activities	–3,384	–4,009	15.6
Effect of exchange rate fluctuations and other changes in value on cash and cash equivalents	34	–	–
Total net changes in cash and cash equivalents	–95	–655	85.5
Cash flows from operating activities	5,304	4,928	7.6
Minus capital expenditure on property, plant and equipment and intangible assets	–3,667	–3,429	–6.9
Free cash flow	**1,637**	**1,499**	**9.2**

1 This information only relates to continuing operations. Please turn to page 96 for a complete cash flow statement.

We increased equity by 17 % compared with the previous year.

Balance sheet structure: equity increased by €1.9 billion. We structured the balance sheet by maturity according to IAS in the consolidated financial statements for fiscal 2005 for the first time. Corresponding figures as of December 31, 2004 have been adjusted.

As of December 31, 2005, the balance sheet total was €108.1 billion. This represents an increase of €14.7 billion over the previous year. Significant price increases, above all for electricity and gas, led to a rise in assets from derivatives. This was contrasted by corresponding liabilities from derivatives. The effect described above was a major reason why "other receivables and other assets" rose by €9.9 billion. €3.3 billion of this sum is allocable to non-current assets and €6.6 billion is attributable to current assets. There was a positive currency effect on property, plant and equipment and intangible assets to the tune of €2.1 billion in total.

The aforementioned effects led to comparable changes on the liabilities side of the balance sheet. Other liabilities grew considerably primarily owing to the change in the market value of derivatives. They were €10.4 billion higher year on year. €4.0 billion thereof is allocable to non-current liabilities, and €6.4 billion is attributable to current liabilities. Provisions dropped by €0.3 billion. At the end of 2005 we had €13.1 billion in equity. Compared to 2004, this represents an increase of €1.9 billion. RWE's equity ratio was marginally higher, rising from 12.0 % to 12.1 %.

Balance sheet structure	**12/31/05**		12/31/04	
	€ million	%	€ million	%
Assets				
Non-current assets	70,344	65.1	65,406	70.1
Intangible assets	17,215	15.9	17,718	19.0
Property, plant and equipment	36,089	33.4	34,518	37.0
Current assets	37,778	34.9	27,964	29.9
Other receivables and other assets	11,112	10.3	4,550	4.9
Total	**108,122**	**100.0**	**93,370**	**100.0**
Equity and liabilities				
Equity	13,117	12.1	11,193	12.0
Non-current liabilities	64,302	59.5	60,321	64.6
Provisions	28,064	26.0	27,830	29.8
Financial liabilities	21,458	19.8	22,488	24.1
Current liabilities	30,703	28.4	21,856	23.4
Other liabilities	11,809	10.9	5,437	5.8
Total	**108,122**	**100.0**	**93,370**	**100.0**

Net worth, financial position and earnings situation of RWE AG (holding company)

Management holding company and Group Centre. RWE AG is the management holding company of the RWE Group. Through the Group Centre, it performs general management tasks. RWE AG's situation is largely determined by the Group's activities.

The financial statements of RWE AG, which have been issued an unqualified audit opinion by PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, are published in the *Bundesanzeiger (Federal Gazette)* and filed with the Commercial Register of the Essen District Court. They can be ordered from RWE AG and are also available on the Internet.*

* 01

The ***financial statements*** of RWE AG are prepared in accordance with the German Commercial Code and the German Stock Corporation Act. A brief overview is provided below:

Balance sheet of RWE AG (abridged) € million	**12/31/05**	12/31/04
Non-current assets		
Financial assets	43,155	42,306
Current assets		
Accounts receivable from affiliates	6,620	4,230
Other accounts receivable and other assets	405	470
Marketable securities and cash and cash equivalents	2,100	2,734
Total assets	**52,280**	**49,740**
Equity	5,995	4,981
Provisions	8,565	8,348
Accounts payable to affiliates	30,901	30,110
Other liabilities	6,819	6,301
Total equity and liabilities	**52,280**	**49,740**

Income statement of RWE AG (abridged) € million	2005	2004
Net income from financial assets	3,209	2,542
Net interest	-1,301	-1,611
Other expenses and income	277	522
Profit from ordinary activities	**2,185**	**1,453**
Taxes on income	-327	-209
Net profit	**1,858**	**1,244**
Transfer to retained earnings	-874	-400
Distributable profit	**984**	**844**

The ***net worth*** of RWE AG is determined by the management of investments and the activities it undertakes for the Group companies. The holding company holds the shares in the operating companies and handles financing for them. This is reflected in corresponding accounts receivable from and payable to affiliates.

Provisions for pension obligations also include coverage for the vested benefits of subsidiaries' current and former employees. RWE AG is reimbursed for pension expenses by the companies concerned.

* RWE AG's ***financial position**** is mainly characterized by the servicing of debt for the large-scale acquisitions made in recent years as well as by the procurement of financial resources for the subsidiaries' operating activities.

Dividend payment up 17%. RWE AG's net profit amounted to €1,858 million and was thus 49% up on the previous year. €874 million was transferred to retained earnings. Distributable profit thus totaled €984 million. The Supervisory Board and the Executive Board of RWE AG will propose to the April 13, 2006 Annual General Meeting that a dividend of €1.75 per share be paid for fiscal 2005. This dividend proposal would cause the dividend to rise by 17% compared with the previous year.

Workforce, research and development, procurement

Operating personnel changes led to a net increase of nearly 400 positions.

Employee headcount stable net of deconsolidation effects. As of December 31, 2005, the RWE Group employed 85,928 people (full time equivalent). This was 11,849 fewer, or 12 % less, than in the previous year. This development is nearly exclusively due to the sale of companies through which a total 12,400 staff members left the Group. The most significant impact was felt from the deconsolidation of RWE Umwelt (-10,408 employees). Subsidiaries that were included in the consolidated financial statements for the first time added 158 staff members. Operating personnel changes resulted in a net addition of 393 employees. Our trainees are not included in these figures. As in the previous years, in 2005 we trained far more people than we needed. As of December 31, 2005, 3,115 young adults were in a professional training programme at RWE.

Workforce[1]	12/31/05	12/31/04	+/- in %
RWE Power[2]	18,702	18,792	-0.5
RWE Energy	37,598	39,861	-5.7
RWE npower	10,125	9,555	6.0
RWE Thames Water	16,306	16,051	1.6
Other[3]	3,197	13,518	-76.4
RWE Group	**85,928**	**97,777**	**-12.1**
Germany	43,579	55,407	-21.3
Outside Germany	42,349	42,370	-

1 Converted to full time equivalent.
2 Including RWE Trading.
3 Including RWE Systems; the previous year's figure also includes RWE Umwelt (10,408 employees).

Research and development: focus on efficiency improvements and reducing emissions of power generation activities. In fiscal 2005 we spent €55 million on research and development (R & D). This was much less than in the prior year (€114 million). In the past, the lion's share of our R & D activities related to Heidelberger Druckmaschinen, which we deconsolidated in 2004. In the year under review, 223 staff members were entrusted with R & D tasks.

For energy and water, product innovations are of little importance. Ensuring the security, efficiency and affordability of our utility products and services is crucial to our competitiveness. To this end, we gradually optimize existing processes across all parts of the value chain. Moreover, we are working on putting new technologies into practice, going as far as readying them for commercial use on a large technical scale. The lion's share of our major R & D projects, most of which we conduct in cooperation with external partners from the fields of industry and research, pursue this objective. Therefore, the activities are only partially included in our R & D expenditure.

In the field of ***power generation***, we have initiated the first phase of activities seeking to improve the efficiency with which our power plants use primary energy sources and reduce emissions in the short term. In 2005 major progress was made in the development of lignite drying methods before the combustion process in power plants. These techniques will enable the improvement of the efficiency of new lignite power station blocks by some four percentage points over the current state of the art. With the successful field trials of a fine grain fluidized bed drying method developed in-house behind us, the technique is ready for commercial use. In 2005 we initiated preparatory work for the construction of a pilot plant at the most modern lignite power station we have at present in Niederaussem in the vicinity of Cologne (Germany).

Moreover, we are involved in the development of innovative materials and components for a new generation of coal-fired power plants operating with steam temperatures of 700 °C and a steam pressure of 350 bar. The state of the art is 600 °C and 270 bar. The first uninterrupted trial runs have been underway since 2005. This will pave the way to increasing the efficiency of power production from hard coal and lignite by another four percentage points to more than 50 %. Currently, the world average is 31 %.

In the medium to long term, our R & D activities will centre on refining methods for CO_2 sequestration in power station processes as well as subsequent CO_2 compression and safe underground storage. Our involvement in EU-subsidized multi-party projects makes a contribution to this cause. We are exploring technologies for CO_2 separation before and after combustion in power stations within the scope of the "ENCAP" and "CASTOR" projects. As part of the "CO_2SINK" project, we are conducting tests today to explore whether large amounts of carbon dioxide can be stored underground safely. The project is being carried out in Ketzin in the German state of Brandenburg. About 100 metric tons of CO_2 will be buried 700 metres under the ground at this site per day in the next two years.

We also extended our range of activities in the field of ***distributed power supply***. Our efforts are primarily directed to bringing a number of distributed power generation techniques to market for use in small customer units such as multiple-family homes. To this end, we designed facilities running on fuel cells, Stirling engines and micro gas turbines with an electric output of up to about 15 kW.

Innovative processes for assessing the state of cable networks are one of the areas we are working on in the field of ***power and gas grids***. These techniques will allow ageing indicators to be detected early enough for servicing work to be carried out in order to ensure that supply interruptions are reduced to a minimum.

In the ***water sector***, our R&D activities primarily focus on reliably and efficiently supplying our customers with high-quality water and wastewater management services through the use of innovative technologies. In addition, RWE Thames Water leads the world in expertise in sea water desalination methods through its Spanish subsidiary Pridesa.

Procurement structures further improved. We pool our purchasing activities through corporate procurement in order to reduce costs. To this end, we increasingly employ modern supply management processes. Related projects include Web-based tools such as our Group purchasing portal, electronic catalogues, online auctions and Internet-based bidding processes. Not only does this enable us to leverage economies of scale, but it also allows us to optimize procurement processes. Our purchasing procedures are generally coordinated by RWE Systems. RWE Trading, RWE Power and RWE Energy are in charge of raw materials procurement.

In 2005 we intermittently reduced electricity production in Germany owing to the rise in hard coal prices, causing us to use less of this fuel.

* 184

The amount of hard coal purchased to generate electricity dropped from 23 million metric tons of hard coal units* (HCU) in 2004 to approximately 21 million metric tons in 2005. This includes coal used in power plants not owned by RWE that we can deploy at our discretion on the basis of long-term agreements. At RWE Power, hard coal usage decreased by 2.7 million metric tons of HCU to 14.7 million metric tons. The decline is attributable to third-party power plants whose capacity utilization decreased considerably as a result of high coal and CO_2 costs. Their hard coal consumption dropped from 12.2 million metric tons to 9.5 million metric tons of HCU. Hard coal consumption in RWE's in-house power stations matched the prior-year level, at 5.2 million metric tons of HCU. RWE npower used 6.1 million metric tons of HCU to run its power stations. This represents a slight increase over the prior year.

In 2005 the average spot price for imported hard coal in Europe's sea ports was €57 per metric ton of HCU—15% lower than in the prior year. Reduced freight costs were one of the reasons for this decline. Our long-term German hard coal purchasing agreements are based on prices set by the German Federal Office of Economics and Export Control (BAFA)*, which rose by 18% to €65 averaged for the year. The divergent price developments are due to the fact that BAFA prices track spot prices, with a lag of several months. Therefore, BAFA prices still partially reflected the high spot prices seen in 2004.

RWE sources lignite from proprietary opencast mines. In the Rhineland, our main mining region, we produced more than 97 million metric tons of lignite in 2005. Our power plants used 88 million metric tons to generate electricity, and we used 9 million metric tons to manufacture refined products.

In the year being reviewed, we further improved the organizational structure of our gas procurement activities in Continental Europe. Purchasing is now managed centrally from Prague via RWE Transgas. In the reporting year, we sourced some two thirds of the gas we used directly from producers. Upstream companies in Russia and Norway are among the RWE Group's most important gas suppliers. In 2005 the RWE Group purchased a total of about 430 billion kWh of gas. This represents an increase of 10 billion kWh over the previous year. The gas procurement cost trend in the year under review was marked by the boom on the world oil market. This is because gas prices are contractually linked to oil prices in supply agreements in Continental Europe. Average import prices in 2005 in Germany were 35% up year on year. Prices quoted on the UK spot market for natural gas were more than 40% higher than in 2004.

Groupwide purchases of electricity from third parties (excluding amounts purchased for trading purposes) amounted to 98.3 billion kWh. RWE Energy accounted for 72.7 billion kWh. RWE npower accounted for 25.6 billion kWh, which were largely purchased via RWE Trading.

Risk management

Groupwide risk management system records, evaluates, controls and monitors risks.

Proven systems for identifying and monitoring risks and opportunities. Continuous early detection and standardized recording, evaluation, control and monitoring of risks are handled by the RWE Group using a groupwide risk management system. We strive to obtain information on risks and their financial impact as early as possible in order to counter them with suitable measures. We also aim to detect and seize existing opportunities along with their earning potential through our budgeting and controlling process.

To strike a proper balance between profit opportunities and potential losses in the long term, risks must be systematically included in the decision-making process in accordance with uniform Group standards. The operating units identify and report risks in line with their accountability to the RWE Group's risk management officers who examine the risk profile on the basis of the Group's guidelines. This method fulfils the Executive Board's reporting duties pursuant to the German Controlling and Transparency in the Corporate Sector Act (KonTraG). Beyond this, thanks to its holistic approach, it also promotes the continued development of a value-based risk culture within the RWE Group.

We fully integrated risk reporting in our budgeting and controlling process.

We evaluate risks according to their damage potential and probability of occurrence and aggregate them at the business unit, divisional and Group levels. Here, a risk's damage potential is defined against reference variables, i. e. the operating result and equity of the business unit concerned or the Group as a whole. We can thus ensure a systematic and uniform analysis of our current risk situation throughout the Group, on the basis of which specific risk-control initiatives can be developed for the business units concerned. Our risk reporting scheme is fully integrated in our standardized budgeting and controlling process. The RWE Group's management and supervisory bodies are regularly informed of the current risk situation. The efficiency and efficacy of our risk management system is monitored internally and verified by the external auditor.

We break down major risks and opportunities into the following categories:

- *Business risk:* At present, there are no identifiable risks that could jeopardize the continued operation of RWE AG or the RWE Group.

- *Changes in the general economic climate:* Economic trends in our core markets can affect the degree of capacity utilization, having either a positive or negative impact on revenue and results.

- *Changes in the price of commodities:* Certain risks and opportunities are inherent in our production operations, and above all in our electricity generation business. The latter is significantly influenced by the development of market prices for electricity, fossil fuels—especially hard coal and gas—as well as by the development of the price of CO_2 certificates. A risk arises, e. g., if higher commodity prices cannot be passed on by increasing electricity prices. Opportunities stem from the widening of the spread between electricity prices and prices for fossil fuels. In addition to production, sales operations are also exposed to risks. Such risks arise, e. g., as a result of unexpected fluctuations in demand owing to changes in temperature. Our price risks on purchasing and sales markets are determined using special evaluation models, while taking current forward prices and expected price volatility into account. Among other things, we use financial derivatives to mitigate risks associated with sales and procurement. Additional risks and opportunities arise from our oil and gas production operations. Unexpected disadvantageous changes in price in this area are also minimized through the strategic use of derivative hedges.

  Our electricity and gas businesses face the price and sales risks as well as marketing opportunities resulting from the deregulation of Europe's electricity and gas markets. We address these risks with differentiated pricing strategies and appropriate marketing policies as well as with effective measures to cut costs.

  Our trading activities are principally designed to mitigate earnings risks stemming from price fluctuations on energy markets. In this context, our trading business functions as a central platform for hedging commodity price risks throughout the RWE Group. This enables us to create a stable basis of planning for our company. In addition, we conclude trades in order to take strategic advantage of price changes to a limited extent. This leads to risks from unexpected price fluctuations as well as credit risks in the event that trading partners fail to fulfil their contractual obligations. The RWE Group's integrated trading and risk management system is firmly aligned with best practice as applied to the trading business. Specific benchmarks for price risks are established on a daily basis. The RWE AG Risk Committee* sets risk limits that are continuously monitored. Among other things, we use the value-at-risk method* to quantify price risks associated with energy trading.

- *Operating risks:* We operate technologically complex and interconnected production plants all along our value chain. Earnings risks can arise from uninsured damage to our lignite mining equipment, production plants, or power plant components. Risks associated with possible outages caused by the ageing of components in our power stations will increase. Our grid business is exposed to the risk of facilities being destroyed by force majeure such as severe weather conditions. We address these risks through high safety standards as well as regular audit, maintenance and servicing work. As appropriate, insurance policies also limit possible effects of damage.

- *Changes in prices in the finance sector:* Within the scope of our operations, we are also exposed to currency, interest-rate and share-price fluctuation risks. Due to our international presence, currency risk management is very important. The pound Sterling and US dollar are our major foreign currencies. RWE conducts sizeable operations in these currency zones. Furthermore, fuel prices are quoted in these currencies. Group companies outside the Eurozone are generally obliged to hedge all local currency risks via the Group's holding company, RWE AG. The parent company determines the net financial position for each currency and hedges it with external market partners if necessary. Risks are quantified using the value-at-risk (VaR) method, as is the case with commodity price risks. The Executive Board of RWE AG has established a system that limits risks. On December 31, 2005, the VaR for RWE AG's foreign currency position was €0.2 million. Interest rate management is also ascribed significant importance. Our interest-rate risk primarily stems from our financial debt and interest-bearing investments. Interest-rate risks arise whenever the interest curve rises or falls. Negative changes in value caused by unexpected interest-rate movements are hedged with non-derivative and derivative financial transactions. At the end of 2005, the VaR from interest obligations connected to our financial debt and associated hedges was €56.1 million. The VaR from interest-bearing investments including hedges amounted to €21.5 million. We are also exposed to both risks and opportunities associated with share investments. The VaR for share price risks was €19.4 million. Opportunities and risks from changes in the value of securities are controlled by a professional fund management system.

Financial transactions at the Group level are recorded using centralized risk management software and monitored by RWE AG. This enables the balancing of risks across individual companies. A more detailed description of the tools used to hedge financial risks can be found in the notes.* Range of action, responsibilities and controls are set forth in internal guidelines to which our Group companies are obliged to adhere.

* 151

- *Credit risks:* Most of the credit transactions performed by our finance and trading departments are with banks and business partners of good credit standing. We mitigate credit risks in both sectors by placing limits on transactions and—if necessary—receiving cash collateral. In addition, we conclude credit insurance policies and bank guarantees. Credit risks are monitored daily for trading transactions and weekly for finance transactions.

  In our sales business, we are exposed to credit risks due to the possibility that customers may fail to meet their financial obligations. We mitigate this risk by subjecting our customer portfolio to a regular creditworthiness check in compliance with our credit risk guidelines.

- *Liquidity risk:* RWE AG usually handles the refinancing of the liabilities of its fully consolidated subsidiaries that mature. Here, risks arise if liquidity reserves are no longer sufficient for the Group to meet its financial obligations in a timely manner. Cash and cash equivalents and marketable securities worth a combined €12.8 billion (as of the end of 2005) are available to cover our capital requirement. In addition, we have a fully committed syndicated credit line of €4.0 billion as well as a considerable amount of unused funds from the aforementioned US$ 5.0 billion commercial paper programme and €20.0 billion debt issuance programme.* This makes the liquidity risk very low.

* 154

- *Regulatory risks:* The RWE Group's exposure to the constant change in the political, legal and social environment in which it does business can be expected to have an impact on earnings. Lignite and hard coal power plants account for a significant portion of our electricity generation portfolio. This represents a risk due to the EU-wide CO_2 emissions trading system. Risks can arise from changes made to the allocation rules and national emissions plans for the second trading period (2008-2012) and from unexpected increases in the price of CO_2 certificates. Therefore, CO_2 price risk management is an integral component of our centralized risk management system. We intend to continue reducing specific CO_2 emissions and make our overall portfolio more flexible by investing in power plants in the future.

  Earnings risks exist in the grid business as a result of the regulation of the German electricity and gas sectors. We intend to largely offset the negative effects stemming from the enforcement of the German Energy Act in fiscal 2006 by taking additional measures to cut costs and enhance efficiencies throughout the entire RWE Energy Group. Naturally, however, there is still some uncertainty as regards the extent of the impact from regulation.

- *IT risks:* RWE has established a mandatory groupwide process for engineering, managing and auditing IT projects in order to manage IT risks during the development of IT solutions designed to support business processes. IT operations are handled by modern computing centres which continuously update both hardware and networks. They are subject to a groupwide security directive, compliance with which is regularly monitored.

- *Capital expenditure and divestments:* Decisions approving acquisitions and capital expenditure on property, plant and equipment must take into account both the opportunities and risks associated with tying up capital for extensive periods of time. At RWE, such decisions are prepared and implemented in adherence with specific accountability rules and approval processes. The same applies to divestments such as the planned sale of our UK and North American water activities.

- *Legal risks:* RWE Group companies are involved in litigations and arbitration proceedings connected with their operations. However, RWE does not expect any major negative repercussions from these proceedings on the RWE Group's economic or financial position. Additionally, companies belonging to the RWE Energy Division are directly involved in various administrative and regulatory procedures (including approval procedures) or are directly affected by their results.

  Raw materials production and power generation activities might be curtailed by risks arising from approval processes for our opencast mines and nuclear power plants. We prepare our applications for approval with great care and ensure that approval processes are handled competently in order to prevent such risks from arising.

  Outside shareholders initiated several legal proceedings to examine the appropriateness of the conversion ratios and the amount of cash paid in compensation in connection with company restructurings pursuant to German company law. We are convinced that the conversion ratios and cash compensation calculated on the basis of expert opinions and verified by independent auditing firms are adequate and will stand up to scrutiny in court.

Outlook for 2006

According to estimates by economic research institutes, the economic environment in our core markets continues to be favourable.

Economic research institutes forecast stable economy. According to estimates by leading economic institutions, the world economy will keep its momentum in 2006. A major slowdown does not seem likely at present. Germany, our largest market, is expected to increase gross domestic product (GDP) by 1.2%—a slightly higher growth rate than in 2005. Cautious optimism is based on an expected reform of economic policy that could bolster investment. Persistently moderate euro exchange rates could stimulate exports. Consumer spending is also forecasted to post a marginal increase. The moderate cyclical upturn witnessed in the UK since the end of 2005 is likely to continue given the rise in consumer confidence. Since interest rates are low and corporate earnings forecasts are favourable at present, investment is expected to pick up. Nevertheless, real GDP growth will remain moderate. Initial forecasts have GDP rising by just under 2%. EU member states in Central Eastern Europe are anticipated to consolidate their positive economic trends. Real GDP in some of these economies is expected to grow by more than 4%. Conversely, prognoses for the USA have worsened somewhat. Interest rate hikes could dampen growth. Regardless of this, economic research institutes expect that price-adjusted growth will exceed 3%, falling just shy of the performance achieved in 2005.

Due to the oil price boom, prices for other primary energy sources and CO_2 certificates are expected to remain high.

Prices for primary energy sources and CO_2 remain high. The high level of prices on the world's energy markets is expected to persist in 2006. In light of the continued scarcity of production capacity, crude oil prices are not anticipated to drop significantly in the near future. Furthermore, energy prices are exposed to additional risks from unstable political situations—above all in the Middle East. Gas prices will remain high as long as the boom on the oil market persists. Hard coal prices in northwestern Europe were on a downward trend in 2005 following the records posted in 2004. They have risen somewhat of late. As explained earlier, prices established by the German Federal Office for Economics and Export Control (BAFA), which are of key importance for Germany, track spot prices on the European market with a lag of several months. Therefore, we expect they will be below 2005 levels averaged over the year.

Power production costs are affected by the development of prices on fuel markets as well as pan-European emissions trading. Certificates currently trade for €26.70 per metric ton of CO_2 (as of February 10, 2006). They are thus much more expensive than the average for 2005 (€18). As mentioned above, due to the persistently