ties from finance lease agreements are measured at the lower of fair value of the leasing object or present value of minimum lease payments.

Prepayments from customers and deferred income are recognized as liabilities under other liabilities. Deferred income includes advances and contributions in aid of construction and building connection that are carried as liabilities by the utilities which are generally amortized and included in income over the term of the corresponding asset. Moreover, this item also generally includes taxable and non-taxable government grants for capital expenditure on non-current assets, which are recognized as other operating income in line with the assets' depreciation.

***Derivative financial instruments and hedging transactions.*** Derivative financial instruments are accounted for as assets or liabilities. When recorded for the first time, they are stated as of the settlement date. All derivative financial instruments are stated at fair value regardless of their purpose. Changes in the fair value are recognized with an effect on income, unless the instruments are used for hedging purposes. In such cases, recognition of changes in the fair value depends on the type of hedging transaction.

Fair value hedges are used to hedge the risk of a change in the fair value of an asset or liability carried on the balance sheet. Hedges of unrecognized firm commitments are also recognized as fair value hedges. For fair value hedges changes in the fair value of the hedging instrument are stated in the income statement, analogously to the changes in the fair value of the respective underlying transactions, i.e. gains and losses from the fair valuation of the hedging instrument are allocated to the same line items of the income statement as those of the related hedged item. In this regard, changes in the fair value must pertain to the hedged risk. In the event that unrecognized firm commitments are hedged, changes in the fair value of the firm commitments with regard to the hedged risk result in the recognition of an asset or liability with an effect on income.

Cash flow hedges are used to hedge the risk of variability in cash flows related to an asset or liability carried on the balance sheet or related to a highly probable forecast transaction. If a cash flow hedge exists, unrealized gains and losses from the hedge are initially stated as other comprehensive income. Such gains or losses are disclosed in the income statement as soon as the hedged underlying transaction has an effect on income. If forecast transactions are hedged and such transactions lead to the recognition of a financial asset or financial liability in subsequent periods, the amounts that were recognized in equity until this point in time must be recognized in the income statement in the period during which the asset or liability affects the income statement. If non-financial assets or liabilities result from the transaction, the amounts recognized in equity without an effect on income are included in the initial cost of the asset or liability.

Hedges of a net investment in a foreign entity are used to hedge the currency risk from investments with foreign functional currencies. Unrealized gains and losses from hedges are recognized as part of the currency translation adjustment in other comprehensive income until the investment is sold.

IAS 39 sets certain conditions for hedge accounting. In particular, the hedging relationship must be documented in detail and be effective, i. e. the changes in the fair value of the hedging instrument must be within 80 % to 125 %, both prospectively and retrospectively, of the opposite change in the fair value of the hedged item. Only the effective portion of a hedge is recognized in accordance with relevant rules for fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. The ineffective portion of a hedge is recognized immediately in the income statement with an effect on income.

Contracts that were entered into and continue to be held for the purpose of receipt or delivery of non-financial items in accordance with the company's expected purchase, sale or usage requirements (own-use contracts) are not recognized as derivative financial instruments and are accounted for as pending contracts. Written options to buy or sell a non-financial item, that can be settled in cash, are not own-use contracts.

Results of derivative energy trading activities are stated in net amounts.

***Contingent liabilities.*** Contingent liabilities are possible obligations to third parties or present obligations, which are not recognised because it is not probable that an outflow of economic benefits will be required to settle the obligations or the amount of which cannot be measured reliably. On principle, contingent liabilities are not recognized on the balance sheet. The amounts disclosed in the notes correspond to the exposure at the balance-sheet date.

***Management judgments in the application of accounting policies.*** Management judgments are required in the application of accounting policies. In particular, this pertains to the following items:

- With regard to certain contracts a decision must be made as to whether they are to be treated as derivatives or as so-called own-use contracts, and be accounted for as pending contracts.
- Financial assets must be allocated to the categories "held to maturity investments", "loans and receivables", "financial assets available for sale", and "financial assets at fair value through profit or loss".
- With regard to provisions for pensions and similar liabilities, there are various options for the recognition of actuarial gains and losses.
- With regard to assets held for sale, it must be determined if the assets can be sold in their current condition and if the sale of such is highly probable. If that is the case, the assets and any related liabilities must be reported and measured as "assets held for sale" or "liabilities held for sale", respectively.
- RWE Thames Water has capitalized €83 million in planning and construction expenses under "Property, plant and equipment" in relation to a planned desalination water treatment plant at Beckton in East London. However, planning permission for this plant has not been granted following the intervention of the Mayor of London. RWE Thames Water has appealed this decision, on the grounds that the plant is an essential element in securing adequate supplies of water to the population of London. The current position reflects the best estimate of the outcome of the appeal. If it emerges at any stage that the current judgment needs to be revised, then a reappraisal of the amounts capitalized may become necessary.

The explanation of the accounting policies contains a description of the decisions taken by the RWE Group with regard to these items.

***Management estimates and judgments.*** Preparation of consolidated financial statements pursuant to IFRS requires assumptions and estimates to be made, which have an impact on the recognized value of the assets and liabilities carried on the balance sheet, on income and expenses and on the disclosure of contingent liabilities.

Among other things, these assumptions and estimates relate to the accounting and measurement of provisions, whereby the discount rate for pension provisions and similar obligations is one very important estimate. An increase or decrease of one percentage point in the discount rate would result in a reduction of €1,510 million or an increase of €1,660 million, respectively, in the pension obligations of the pension plans in Germany. For the group companies in the UK, an increase or decrease of one percentage point in the discount rate would reduce or increase pension obligations by €750 million or €928 million, respectively. An increase or decrease of one percentage point in the discount rate would result in a €141 million reduction or a €163 million increase, respectively, in the pension obligations of the US group companies. As actuarial gains and losses may only be recognized if they exceed 10% of the greater of the total pension obligations or the fair value of the plan assets, changes in the discount rate for the benefit systems in the RWE Group do not generally have an effect on the carrying amount of the provisions in the following fiscal year.

Above and beyond this, the impairment test for goodwill is also based on certain key assumptions pertaining to the future. Based on current knowledge, changes in these key assumptions will not cause the carrying amounts of the cash-generating units to exceed the recoverable amounts, and thus lead to an adjustment of the carrying amounts in the next fiscal year. Due to the planned disposal of the UK and North American water business, the valuation of these cash-generating units is based on market-related data, and changes in such may have an impact on the carrying amount. In particular, the valuation depends on equity market conditions, the development of long-term interest rates on the capital market, the development of assets subject to regulation and the decisions of the local regulatory authorities.

All assumptions and estimates are based on the circumstances and forecasts prevailing on the balance-sheet date. Furthermore, as of the balance-sheet date realistic assumptions regarding the future development of overall economic conditions in the sectors and regions in which the Group conducts operations are taken into consideration with regard to the expected future development of business. Actual amounts may deviate from the estimated amounts due to deviation between the assumptions and the actual development of such overall conditions. In such cases, the assumptions, and, if necessary, the carrying amounts of the affected assets and liabilities are adjusted accordingly.

As of the date of preparation of the consolidated financial statements it is not presumed that there will be a material change in the assumptions and estimates, and therefore viewed from the current perspective there is no expectation of material adjustment to the carried amounts of the recognized assets and liabilities in the 2006 fiscal year.

# Changes in accounting policies

The International Accounting Standards Board (IASB) has approved a number of changes to the existing International Financial Accounting Standards (IFRSs) and adopted several new IFRSs, which became effective as of January 1, 2005. The RWE Group is applying the following IFRSs in the reporting period for the first time:

| | |
|---|---|
| *IAS 1 (2003)* | "Presentation of Financial Statements" |
| *IAS 2 (2003)* | "Inventories" |
| *IAS 8 (2003)* | "Accounting Policies, Changes in Accounting Estimates and Errors" |
| *IAS 10 (2003)* | "Events After the Balance-Sheet Date" |
| *IAS 16 (2003)* | "Property, Plant and Equipment" |
| *IAS 17 (2003)* | "Leases" |
| *IAS 21 (2003)* | "The Effects of Changes in Foreign Exchange Rates" |
| *IAS 24 (2003)* | "Related Party Disclosures" |
| *IAS 27 (2003)* | "Consolidated and Separate Financial Statements" |
| *IAS 28 (2003)* | "Investments in Associates" |
| *IAS 31 (2003)* | "Interests in Joint Ventures" |
| *IAS 32 (2003)* | "Financial Instruments: Disclosure and Presentation" |
| *IAS 33 (2003)* | "Earnings per Share" |
| *IAS 39 (2004)* | "Financial Instruments: Recognition and Measurement" |
| *IAS 40 (2003)* | "Investment Property" |
| *IFRS 2* | "Share-based Payment" |
| *IFRS 4* | "Insurance Contracts" |
| *IFRS 5* | "Non-current Assets Held for Sale and Discontinued Operations" |
| *IFRIC 2* | "Members' Shares in Co-operative Entities and Similar Instruments" |
| *SIC-12 (2004)* | "Consolidation—Special Purpose Entities" |

First-time application of the aforementioned IFRSs had the following material effects on the RWE Group's annual financial statements for the period ended December 31, 2005:

According to ***IAS 1 (2003)***, balance sheets must be classified by maturity. Therefore, assets and liabilities on the balance sheet of the RWE Group are classified as non-current or current. Assets and liabilities are classified as current if they are expected to be realized / settled within twelve months after the balance-sheet date, or if they can be realized or settled within the normal operating cycle.

Investment property is now stated separately from property, plant and equipment under non-current assets. Investments accounted for using the equity method are stated separately. Other non-current financial assets largely consist of the remaining other investments and non-current securities.

Loans are stated as current or non-current financial receivables, in line with their maturities. As a rule, trade accounts receivable and payable are stated as current items.

Provisions for pensions and similar obligations are stated under non-current liabilities, in line with their nature. All other obligations are stated under current or non-current liabilities, in line with their maturity.

On principle, deferred taxes are classified on the balance sheet as non-current. Prepaid expenses and deferred income are no longer stated separately on the balance sheet. Instead, they are stated under "Other receivables and other assets" and "Other liabilities," respectively.

In the income statement, income from investments accounted for using the equity method is stated separately from other income from investments. Financial income is stated separately from finance costs.

***IAS 39 (2004)*** introduces minor changes in hedge accounting. Hedges of unrecognized firm commitments are now generally recognized as fair value hedges instead of as cash flow hedges. If forecast transactions are hedged and such transactions lead to the recognition of a financial asset or financial liability in subsequent periods, the amounts that were recognized in equity until this point in time must be recognized in the income statement in the period during which the asset or liability affects the income statement. If non-financial assets or liabilities result from the transaction, the amounts recognized in equity without an effect on income are included in the initial cost of the asset or liability.

IAS 39 (2004) has established a firm scope of application for the purchase and sale of non-financial items. Consequently, contracts that were entered into and continue to be held for the purpose of receipt or delivery of non-financial items in accordance with the company's expected purchase, sale or usage requirements (own-use contracts) are not under the scope of IAS 39 (2004). Written options to buy or sell a non-financial item that can be settled in cash are not own-use contracts.

The first-time application of IAS 39 (2004) led to immaterial changes from the previous approach. Taking issues of materiality into account, there was no need to adjust amounts stated for the previous year.

***IFRS 5*** sets out requirements for the measurement, presentation and disclosure of certain non-current assets, asset groups and associated liabilities that have been, or are intended to be sold ("disposal groups"), as well as operations that have been sold or are held for sale ("discontinued operations"). Assets, and if applicable liabilities, must be stated separately on the balance sheet as "held for sale", if they can be sold in their present condition, and if their sale is highly probable. Non-current assets and disposal groups classified as held for sale are measured at the lower of the carrying amount or fair value less costs to sell. IFRS 5 stipulates that additional information on discontinued operations must be included in the notes. Application of IFRS 5 has caused certain assets and disposal groups to be classified as "held for sale" or as "discontinued operations". Related information is provided in the notes on the scope of consolidation.

***Accounting for $CO_2$ emission allowances.*** RWE has been subject to the European emissions trading scheme since January 1, 2005. Companies affected by the scheme are allocated $CO_2$ emission allowances, which must be returned to the authority in charge within four months from the end of the calendar year in line with the $CO_2$ actually emitted during the year. If actual $CO_2$ emissions exceed the allocation for the year, allowances needed to make up the difference must be bought.

In the consolidated financial statements, purchased $CO_2$ allowances are accounted for as current intangible assets at cost, while allowances obtained free of charge are stated at €0. A provision is recognized to cover the obligation to return emission allowances which is measured at the carrying amount of the capitalized $CO_2$ emission allowances. If a portion of the obligation is not covered by existing allowances, then the provision for this portion of the obligation is measured at the market price of the allowances on the cut-off date.

# *New accounting policies*

The International Accounting Standards Board (IASB) and International Financial Reporting Interpretations Committee (IFRIC) have adopted further standards and interpretations, which were not yet effective in the 2005 financial year. These IFRSs can only be applied if they are endorsed by the EU, which is still pending in some cases.

*IFRS 6 **"Exploration for and Evaluation of Mineral Resources"*** includes rules for accounting expenses related to the exploration and evaluation of minerals, oil, natural gas and similar finite resources before their technological and economic production can be proven. IFRS 6 does not mandate an accounting policy specific to exploration and evaluation expenses. Instead, it sets forth the basic conditions under which the company preparing the accounts selects an accounting method. Furthermore, IFRS 6 prescribes that impairment tests pursuant to IAS 36 be carried out on exploration and evaluation assets. IFRS 6 becomes effective for the first time for fiscal years starting on January 1, 2006, or thereafter. First-time application of IFRS 6 is not expected to have any material impact on the RWE Group's consolidated financial statements.

*IFRS 7 **"Financial Instruments: Disclosures"*** combines and expands disclosures on financial instruments previously required under IAS 32 and under IAS 30. The latter was previously only required of banks and similar financial institutions. IFRS 7 will be effective for all industries in the future. As part of the development of IFRS 7, IAS 1 was amended to add requirements for disclosures about capital management. IFRS 7 and the amendment to IAS 1 become effective for the first time for fiscal years that start on January 1, 2007, or thereafter.

*IAS 19 **Amendment (2004) "Actuarial Gains and Losses, Group Plans and Disclosures"***. By adopting the change to IAS 19 "Employee Benefits" in December 2004, the IASB introduced another option for treating actuarial gains and losses, also allowing for them to be accounted for without an effect on the income statement in the future. In addition, further disclosures on pension commitments will become necessary in the future. IFRS 19 (2004) becomes effective for the first time for fiscal years starting on January 1, 2006, or thereafter. With exception of the necessary additional information in the notes, first-time application of the new version of IAS 19 is not expected to have a material impact on the RWE Group's consolidated financial statements.

***IFRIC 4 "Determining Whether an Arrangement Contains a Lease"*** contains criteria for identifying lease elements in arrangements which are not formally referred to as leases. Contractual elements that meet IFRIC 4 criteria must be accounted for as leases in accordance with IAS 17. The application of IFRIC 4 becomes effective for the first time for fiscal years starting on January 1, 2006, or thereafter. First-time application of this Interpretation is not expected to have any material impact on the RWE Group's consolidated financial statements.

***IFRIC 5 "Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds"*** governs the recognition and measurement of claims and obligations from funds accrued for the decommissioning of plants and similar obligations. This Interpretation becomes effective for the first time for fiscal years starting on January 1, 2006, or thereafter. No material impact on the RWE Group's consolidated financial statements is expected.

***IFRIC 6 "Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment"*** governs the accounting of provisions related to disposal liabilities stemming from the European Union's Directive on Waste Electrical and Electronic Equipment. The application of IFRIC 6 becomes effective for the first time for fiscal years starting on December 1, 2005, or thereafter. Here again, no material impact on the RWE Group's consolidated financial statements is expected.

***IFRIC 7 "Applying the Restatement Approach under IAS 29 'Financial Reporting in Hyperinflationary Economies'"*** clarifies certain issues related to the application of IAS 29 for cases in which the country, the currency of which is the functional currency of the reporting enterprise, becomes a hyperinflationary country. The application of IFRIC 7 becomes effective for the first time for fiscal years starting on March 1, 2006, or thereafter. First-time application of IFRIC 7 is not expected to have any material impact on the RWE Group's consolidated financial statements.

***Additional amendments to IAS 39*** were also adopted by the IASB, which become effective for the first time for fiscal years starting on January 1, 2006, or thereafter. These amendments relate to the option to classify financial instruments as "financial assets or financial liabilities recognized at fair value through profit and loss," to the recognition of cash flow hedges for hedging currency risks associated with forecast transactions that have a high probability of occurrence within a group, and to the recognition of financial warranties issued, which will fall under the scope of IAS 39 in the future.

# Notes to the Income Statement

## (1) Revenue (including natural gas tax / electricity tax)

Revenue is recorded when the risk stemming from a delivery or service has been transferred to the customer. This does not apply to contract revenue recognized under the percentage of completion method for customer-specific construction contracts.

To improve the presentation of the business development, revenue generated by energy trading operations is stated as net figures. This means that revenue only reflects realized gross margins. By contrast, electricity, gas, coal and oil transactions that are subject to physical settlement are stated as gross figures. Energy trading revenue is generated by RWE Trading. In fiscal 2005, gross revenue (including energy trading) amounted to €59,403 million (previous year: €58,060 million).

The segment reporting on pages 157 to 160 contains a breakdown of revenue (including natural gas tax / electricity tax) by division and geographical region. Of the €41,819 million in revenue (previous year: €42,137 million), €10 million (previous year: €327 million) are attributable to revenue from customer-specific construction contracts. Deconsolidations and first-time consolidations reduced revenue by a net €3,994 million.

Natural gas tax / electricity tax are the taxes paid directly by Group companies.

## (2) Other operating income

| € million | 2005 | 2004 |
|---|---|---|
| Release of provisions | 798 | 1,508 |
| Disposal of non-current assets including income from deconsolidation | 344 | 543 |
| Disposal and write-back of current assets excluding marketable securities | 174 | 68 |
| Derivative financial instruments | 59 | 70 |
| Currency gains | 283 | 275 |
| Cost allocations / refunds | 129 | 59 |
| Rent and lease | 53 | 40 |
| Compensation for damage / insurance benefits | 69 | 33 |
| Miscellaneous | 528 | 664 |
| | **2,437** | **3,260** |

Income from the disposal of non-current financial assets and loans is disclosed under income from investments if it relates to investments; otherwise it is recorded as part of the financial result as is the income from the disposal of current marketable securities.

In addition to currency gains, there are also currency losses which are disclosed under other operating expenses.

Miscellaneous other operating income includes €39 million in income from the disposal of assets held for sale.

A decrease of €369 million in other operating income is attributable to changes in the scope of consolidation.

## *(3) Cost of materials*

| € million | 2005 | 2004 |
|---|---|---|
| Cost of raw materials and of goods for resale | 20,077 | 17,734 |
| Cost of purchased services | 4,423 | 5,241 |
| | **24,500** | **22,975** |

The cost of raw materials used also contains expenses for the use and disposal of spent nuclear fuel assemblies as well as €103 million (previous year: €65 million) in taxes paid for RWE Dea's foreign production companies.

A total of €17,584 million in material costs (previous year: €15,923 million) was netted out against energy trading revenue. A decrease of €1,832 million in cost of materials is attributable to changes in the scope of consolidation.

## *(4) Staff costs*

| € million | 2005 | 2004 |
|---|---|---|
| Wages and salaries | 4,252 | 4,886 |
| Cost of social security, pensions and other benefits | 1,118 | 1,236 |
| | **5,370** | **6,122** |

The cost of pension benefits is €351 million (previous year: €305 million); this figure consists mainly of €301 million in current service costs (previous year: €216 million). In addition to this, amortization of past service costs amounted to €0 million (previous year: €46 million) and recognized actuarial losses to €23 million (previous year: €0 million).

Converted to full time equivalents, the RWE Group's average personnel headcount totalled 86,426 (previous year: 106,138). One full time equivalent is equal to a full-time position, whereas part-time and fixed-term employees are included on a prorated basis in accordance with the extent of their part-time work or their duration of employment. In addition, the Group employed 2,842 trainees (previous year: 3,554).

A decrease of €1,094 million in staff costs is attributable to changes in the scope of consolidation.

## *(5) Depreciation, amortization, and impairment losses*

Depreciation on property, plant and equipment amounted to €2,423 million (previous year: €2,661 million) and to €28 million (previous year: €49 million) on investment property. Intangible assets were written-down by €1,311 million (previous year: €1,055 million), of which €328 million (previous year: €330 million) was related to customer relationships capitalized in connection with acquisitions made in prior financial years.

Impairment losses were also recognized in the reporting period. These impairment losses amounted to €46 million (previous year: €80 million) on property, plant and equipment, and to €11 million (previous year: €27 million) on investment property. Impairment losses of €0 million (previous year: €41 million) were recorded on intangible assets (excluding goodwill), while €814 million in impairment losses on goodwill were recognized in the year under review (previous year: €492 million).

A reduction of €568 million in depreciation, amortization and impairment losses resulted from changes in the scope of consolidation.

## *(6) Other operating expenses*

| € million | 2005 | 2004 |
|---|---|---|
| Concessions, licenses and other contractual obligations | 584 | 577 |
| Disposal of non-current assets, including expenses from deconsolidation | 109 | 223 |
| Additions to provisions | 332 | 482 |
| Disposal of current assets and decreases in values excluding inventories and marketable securities | 232 | 304 |
| Derivative financial instruments | 143 | 140 |
| Maintenance and renewal obligations | 486 | 559 |
| Insurance, commissions, freight and similar distribution costs | 331 | 453 |
| Lease payments for plant and grids as well as rents | 353 | 392 |
| Advertising | 157 | 169 |
| Currency losses | 276 | 290 |
| Other taxes, primarily on property | 118 | 114 |
| Postage and monetary transactions | 124 | 181 |
| Structural and adaptation measures | 322 | 347 |
| General administration | 256 | 412 |
| Legal and other consulting and data processing services | 475 | 453 |
| Miscellaneous | 581 | 958 |
| | **4,879** | **6,054** |

Amongst other items, miscellaneous other operating expenses include fees and membership dues amounting to €103 million (previous year: €106 million).

A decrease of €882 million in other operating expenses is attributable to changes in the scope of consolidation.

## *(7) Income from investments*

Income from investments includes all income and expenses which have arisen in relation to operating investments. It is comprised of income from investments accounted for using the equity method and other income from investments.

| € million | 2005 | 2004 |
|---|---|---|
| **Income from investments accounted for using the equity method** | **557** | **298** |
| of which: amortization and impairment losses on investments accounted for using the equity method | (22) | (-) |
| Income from non-consolidated subsidiaries | 10 | -16 |
| of which: amortization and impairment losses on non-consolidated subsidiaries | (6) | (15) |
| Income from other investments | 60 | 55 |
| of which: impairment of shares in other investments | (11) | (8) |
| Income from the disposal of investments | 202 | 483 |
| Expenses from the disposal of investments | 39 | 8 |
| Income from loans to investments | 39 | 36 |
| Expenses from loans to investments | 62 | 7 |
| Other | – | 5 |
| **Other income from investments** | **210** | **548** |
| | **767** | **846** |

Income from investments includes impairment losses on other financial assets in the amount of €17 million (previous year: €23 million) and impairment losses on loans to investments amounting to €62 million (previous year: €1 million).

Changes in the scope of consolidation increased income from investments by €28 million.

## *(8) Financial result*

| € million | 2005 | 2004 |
|---|---|---|
| Interest and similar income | 1,208 | 1,117 |
| Other financial income | 1,097 | 838 |
| **Financial income** | **2,305** | **1,955** |
| Interest and similar expenses | 2,193 | 2,247 |
| Interest accretion to | | |
| Provisions for pensions and similar obligations | 528 | 557 |
| Provisions for nuclear waste management as well as to mining provisions | 567 | 559 |
| Other provisions | 143 | 211 |
| Other finance costs | 559 | 866 |
| **Finance costs** | **3,990** | **4,440** |
| | **-1,685** | **-2,485** |

The financial result breaks down into net interest, interest accretion to provisions and other financial income and other finance costs.

Net interest includes interest income from all interest-bearing securities and loans, expenses and income relating to marketable securities and all interest expenses. Net interest also includes shares in profit and dividends from non-current and current marketable securities.

| € million | 2005 | 2004 |
|---|---|---|
| Interest and similar income | 1,208 | 1,117 |
| Interest and similar expenses | 2,193 | 2,247 |
| **Net interest** | **–985** | **–1,130** |

Interest accretion to provisions contains the reversal allocable to the current year of the discounting of non-current provisions from the annual update of the present value calculation.

The financial result also contains all other financial income and finance costs which cannot be allocated to net interest or to interest accretion to provisions. Among other things, other financial income includes €842 million in gains realized from the disposal of marketable securities (previous year: €155 million). Other finance costs include write-backs of marketable securities due to their increased fair values in the amount of €3 million (previous year: €41 million) and €189 million (previous year: €201 million) in realized losses from the disposal of marketable securities.

Changes in the scope of consolidation improved the financial result by €81 million.

## *(9) Taxes on income*

| € million | 2005 | 2004 |
|---|---|---|
| Current taxes on income | 1,073 | 1,039 |
| Deferred taxes | 148 | 482 |
| | **1,221** | **1,521** |

Current taxes on income contain €78 million in net tax income (previous year: expenses of €85 million) relating to prior periods.

Changes in tax rates led to a deferred tax income of €8 million (previous year: €6 million). German deferred taxes are calculated using a tax rate of 39.40% (previous year: 39.28%). The increase in the tax rate stems from a change in the municipality multiplier for trade taxes in Germany.

Due to the utilization of tax loss carryforwards unrecognized in prior years, current taxes on income were reduced by €190 million (previous year: €112 million). Deferred tax expenses decreased by €240 million (previous year: €1 million), due to previously unrecognized tax loss carryforwards that are to be reassessed.

The income tax expense is derived from the theoretical tax expense. A tax rate of 39.40% (previous year: 39.28%) was applied to income from continuing operations before taxes.

| € million | 2005 | 2004 |
|---|---|---|
| **Income from continuing operations before tax** | **3,828** | **3,935** |
| **Theoretical tax expense** | **1,508** | **1,546** |
| Differences from foreign tax rates | -104 | -78 |
| Tax effects on | | |
| Tax-free domestic dividend income | -86 | -42 |
| Tax-free foreign dividend income | -22 | -35 |
| Other tax-free income | -8 | -22 |
| Expenses not deductible for tax purposes | 102 | 102 |
| Amortization of goodwill from capital consolidation | 321 | 193 |
| Accounting for associates using the equity method (including amortization of associates' goodwill) | -105 | -10 |
| Capitalization of deferred taxes on unutilizable loss carryforwards and / or utilization of unrecognized loss carryforwards and write-downs on loss carryforwards | -309 | -6 |
| Income on the disposal of investments | -190 | -99 |
| Other | 114 | -28 |
| **Effective tax expense** | **1,221** | **1,521** |
| Effective tax rate in % | 31.9 | 38.7 |

# *Notes to the Balance Sheet*

## *(10) Intangible assets*

| € million | Development costs | Concessions, patent rights, licenses and similar rights | Customer relationships and similar assets | Goodwill | Prepayments | Total |
|---|---|---|---|---|---|---|
| **Cost** | | | | | | |
| Balance at 01/01/05 | 117 | 1,958 | 2,906 | 14,873 | 135 | 19,989 |
| Additions / disposals due to changes in the scope of consolidation | -1 | -203 | □ | -562 | 3 | -763 |
| Additions | 72 | 161 | | □ | 23 | 256 |
| Transfers | | 18 | | | -14 | 4 |
| Currency translation adjustments | 4 | 30 | 84 | 710 | 3 | 831 |
| Disposals | 1 | 427 | | | 1 | 429 |
| Balance at 12/31/05 | 191 | 1,537 | 2,990 | 15,021 | 149 | 19,888 |
| **Accumulated depreciation / amortization / impairment losses** | | | | | | |
| Balance at 01/01/05 | 61 | 1,167 | 549 | 494 | | 2,271 |
| Additions / disposals due to changes in the scope of consolidation | -1 | -90 | | -549 | | -640 |
| Depreciation / amortization / impairment losses in the reporting period | 30 | 139 | 328 | 814 | | 1,311 |
| Transfers | | □ | | | | □ |
| Currency translation adjustments | 2 | 7 | 15 | 93 | | 117 |
| Disposals | 1 | 382 | | | | 383 |
| Write-backs | | 3 | | | | 3 |
| Balance at 12/31/05 | 91 | 838 | 892 | 852 | | 2,673 |
| **Carrying amounts** | | | | | | |
| Balance at 12/31/05 | 100 | 699 | 2,098 | 14,169 | 149 | 17,215 |
| **Cost** | | | | | | |
| Balance at 01/01/04 | 193 | 2,251 | 2,905 | 18,097 | 150 | 23,596 |
| Additions / disposals due to changes in the scope of consolidation | -85 | 99 | 2 | -858 | 2 | -840 |
| Additions | 14 | 92 | □ | | -5 | 101 |
| Transfers | | 12 | | | □ | 12 |
| Currency translation adjustments | -3 | -13 | -1 | -199 | -2 | -218 |
| Disposals | 2 | 483 | | 2,167 | 10 | 2,662 |
| Balance at 12/31/04 | 117 | 1,958 | 2,906 | 14,873 | 135 | 19,989 |
| **Accumulated depreciation / amortization / impairment losses** | | | | | | |
| Balance at 01/01/04 | 68 | 1,441 | 230 | 2,439 | | 4,178 |
| Additions / disposals due to changes in the scope of consolidation | -12 | -20 | 1 | -293 | | -324 |
| Depreciation / amortization / impairment losses in the reporting period | 6 | 227 | 330 | 492 | | 1,055 |
| Transfers | | 1 | | | | 1 |
| Currency translation adjustments | -1 | -2 | -12 | 22 | | 7 |
| Disposals | □ | 480 | | 2,166 | | 2,646 |
| Write-backs | | | | | | |
| Balance at 12/31/04 | 61 | 1,167 | 549 | 494 | | 2,271 |
| **Carrying amounts** | | | | | | |
| Balance at 12/31/04 | 56 | 791 | 2,357 | 14,379 | 135 | 17,718 |

□ Negligible amount.

In the reporting period, a total of €55 million (previous year: €114 million) was spent on research and development. Development costs of €72 million (previous year: €14 million) were capitalized.

Goodwill was allocated to cash-generating units at the segment level or at a level beneath the segment level to perform impairments tests. The carrying amounts of goodwill allocated to segments break down as follows:

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| RWE Power | 963 | 956 |
| of which: RWE Trading | (434) | (442) |
| RWE Energy | 3,791 | 3,675 |
| RWE npower | 4,330 | 4,215 |
| RWE Thames Water | 5,079 | 5,514 |
| of which: North America | (2,221) | (2,613) |
| Other | 6 | 19 |
| | 14,169 | 14,379 |

In fiscal 2005 impairment losses of €814 million were recognized on goodwill, of which €759 million was related to the cash-generating unit Thames Water North America and €55 million was related to the Group's international water activities. In the previous year, an impairment loss on goodwill in the amount of €492 million was recognized. The carrying amount of goodwill increased by €617 million due to currency effects.

Due to revised growth projections in the regulated business and in particular in the non-regulated business, which resulted in adjustment of the medium-term budget, in the fourth quarter of 2005 RWE performed another impairment test on the goodwill recognized for the cash-generating unit RWE Thames Water North America. This impairment test, performed on the basis of fair value less costs to sell, resulted in the recognition of an impairment loss of €759 million on the cash-generating unit's goodwill. Other assets were not affected by changes in valuation. The fair value less costs to sell was determined on the basis of an enterprise valuation model using the discounted cash flow method and reviewed using valuation methods (multiples) which reflect market prices. The discount rate used was 5.64 %.

The impairment test involves determining the recoverable amount of the cash-generating units, which corresponds to the fair value less costs to sell or the value in use. The fair value reflects the best estimate of the sum that an independent third party would pay to purchase the cash-generating units as of the balance-sheet date; selling costs are deducted. Value in use is the present value of the future cash flows expected to be derived from a cash-generating unit. Fair value and value in use are determined on the basis of an enterprise valuation model, whereby the fair value is assessed from an external perspective and the value in use from a company-internal perspective. Fair values and values in use are determined based on cash flow budgets, which are based on the medium-term budget for a period of five years, which has been approved by the Executive Board and which is valid when the impairment test is performed. These budgets are based on past experience as well as on future expected market trends.

The medium-term budget is based on the general economic data derived from macroeconomic and financial studies and makes assumptions primarily on the development of gross domestic product, consumer prices, interest rates and nominal wages.

The main assumptions underlying the budgets for the divisions active on Europe's electricity and gas markets—RWE Power, RWE Energy and RWE npower—are the premises relating to the development of world market prices for crude oil, natural gas and coal, wholesale and retail electricity and gas prices as well as to the development of market shares and regulatory framework conditions.

Basic conditions established by regulatory authorities constitute a further key assumption underlying the budget for RWE Thames Water, which is predominantly active in regulated markets. These conditions determine end consumer prices, the budget of capital expenditure and the return achievable in the corresponding regulatory period.

Discount rates are determined on the basis of market data. For the cash-generating units these rates are between 5.5 % and 6.9 % (previous year: 5.8 % to 7.3 %) after tax and between 7.5 % and 10.5 % (previous year: 7.5 % to 11.0 %) before tax.

RWE extrapolates future cash flows going beyond the detailed budget horizon based on constant growth rates of 0.0 % to 1.0 %, which are derived from past experience and future expectations for each division, and none of which exceed the average growth rates of the markets on which the companies are active. Growth rates are determined subtracting the capital expenditure required to achieve them.

# (11) Property, plant and equipment

| € million | Land, land rights and buildings incl. buildings on third-party land | Technical plant and machinery | Other equipment, factory and office equipment | Prepayments to other enterprises | Plants under construction | Total |
|---|---|---|---|---|---|---|
| **Cost** | | | | | | |
| Balance at 01/01/05 | 12,793 | 71,426 | 3,428 | 95 | 1,034 | 88,776 |
| Additions / disposals due to changes in the scope of consolidation | -1,452 | -267 | -1,138 | -4 | -137 | -2,998 |
| Additions | 690 | 2,296 | 247 | 16 | 620 | 3,869 |
| Transfers | -39 | 333 | -25 | -11 | -329 | -71 |
| Currency translation adjustments | 298 | 1,581 | 57 | □ | 37 | 1,973 |
| Disposals | 132 | 1,088 | 231 | □ | 37 | 1,488 |
| Balance at 12/31/05 | 12,158 | 74,281 | 2,338 | 96 | 1,188 | 90,061 |
| **Accumulated depreciation / amortization / impairment losses** | | | | | | |
| Balance at 01/01/05 | 5,060 | 46,518 | 2,668 | | 12 | 54,258 |
| Additions / disposals due to changes in the scope of consolidation | -678 | -464 | -868 | | -2 | -2,012 |
| Depreciation / amortization / impairment losses in the reporting period | 487 | 1,644 | 178 | □ | 114 | 2,423 |
| Transfers | -25 | -4 | 9 | | | -20 |
| Currency translation adjustments | 124 | 415 | 26 | | | 565 |
| Disposals | 60 | 953 | 211 | | 7 | 1,231 |
| Write-backs | 9 | 2 | | | | 11 |
| Balance at 12/31/05 | 4,899 | 47,154 | 1,802 | □ | 117 | 53,972 |
| **Carrying amounts** | | | | | | |
| Balance at 12/31/05 | 7,259 | 27,127 | 536 | 96 | 1,071 | 36,089 |
| **Cost** | | | | | | |
| Balance at 01/01/04 | 13,488 | 71,482 | 4,326 | 73 | 890 | 90,259 |
| Additions / disposals due to changes in the scope of consolidation | -792 | -1,273 | -876 | 1 | -78 | -3,018 |
| Additions | 426 | 2,016 | 239 | 26 | 615 | 3,322 |
| Transfers | 9 | 256 | 32 | -5 | -339 | -47 |
| Currency translation adjustments | -111 | -215 | 17 | 1 | -28 | -336 |
| Disposals | 227 | 840 | 310 | 1 | 26 | 1,404 |
| Balance at 12/31/04 | 12,793 | 71,426 | 3,428 | 95 | 1,034 | 88,776 |
| **Accumulated depreciation / amortization / impairment losses** | | | | | | |
| Balance at 01/01/04 | 5,158 | 46,049 | 3,365 | | 12 | 54,584 |
| Additions / disposals due to changes in the scope of consolidation | -461 | -661 | -732 | | -6 | -1,860 |
| Depreciation / amortization / impairment losses in the reporting period | 537 | 1,819 | 298 | | 7 | 2,661 |
| Transfers | -23 | 9 | 6 | | | -8 |
| Currency translation adjustments | -22 | -22 | 22 | | -1 | -23 |
| Disposals | 125 | 674 | 291 | | | 1,090 |
| Write-backs | 4 | 2 | □ | | | 6 |
| Balance at 12/31/04 | 5,060 | 46,518 | 2,668 | | 12 | 54,258 |
| **Carrying amounts** | | | | | | |
| Balance at 12/31/04 | 7,733 | 24,908 | 760 | 95 | 1,022 | 34,518 |

□ Negligible amount.

€556 million (previous year: €0 million) of the additions / disposals due to changes in the scope of consolidation result from the reclassification of assets held for sale.

Property, plant and equipment are subject to restrictions in the amount of €160 million (previous year: €278 million) in the form of land charges and chattel mortgages. Of the carrying amount of property, plant and equipment, €52 million (previous year: €519 million) is attributable to assets leased under finance leases. These assets are principally comprised of technical plant and equipment amounting to €33 million (previous year: €508 million). Disposal of property, plant and equipment resulted from the sale and decommissioning of plants.

## *(12) Investment property*

| € million | |
|---|---|
| **Cost** | |
| Balance at 01/01/05 | 884 |
| Additions / disposals due to changes in the scope of consolidation | -16 |
| Additions | 3 |
| Transfers | 67 |
| Currency translation adjustments | 1 |
| Disposals | 112 |
| Balance at 12/31/05 | 827 |
| **Accumulated depreciation / amortization / impairment losses** | |
| Balance at 01/01/05 | 377 |
| Additions / disposals due to changes in the scope of consolidation | -9 |
| Depreciation / amortization / impairment losses in the reporting period | 28 |
| Transfers | 20 |
| Currency translation adjustments | ⊏ |
| Disposals | 51 |
| Write-backs | 14 |
| Balance at 12/31/05 | 351 |
| **Carrying amounts** | |
| Balance at 12/31/05 | 476 |

| € million | |
|---|---|
| **Cost** | |
| Balance at 01/01/04 | 872 |
| Additions / disposals due to changes in the scope of consolidation | 1 |
| Additions | 6 |
| Transfers | 39 |
| Currency translation adjustments | 3 |
| Disposals | 37 |
| Balance at 12/31/04 | 884 |
| **Accumulated depreciation / amortization / impairment losses** | |
| Balance at 01/01/04 | 337 |
| Additions / disposals due to changes in the scope of consolidation | 1 |
| Depreciation / amortization / impairment losses in the reporting period | 49 |
| Transfers | 8 |
| Currency translation adjustments | ⊏ |
| Disposals | 18 |
| Write-backs | |
| Balance at 12/31/04 | 377 |
| **Carrying amounts** | |
| Balance at 12/31/04 | 507 |

⊏ Negligible amount.

As of December 31, 2005, the fair value of investment property amounted to €642 million (previous year: €715 million). The fair value of investment property is determined using internationally accepted valuation methods such as the discounted cash flow method or is derived from the current market prices of comparable real estate. €115 million of the fair value (previous year: €111 million) is based on a valuation made by independent appraisers. Rental income generated in the reporting period amounted to €53 million (previous year: €66 million). Direct operating expenses totaled €20 million (previous year: €27 million).

## (13) Investments accounted for using the equity method

The following summaries present the key items from the balance sheets and income statements of companies accounted for using the equity method:

| € million | 12/31/05 |
|---|---|
| Equity | |
| Assets | 17,562 |
| Liabilities | 11,545 |
| | 6,017 |
| Adjustment to RWE interest and equity method | -3,400 |
| **Investments accounted for using the equity method** | **2,617** |

| € million | 2005 |
|---|---|
| Revenue | 11,901 |
| Income | 841 |
| Adjustment to RWE interest and equity method | -284 |
| Income from investments accounted for using the equity method | 557 |

The fair value of investments accounted for using the equity method, as far as quoted market prices exist, amounted to €4 million as of December 31, 2005 (previous year: €4 million).

## (14) Other non-current financial assets

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| Non-consolidated subsidiaries | 189 | 239 |
| Other investments | 641 | 664 |
| Non-current securities | 1,012 | 1,036 |
| | **1,842** | **1,939** |

Non-current securities primarily consist of fixed-interest marketable securities and shares of public companies. They are not subject to any restrictions on disposal.

## (15) Financial receivables

| € million | 12/31/05 Non-current | 12/31/05 Current | 12/31/04 Non-current | 12/31/04 Current |
|---|---|---|---|---|
| Loans to non-consolidated subsidiaries and investments | 1,008 | 44 | 971 | 9 |
| Collaterals for trading activities | | 2,597 | | 471 |
| Deferred interest | | 176 | | 184 |
| Other financial receivables | 492 | 338 | 330 | 438 |
| | **1,500** | **3,155** | **1,301** | **1,102** |

## (16) Other receivables and other assets

| € million | 12/31/05 Non-current | 12/31/05 Current | 12/31/04 Non-current | 12/31/04 Current |
|---|---|---|---|---|
| Derivatives | 6,211 | 9,544 | 2,930 | 3,007 |
| Pension plan assets | 554 | | 529 | |
| Prepayments for items other than inventories | | 263 | | 278 |
| Accounts receivable from investment grants and subsidies | | 10 | 9 | 14 |
| Prepaid expenses | | 262 | | 309 |
| Miscellaneous other assets | 50 | 1,033 | 47 | 942 |
| | **6,815** | **11,112** | **3,515** | **4,550** |

Changes in the scope of consolidation reduced other receivables and other assets by €119 million.

Other receivables and other assets are measured at amortized cost, which essentially corresponds to their fair value. Derivative financial instruments are stated at fair value.

Loans had interest rates of up to 5 % (previous year: 3 % to 11 %).

## (17) Deferred taxes

The deferred tax assets of €3,790 million (previous year: €3,243 million) and deferred tax liabilities of €4,873 million, (previous year: €4,134 million) principally relate to measurement differences to the tax bases. €2,882 million and €3,138 million of the total amount of gross deferred tax assets and liabilities, respectively, will be realized within twelve months.

The following is a breakdown of deferred tax assets and liabilities by item:

| € million | 12/31/05 Deferred tax assets | 12/31/05 Deferred tax liabilities | 12/31/04 Deferred tax assets | 12/31/04 Deferred tax liabilities |
|---|---|---|---|---|
| Non-current assets | 802 | 5,297 | 769 | 4,257 |
| Current assets | 117 | 2,503 | 81 | 1,087 |
| Exceptional tax items | | 510 | | 514 |
| Non-current liabilities | | | | |
| Provisions for pensions | 1,482 | 74 | 1,407 | 72 |
| Other non-current provisions | 2,620 | 280 | 2,643 | 410 |
| Current liabilities | 2,765 | 635 | 504 | 125 |
| | **7,786** | **9,299** | **5,404** | **6,465** |
| Tax loss carryforwards | 430 | | 170 | |
| **Gross total** | **8,216** | **9,299** | **5,574** | **6,465** |
| Netting | -4,426 | -4,426 | -2,331 | -2,331 |
| **Net total** | **3,790** | **4,873** | **3,243** | **4,134** |

Deferred tax assets and deferred tax liabilities were netted out against each other for each company and / or tax group.

Total deferred tax assets include the following capitalized tax reduction claims which result from the expected utilization of previously unused tax loss carryforwards in subsequent years:

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| Corporate income tax (or comparable foreign income tax) | 164 | 166 |
| Trade tax | 266 | 4 |
| | **430** | **170** |

The realization of these tax carryforwards is guaranteed with sufficient certainty. There are €681 million in corporate income tax loss carryforwards and €928 million in trade tax loss carryforwards for which no deferred tax claims have been recognized (previous year: €1,527 million and €3,816 million, respectively).

As of December 31, 2005, the balance of corporate income tax reductions and increases related to future disbursements amounted to €740 million (previous year: €699 million). These corporate income tax reductions and increases can occur or be utilized by 2019. According to the German Tax Benefit Reduction Act, corporate income tax credits based on profit distributions can be utilized again from January 1, 2006 onwards.

Foreign tax loss carryforwards can be used for an unlimited period.

In the year under review, €172 million in deferred taxes (previous year: €33 million) arising from the translation of foreign financial statements and €142 million (previous year: €78 million) from valuations without an effect on income were offset against equity.

## (18) Inventories

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| Raw materials, incl. nuclear fuel assemblies and earth excavated for lignite mining | 1,143 | 1,244 |
| Work in progress – goods | 123 | 111 |
| Work in progress – services | 183 | 229 |
| Finished goods and goods for resale | 734 | 386 |
| Prepayments | 74 | 73 |
| | **2,257** | **2,043** |

Changes in the scope of consolidation resulted in a decrease of €179 million in inventories.

Inventories are not subject to any restrictions on disposal and there are no further obligations.

## (19) Trade accounts receivable

A decrease of €466 million in trade accounts receivables is attributable to changes in the scope of consolidation.

Trade accounts receivable from associates totaled €308 million (previous year: €333 million).

Expenses and profit contributions from customer-specific construction contracts totalling €269 million (previous year: €881 million) were capitalized. Prepayments in the amount of €257 million (previous year: €813 million) were deducted from this.

## (20) Marketable securities

Current marketable securities amount to €10,344 (previous year: €11,013 million), consisting of fixed-interest marketable securities of €7,770 million with a term of more than three months from the date of acquisition, and stocks and profit-participation certificates of €2,574 million. Marketable securities are stated at fair value. As of December 31, 2005, the average return obtainable on fixed-interest bonds was 3.7 % (previous year: 3.6 %).

## (21) Cash and cash equivalents

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| Cash | 1,313 | 1,354 |
| Marketable securities and other cash investments (maturity three months or less from the date of acquisition) | 118 | 172 |
| | **1,431** | **1,526** |

Demand deposits are only kept for short-term cash positions at banks with outstanding creditworthiness. As in the previous year, interest rates are maintained at interbank levels.

## (22) Equity

A breakdown of equity is shown on page 97.

Subscribed capital breaks down as follows:

| | 12/31/05 Number of shares '000 | % | 12/31/04 Number of shares '000 | % | 12/31/05 € million | 12/31/04 € million |
|---|---|---|---|---|---|---|
| Common shares | 523,405 | 93.1 | 523,405 | 93.1 | 1,340 | 1,340 |
| Preferred shares | 39,000 | 6.9 | 39,000 | 6.9 | 100 | 100 |
| | **562,405** | **100.0** | **562,405** | **100.0** | **1,440** | **1,440** |

Common and preferred shares are no-par value bearer share certificates.

Contingent capital of €51,200,000 (previous year: €51,200,000) is available to offer subscription rights to common shares in the name of the bearer. The subscription rights were granted to members of the Executive Board as well as to other executives of RWE AG and subordinate affiliates.

Pursuant to the resolution passed by the Annual General Meeting on April 14, 2005, the Executive Board was authorized to purchase shares of any class in RWE, totalling up to 10% of the company's share capital until October 13, 2006.

***Accumulated other comprehensive income*** reflects changes in the fair values of "financial instruments available for sale" and of cash flow hedges as well as such stemming from currency translation adjustments from foreign financial statements.

In the year under review, –€60 million in changes in the fair values of cash flow hedges (previous year: €406 million) and €431 million in "financial instruments available for sale" (previous year: €406 million) were disclosed under accumulated other comprehensive income without an effect on income. In the reporting period, €90 million in cash flow hedges were realized as expenses (previous year: income of €34 million) and €571 million in "financial instruments available for sale" were realized as income (previous year: income of €199 million).

*Dividend proposal.* We propose to the Annual General Meeting that RWE AG's distributable profit for fiscal 2005 be appropriated as follows:

Distribution of a dividend of €1.75 per individual share certificate on the dividend-bearing

| | |
|---|---|
| capital stock of €1,439,756,800.00: | €984,208,750.00 |
| Profit carryforward: | €71,077.47 |
| **Distributable profit:** | **€984,279,827.47** |

*Minority interest.* The share ownership of third parties in group entities is presented in this item. In particular, significant minority interests are held in the Hungarian-based power utilities, and enviaM, in the RWE Thames Water division and the Czech gas companies.

## (23) Share-based payment

In the year under review, the groupwide share-based payment systems for executives of RWE AG and subordinate affiliates consisted of the following: the Executive Stock Option Plan (AOP-F), the Long-Term Incentive Plan (LTIP) and the new long-term incentive plan 'Beat'. If the persons holding stock options are not employed by RWE AG, the expenses associated with the exercise of the options are borne by the respective Group company.

| | AOP-F[1] | | LTIP[2] | | |
|---|---|---|---|---|---|
| | 2001 tranche | 2001A tranche | 2002 tranche | 2003 tranche | 2004 tranche |
| Grant date | 01/15/01 | 08/02/01 | 09/20/02 | 07/01/03 | 05/25/04 |
| Number of options granted | 5,222,300 | 5,262,300 | 5,950,350 | 6,677,450 | 9,192,800 |
| Term | 5 years | 5 years | 5 years | 5 years | 5 years |
| Vesting conditions | Three-year waiting period, the quoted market price of the common share—calculated on the basis of the total return approach—must increase prior to the excercise date by at least 6% annually on average and may not trail the Dow Jones STOXX share index by more than ten percentage points over the same period<br><br>Four-week exercise periods, starting on the 21st trading day following the publication of the revenue and earnings figures for the completed fiscal year and of the semi-annual results | | Two-year waiting period; the common share price must have risen by at least 10% prior to the exercise date and must have outperformed the Dow Jones STOXX Utilities Price Index on ten consecutive days in the same period (this last condition does not apply if the common share price increases by at least 20%)<br><br>Upon achievement of the above performance targets, the options can be exercised on a daily basis following expiration of the waiting period, with the exception of short blocking periods prior to the publication of corporate data. The number of options which may be exercised depends on the increase in the price of the common share compared to the exercise price determined when the options are granted. In the event of a 20% increase all of the options can be exercised; for a 15% or 10% increase, 60% or 25% of the options can be exercised, respectively. | | |
| Exercise price | The exercise price equals the quoted market price of the common share on the first trading day after expiry of the relevant exercise period, minus a performance-related markdown. The markdown is limited to 40 percentage points. | | €34.24 | €26.37 | €35.45 |
| Form of settlement | Shares from contingent capital, existing common shares or cash settlement amounting to the difference between the share price upon exercise and the exercise price (at the discretion of RWE AG) | | Cash settlement amounting to the difference between the share price upon exercise and the exercise price or provision of common shares (at the discretion of RWE AG). Settlement is limited to 50% of the exercise price. | | |

1 Executive Stock Option Plan.
2 Long-Term Incentive Plan.

During the reporting period, a new long-term incentive plan ('Beat') for executives was introduced, in order to create a uniform, international framework for long-term compensation within the RWE Group:

| Beat | |
|---|---|
| Grant date | 01/01/05 |
| Number of conditionally granted performance shares | 2,551,800 |
| Term | 3 years |
| Pay-out conditions | Automatic pay-out if following a waiting period of three years an outperformance of at least 25% compared to the Dow Jones STOXX Utilities Index peer group has been achieved, measured in terms of their index weighting as of the inception of the programme. Measurement of outperformance is carried out using Total Shareholder Return (TSR), which covers both the development of the share price and reinvested dividends. |
| Determination of payment | 1. Determination of the index weighting of the peer group companies which exhibit a lower TSR than RWE at the end of the term<br>2. Performance factor is calculated by squaring this percentage rate and multiplying it by 1.25<br>3. Total number of performance shares applicable is calculated by multiplying the performance shares conditionally granted by the performance factor<br>4. Payment corresponds to the final number of performance shares valued at the average RWE share price during the last 20 trading days prior to expiration of the programme (with a ceiling of three times the value of the performance shares as of the grant date) |
| Change in corporate control/merger | • If during the waiting period there is a change in corporate control, a compensation payment amounting to the product of the price paid during acquisition of the RWE shares and the final number of performance shares shall be granted. The latter shall be determined as per the regulations of the scheme with regard to the time when the bid for corporate control is submitted.<br>• In the event of merger with another company, compensation shall be calculated on the basis of the expected value of the performance shares at the time of the merger, multiplied by the prorated number of performance shares corresponding to ratio between the total waiting period and the waiting period until the merger takes place. |
| Form of settlement | Cash settlement |

**Executive Stock Option Plan (AOP-F).** The following changes in the number of outstanding AOP-F options occurred in the year under review:

| | 2001 tranche | 2001A tranche |
|---|---|---|
| Outstanding at the start of the fiscal year | 3,651,200 | 4,028,600 |
| Forfeited | –233,600 | –299,600 |
| Exercised | –3,417,600 | –3,714,500 |
| Outstanding at the end of the fiscal year | 0 | 14,500 |
| Exercisable at the end of the fiscal year | 0 | 0 |

The weighted average share price as of the exercise date was €54.92 for the options from AOP-F exercised in the year under review. The exercise price of the outstanding AOP-F options as of the balance-sheet date was €38.19. The weighted average remaining contractual term amounted to 0.6 years.

**LTIP.** The following changes in the number of outstanding LTIP options occurred in the year under review:

| | 2002 tranche | 2003 tranche | 2004 tranche |
|---|---|---|---|
| Outstanding at the start of the fiscal year | 2,813,315 | 6,377,400 | 9,174,100 |
| Forfeited | -135,475 | -382,850 | -112,000 |
| Exercised | -2,669,940 | -5,792,650 | 0 |
| Outstanding at the end of the fiscal year | 7,900 | 201,900 | 9,062,100 |
| Exercisable at the end of the fiscal year | 7,900 | 201,900 | 0 |

The average weighted share price as of the exercise date amounted to €51.50 for the options from LTIP exercised in fiscal 2005. The exercise prices of the outstanding LTIP options as of the balance-sheet date ranged from €26.37 to €35.45. The weighted average remaining contractual term amounted to 3.4 years.

**Beat.** The fair value of the performance shares (PS) conditionally granted in the Beat programme amounted to €18.62 per share as of the grant date. This value was calculated externally using Monte Carlo simulations on the basis of 1 million scenarios. In this calculation, due consideration was taken of the maximum payment stipulated in the programme's conditions for each conditionally granted performance share, discount rates for the remaining term, volatilities and the expected dividends of peer companies as well as the expected dividends of RWE AG.

In the year under review, the number of performance shares issued in the Beat programme developed as follows:

| | 2005 tranche |
|---|---|
| Outstanding at the start of the fiscal year | 0 |
| Granted | 2,551,800 |
| Forfeited | -500 |
| Outstanding at the end of the fiscal year | 2,551,300 |
| Exercisable at the end of the fiscal year | 0 |

The remaining contractual term amounted to two years.

In addition to the above, the following share-based payment systems for executives and employees are operated at the level of the divisions:

| | RWE Thames Water plc | | RWE Npower plc / RWE Trading GmbH | |
|---|---|---|---|---|
| | LTIP | Sharesave Scheme | LTIP | Sharesave Scheme |
| Awards / tranches | 2003-2005 | 2002 | 2004-2005 | 2002-2005 |
| Number of options granted per tranche | 3,260-40,036 | 280,037 | 130,608-145,803 | 228,335-787,875 |
| Term | 3 years | 3 years | 3 years | 3 years |
| Vesting conditions | Waiting period: 2.5 years | Waiting period: 3 years | Waiting period: 2 years | Waiting period: 3 years |
| Exercise price | - | €32.08 | €1.46 | €21.29-39.88 |
| Form of settlement | Existing shares | Existing shares | Existing shares | Existing shares |

In the year under review, the number of outstanding options from the LTIP developed as follows:

| | RWE Thames Water plc | RWE Npower plc / RWE Trading GmbH |
|---|---|---|
| Outstanding at the start of the fiscal year | 34,572 | 129,765 |
| Granted | 40,036 | 130,608 |
| Exercised | 0 | -49,444 |
| Expired | 0 | -382 |
| Outstanding at the end of the fiscal year | 74,608 | 210,547 |
| Exercisable at the end of the fiscal year | 3,260 | 0 |

In the year under review, the number of outstanding Sharesave Scheme options developed as follows:

| | RWE Thames Water plc | RWE Npower plc / RWE Trading GmbH |
|---|---|---|
| Outstanding at the start of the fiscal year | 245,633 | 1,400,893 |
| Granted | 0 | 357,636 |
| Forfeited | -1,564 | 0 |
| Exercised | -188,427 | -461,535 |
| Expired | -43,008 | -85,082 |
| Outstanding at the end of the fiscal year | 12,634 | 1,211,912 |
| Exercisable at the end of the fiscal year | 12,634 | 34,176 |

In the year under review, the total expense for the groupwide share-based payment systems amounted to €310 million (previous year: €87 million). Of this amount, €0 million was attributable to equity-settled share-based payment transactions of RWE AG (previous year: €0 million). As of the balance-sheet date, provisions in the amount of €160 million have been recognized for cash-settled share-based payment programmes (previous year: €97 million). The intrinsic value of the cash-settled share-based payment transactions exercisable as of the balance-sheet date amounts to €3 million.

# (24) Provisions

| € million | 12/31/05 Non-current | Current | Total | 12/31/04 Non-current | Current | Total |
|---|---|---|---|---|---|---|
| Provisions for pensions and similar obligations | 11,997 | - | 11,997 | 11,853 | - | 11,853 |
| Provisions for taxes | 1,719 | 733 | 2,452 | 1,617 | 783 | 2,400 |
| Provisions for nuclear waste management | 8,435 | 240 | 8,675 | 8,691 | 321 | 9,012 |
| Provisions for mining damage | 2,301 | 80 | 2,381 | 1,808 | 140 | 1,948 |
| | **24,452** | **1,053** | **25,505** | **23,969** | **1,244** | **25,213** |
| Other provisions | | | | | | |
| Staff-related obligations (excluding restructuring) | 544 | 674 | 1,218 | 474 | 654 | 1,128 |
| Restructuring obligations | 648 | 207 | 855 | 775 | 311 | 1,086 |
| Purchase and sales obligations | 675 | 798 | 1,473 | 815 | 1,226 | 2,041 |
| Uncertain obligations in the electricity business | 498 | 307 | 805 | 402 | 274 | 676 |
| Environmental protection obligations | 139 | 17 | 156 | 332 | 37 | 369 |
| Interest payment obligations | 152 | 187 | 339 | 323 | 62 | 385 |
| Provisions for $CO_2$ emission allowances | | 186 | 186 | | | |
| Miscellaneous other provisions | 956 | 1,355 | 2,311 | 740 | 1,522 | 2,262 |
| | 3,612 | 3,731 | 7,343 | 3,861 | 4,086 | 7,947 |
| | 28,064 | 4,784 | 32,848 | 27,830 | 5,330 | 33,160 |

***Provisions for pensions and similar obligations.*** The company pension plan consists of defined contribution and defined benefit plans. In the reporting period, €12 million were paid into defined contribution plans (previous year: €53 million).

The amount of provisions for defined benefit plans was calculated using actuarial methods. The following assumptions are applied:

| % | 2005 Germany | 2005 Foreign | 2004 Germany | 2004 Foreign |
|---|---|---|---|---|
| Discount rate | 4.25 | 4.75-5.75 | 5.00 | 5.25-6.25 |
| Compensation increase | 2.75 | 3.90-4.25 | 2.75 | 3.50-4.75 |
| Pension increase | 1.50 | 2.80-2.90 | 1.50 | 2.50-2.90 |
| Rise in health care service cost | - | 5.00-10.00 | - | 5.00-10.00 |
| Expected return on the plan assets | - | 5.60-8.25 | - | 6.10-8.75 |

Provisions for pensions are derived as follows:

| € million | 12/31/05 | | 12/31/04 | |
|---|---|---|---|---|
| **Present value of funded benefit obligations** | | **8,440** | | **7,613** |
| Fair value of plan assets | 7,692 | | 6,746 | |
| Less: capitalized plan assets of pension plans | -554 | | -529 | |
| **Fair value of plan assets (excluding capitalized plan assets)** | | **7,138** | | **6,217** |
| Unrecognized actuarial gains / losses | | –868 | | -1,018 |
| **Accrued provision for funded benefit obligations** | | **434** | | **378** |
| **Present value of unfunded benefit obligations** | **12,202** | | **10,946** | |
| Unrecognized actuarial gains / losses on unfunded benefit obligations | -639 | | 529 | |
| **Accrued provision for unfunded benefit obligations** | | **11,563** | | **11,475** |
| **Provisions for pensions (funded and unfunded benefits)** | | **11,997** | | **11,853** |

The unrecognized actuarial gains / losses of –€1,507 million (previous year: –€489 million) which have not yet been recognized primarily result from actuarial gains / losses in connection with changes in the number of employees and differences in actual market trends compared with the actuarial assumptions. This amount is recognized as income or an expense over the employees' average remaining working lives to the extent that it exceeds 10 % of the greater of the benefit obligation or the fair value of the plan assets.

The table below shows the reconciliation of the fair value of the plan assets:

| € million | 2005 | 2004 |
|---|---|---|
| Beginning balance | 6,746 | 6,598 |
| Expected return on plan assets | 542 | 523 |
| Contributions to the funded plans | 110 | 92 |
| Benefits paid by the funded plans | –407 | -392 |
| Actuarial gains / losses (related to plan assets) | 550 | 59 |
| Other changes (mainly changes in the scope of consolidation, transfers and currency adjustments) | 151 | -134 |
| **Closing balance** | **7,692** | **6,746** |

The actual return on plan assets totals €1,092 million (previous year: €521 million).

Provisions for pensions in fiscal 2005 and 2004 developed as follows:

| € million | 2005 | 2004 |
|---|---|---|
| Beginning balance | 11,853 | 12,303 |
| Additions | 324 | 262 |
| Unused amounts released | 0 | -12 |
| Interest accretion / change in discount rate | 528 | 557 |
| Changes in the scope of consolidation, currency adjustments, transfers | -84 | -648 |
| Amounts used | -624 | -609 |
| **Closing balance** | **11,997** | **11,853** |

Expenses relating to pension provisions break down as follows:

| € million | 2005 | 2004 |
|---|---|---|
| Service costs | 301 | 216 |
| Interest costs | 1,070 | 1,080 |
| Expected return on plan assets | -542 | -523 |
| Amortization of past service cost | - | 46 |
| Recognized actuarial gains / losses | 23 | - |
| | 852 | 819 |

| Roll-forward of provisions<br>€ million | Balance at 01/01/05 | Additions | Unused amounts released | Interest accretion / change in discount rate | Changes in the scope of consolidation, currency adjustments, transfers | Amounts used | Balance at 12/31/05 |
|---|---|---|---|---|---|---|---|
| Provisions for pensions | 11,853 | 324 | | 528 | -84 | -624 | 11,997 |
| Provisions for taxes | 2,400 | 772 | -47 | | -26 | -647 | 2,452 |
| Provisions for nuclear waste management | 9,012 | 154 | -581 | 440 | | -350 | 8,675 |
| Provisions for mining damage | 1,948 | 407 | -20 | 127 | | -81 | 2,381 |
| | **25,213** | **1,657** | **-648** | **1,095** | **-110** | **-1,702** | **25,505** |
| Other provisions | | | | | | | |
| Staff-related obligations (excluding restructuring) | 1,128 | 718 | -16 | 7 | -89 | -530 | 1,218 |
| Restructuring obligations | 1,086 | 49 | -62 | 39 | -33 | -224 | 855 |
| Purchase and sales obligations | 2,041 | 400 | -295 | 48 | -226 | -495 | 1,473 |
| Uncertain obligations in the electricity business | 676 | 217 | -27 | 21 | 57 | -139 | 805 |
| Environmental protection obligations | 369 | 8 | -11 | 2 | -207 | -5 | 156 |
| Interest payment obligations | 385 | 52 | -3 | | -11 | -84 | 339 |
| Provisions for $CO_2$ emission allowances | | 172 | | | 14 | | 186 |
| Miscellaneous other provisions | 2,262 | 801 | -295 | 26 | -120 | -363 | 2,311 |
| | **7,947** | **2,417** | **-709** | **143** | **-615** | **-1,840** | **7,343** |
| **Provisions** | **33,160** | **4,074** | **-1,357** | **1,238** | **-725** | **-3,542** | **32,848** |
| of which: changes in the scope of consolidation | | | | | | | (-669) |

Releases of €559 million were applied to the expense items for which the provisions were recognized. Non-current provisions and current provisions which were like liabilities in nature were reclassified into trade accounts payable or into other liabilities, in accordance with international practices.

***Provisions for nuclear waste management*** are primarily stated as non-current provisions, and their settlement amount is discounted to the balance-sheet date. Due to developments in long-term capital market interest rates, the discount rate was reduced from 5.5 % to 5.0 %. This change resulted in an increase of €644 million in the cash value of the obligations. This is offset by a reduction in the volume of obligations due to lower expected cost increases in the future. Volume-based increases in the provisions are measured at their present value. In the reporting period, they amounted to €154 million (previous year: €105 million). By releasing €581 million in unused provisions (previous year: €821 million), we have taken into account that according to current estimates waste disposal costs are expected to be lower. Additions to provisions for nuclear waste management primarily consist of an interest accretion of €440 million (previous year: €461 million). €644 million in prepayments were deducted from the provisions for nuclear waste management (previous year: €671 million).

***Provisions for mining damage*** also consist primarily of non-current provisions. They are recognized at the settlement amount discounted to the balance-sheet date. An interest rate of 5.0 % (previous year: 5.5 %) was used as the discount rate. The cash value of the obligations increased by €198 million as a result of the reduction in the discount rate. Lower expected costs compared to the previous year had an opposite effect. In the reporting period, allocations to provisions for mining damage amounted to €407 million (previous year: €84 million) and stemmed from an increase in the volume of the obligations. This amounted to €338 million and did not have an impact on income as the same amount was capitalized under property, plant and equipment. The interest accretion of the additions to provisions for mining damage is €127 million (previous year: €98 million).

***Provisions for restructuring*** mainly comprise measures for socially acceptable payroll downsizing from previous years. The restructuring programme initiated in fiscal 2003 to reorganize the energy business in Germany was completed for the most part in 2005.

# (25) Financial liabilities

| € million | 12/31/05 | | 12/31/04 | |
|---|---|---|---|---|
| | Non-current | Current | Non-current | Current |
| Bonds payable (incl. other notes payable) | 18,542 | 625 | 18,922 | 1,120 |
| Commercial paper | | 3,201 | | 1,705 |
| Bank debt | 2,243 | 371 | 2,692 | 443 |
| Other financial liabilities | | | | |
| Collaterals for trading activities | – | 1,126 | – | 695 |
| Miscellaneous other liabilities | 673 | 671 | 874 | 932 |
| | **21,458** | **5,994** | **22,488** | **4,895** |

Accounts payable to associates totaled €102 million (previous year: €231 million).

€21,255 million of current financial liabilities were interest-bearing liabilities (previous year: €20,559 million). Bank debt stems mainly from the former activities of acquired companies. Nominal interest depends on the currency, term and conditions of the agreement and is between 2% and 9% (previous year: 3% to 11%).

Changes in the scope of consolidation caused financial liabilities to decrease by €662 million.

Outstanding bonds payable relate to RWE AG, RWE Finance B.V., RWE Thames Water plc and its subsidiaries, American Water Works Company Inc. and its subsidiaries, as well as to RWE Npower plc. Nominal interest is between 0% and 8.375% for public bonds (previous year: 0% to 8.375%), and between 0.78% and 10.0% for private placements (previous year: 0.05% to 10.0%), depending on currency, terms and time of issue.

The following table presents an overview of our major bonds payable as of December 31, 2005:

| Issuer | Issue volume | Carrying amount | Coupon in % | Maturity |
|---|---|---|---|---|
| RWE AG | €150 million | €150 million | 4.75 | January 2007 |
| RWE AG | €200 million | €194 million | 0.875 | April 2007 |
| RWE AG | €460 million | €437 million | 0.0 | June 2007 |
| RWE AG | €100 million | €100 million | 5.63 | June 2009 |
| RWE AG | €100 million | €100 million | Variable | November 2017 |
| RWE AG | €750 million | €741 million | 5.75 | February 2033 |
| RWE Finance B. V. | £350 million | €511 million | 5.75 | April 2006 |
| RWE Finance B. V. | €1,357 million | €1,353 million | 5.5 | October 2007 |
| RWE Finance B. V. | €1,282 million | €1,279 million | 5.375 | April 2008 |
| RWE Finance B. V. | CHF 500 million | €307 million | 2.0 | December 2008 |
| RWE Finance B. V. | £500 million | €729 million | 4.625 | August 2010 |
| RWE Finance B. V. | €2,200 million | €2,250 million | 6.125 | October 2012 |
| RWE Finance B. V. | £750 million | €1,088 million | 6.375 | June 2013 |
| RWE Finance B. V. | €650 million | €663 million | 4.625 | July 2014 |
| RWE Finance B. V. | €850 million | €854 million | 6.25 | April 2016 |
| RWE Finance B. V. | €1,200 million | €1,087 million | 5.125 | July 2018 |
| RWE Finance B. V. | £650 million | €952 million | 6.5 | April 2021 |
| RWE Finance B. V. | £600 million | €871 million | 5.625 | December 2023 |
| RWE Finance B. V. | £950 million | €1,380 million | 6.25 | June 2030 |
| Thames Water Utilities Finance plc | £175 million | €255 million | 3.375 | July 2021 |
| Thames Water Utilities Finance plc | £330 million | €482 million | 6.75 | November 2028 |
| Thames Water Utilities Finance plc | £200 million | €292 million | 6.5 | February 2032 |
| RWE Npower plc | £131 million | €177 million | 8.375 | August 2006 |
| Pennsylvania–American Water Company | US$150 million | €127 million | 7.8 | September 2026 |
| Other (incl. other notes payable) | Various | €2,788 million | Various | 2006–2038 |
| **Bonds payable (incl. other notes payable)** | | **€19,167 million** | | |

As of December 31, 2005, bonds payable (incl. other notes payable) had a fair value of €21,085 million (previous year: €22,419 million). The fair value of other financial liabilities basically corresponds to the disclosed carrying amounts.

Euro and US dollar commercial paper was issued on the European and US capital markets throughout the reporting period, with a countervalue of between €1.7 billion and €3.7 billion (previous year: €1.7 billion to €2.5 billion). The interest rates ranged from 2.06 % to 4.68 % (previous year: 1.05 % to 2.67 %). As of the cut-off date, RWE held commercial paper totalling €3,201 million (previous year: €1,705 million).

Other financial liabilities primarily consist of finance lease liabilities. Lease agreements principally relate to capital goods in the electricity and water business.

Minimum lease payments for liabilities arising from finance lease agreements have the following maturities:

| | 12/31/05 | | | 12/31/04 | | |
|---|---|---|---|---|---|---|
| € million | Nominal value | Discount | Present value | Nominal value | Discount | Present value |
| Due within 1 year | 24 | 3 | 21 | 66 | 5 | 61 |
| Due within 1-5 years | 135 | 26 | 109 | 303 | 66 | 237 |
| Due after 5 years | 278 | 127 | 151 | 475 | 179 | 296 |
| | **437** | **156** | **281** | **844** | **250** | **594** |

€178 million (previous year: €260 million) of the liabilities are secured by mortgages, and €65 million (previous year: €109 million) by similar rights.

## *(26) Trade accounts payable*

Due to changes in the scope of consolidation, trade accounts payable decreased by a total of €617 million. In the case of individual customer-specific construction contracts, there is a balance on the liabilities side of €44 million (previous year: €60 million).

## *(27) Other liabilities*

| | 12/31/05 | | 12/31/04 | |
|---|---|---|---|---|
| € million | **Non-current** | **Current** | Non-current | Current |
| Tax liabilities | – | 487 | – | 520 |
| Social security liabilities | 464 | 201 | 562 | 197 |
| Derivatives | 5,465 | 9,383 | 1,313 | 2,440 |
| Deferred income | 3,904 | 281 | 3,644 | 526 |
| Miscellaneous other liabilities | 74 | 1,457 | 350 | 1,754 |
| | **9,907** | **11,809** | **5,869** | **5,437** |

The principle component of social security liabilities are the amounts payable to social security institutions.

Deferred income breaks down as follows:

| | 12/31/05 | | 12/31/04 | |
|---|---|---|---|---|
| € million | **Non-current** | **Current** | Non-current | Current |
| Advances and contributions in aid of construction and building connection | 3,505 | 162 | 3,249 | 156 |
| Government grants for non-current assets | | | | |
| Taxable | 17 | 2 | 30 | 3 |
| Non-taxable | 210 | | 188 | |
| Other | 172 | 117 | 177 | 367 |
| | **3,904** | **281** | **3,644** | **526** |

# Other information

## (28) Earnings per share

Basic earnings per share are calculated by dividing the net income attributable to the shares by the average number of shares. The figure may become diluted by potential shares (primarily share options and convertible bonds). When determining diluted earnings per share, stock options issued by RWE as part of the stock option programmes are taken into account if they have a diluting effect. The earnings per share are the same for both common and preferred shares.

| | | 2005 | 2004 |
|---|---|---|---|
| Net income | € million | 2,231 | 2,137 |
| Number of shares outstanding (weighted average) | thousands | 562,375 | 562,364 |
| Earnings per share | | | |
| Basic | € | 3.97 | 3.80 |
| Diluted | € | 3.97 | 3.80 |
| Dividend per share | € | 1.75[1] | 1.50 |

1 Proposal for fiscal 2005.

## (29) Reporting on financial instruments

Financial instruments include non-derivative and derivative financial instruments.

Non-derivative financial assets essentially include other non-current financial assets, accounts receivable, marketable securities as well as cash and cash equivalents. Financial assets available for sale are measured at fair value, while other financial assets are measured at amortized cost. Fair values are derived from the relevant stock market quotation or are measured on the basis of generally accepted valuation methods. On the liabilities side, non-derivative financial instruments principally include liabilities stated at cost. The balance of non-derivative financial instruments is disclosed in the balance sheet, and the maximum default risk corresponds to the amount of financial assets. If default risks associated with financial assets are identified, they are recognized through allowances.

As a utility enterprise with international operations, the RWE Group is exposed to currency, commodity and interest rate risks in its ordinary business activity. Such risks are limited via systematic risk management. Among other things, risks are mitigated through hedges. Derivative financial instruments are used to hedge currency, commodity and interest rate risks from operations as well as from cash investments and financing transactions. The instruments most commonly used are foreign exchange forwards, foreign exchange options, interest rate currency swaps, commodity forwards, commodity options, commodity swaps and interest rate swaps.

Our group companies are subjected to strict risk management. Binding internal directives define the range of action, responsibilities and controls. Accordingly, as a rule, financial derivatives may not be used for speculative purposes and serve only to hedge risks arising from operations. Guidelines have been established by the Group central risk management department for commodities, stipulating that commodity derivatives may be used to hedge price risks, optimize power plant schedules and increase margins. Furthermore, commodity derivatives may be traded, subject to strict limits. The limits are defined by independent organizational units and monitored on a daily basis.

Credit risks associated with contractual partners are systematically reviewed upon conclusion of the contract and constantly monitored. Furthermore, credit risk is reduced through appropriate forms of collateralizing.

Hedge accounting pursuant to IAS 39 is applied primarily for hedges of net investments in foreign entities as well as for hedges of foreign-currency liabilities and interest rate risks from non-current liabilities.

***Fair value hedges*** are mainly used to hedge fixed-interest loans and liabilities against market price risks. Instruments used are interest rate swaps and interest rate currency swaps. In the case of fair value hedges, both the derivative as well as the underlying transaction regarding the hedged risk are measured at fair value with an effect on income.

***Cash flow hedges*** exist primarily to hedge variable-interest loans and liabilities against interest rate risks as well as against foreign currency and price risks from future sales and purchase transactions. Changes in the fair value of hedges used are disclosed under other comprehensive income until the underlying transaction is realized. The hedge's contribution to income is transferred from other comprehensive income to the income statement when the underlying transaction is realized.

***Hedges of a net investment in a foreign entity.*** RWE hedges a significant portion of the foreign currency risks of net investment in foreign entities using bonds with various terms in the appropriate currency as well as with interest rate currency swaps. Every hedge is assigned to an underlying transaction. Exchange rate changes from bonds used for hedging purposes and changes in the fair value of interest rate currency swaps are subsumed under the currency translation adjustment disclosed under other comprehensive income.

When interpreting the positive and negative fair values of derivative financial instruments, with the exception of the relatively low commodity trading volumes, it must be taken into account that they are matched with underlying transactions with offsetting risks. All derivative financial instruments are recognized as assets or liabilities and are stated at fair value regardless of their purpose.

Maturities of derivative interest rate, currency, share-price related or index-related and commodity transactions are based on the maturities of the underlying transactions and are thus primarily short-term and medium-term in nature. Maturities of up to 30 years can be agreed upon to hedge foreign currency risks of foreign investments.

The nominal volume of the derivatives outlined below is specified with being offset. It represents the total of all purchase and sales amounts on which the derivatives are based. The level of the nominal volume enables estimates regarding the scope of the use of derivatives, but does not reflect the risk the group is exposed to from the use of derivatives.

The value-at-risk method is used to quantify the interest rate, currency and stock price risks for financial instruments in line with the international banking standard. The maximum expected loss arising from changes in market prices is calculated and continuously checked on the basis of historical market volatility, with a confidence level of 99 % and a holding period of one day.

Currency risks may exist for financial assets and liabilities in foreign currency. Such risks are counteracted by derivative financial instruments.

Interest rate derivatives used to hedge interest rate risks are nearly exclusively interest rate swaps.

Commodity derivatives are primarily used to hedge electricity, coal, gas and oil prices as well as $CO_2$ emission allowances.

The following derivative transactions were concluded:

| € million | Nominal volume | | Remaining term > 1 year | | Fair value | |
|---|---|---|---|---|---|---|
| | **12/31/05** | 12/31/04 | **12/31/05** | 12/31/04 | **12/31/05** | 12/31/04 |
| Foreign currency derivatives | | | | | | |
| Forwards | 6,248 | 4,908 | 606 | 930 | 1.8 | -96.1 |
| Options | 542 | 865 | 224 | 26 | -27.9 | -28.6 |
| Interest rate currency swaps | 17,355 | 16,036 | 8,407 | 9,744 | 1,266.5 | 2,023.7 |
| | **24,145** | **21,809** | **9,237** | **10,700** | **1,240.4** | **1,899.0** |
| Interest rate derivatives | 12,779 | 5,134 | 8,815 | 4,861 | 53.6 | 12.4 |
| Share-price related / index-related derivatives | 1,041 | 1,037 | 1,024 | 1,037 | -39.0 | 78.4 |
| | **37,965** | **27,980** | **19,076** | **16,598** | **1,255.0** | **1,989.8** |
| Commodity derivatives | | | | | | |
| Options | 2,164 | 3,274 | 822 | 1,159 | 34.4 | -19.4 |
| Swaps | 1,254 | 5,961 | 938 | 1,054 | -654.8 | -79.6 |
| Forwards | 55,640 | 16,918 | 14,641 | 2,697 | 213.7 | 222.9 |
| Other | 171 | 95 | 70 | 67 | 58.7 | 70.2 |
| | **59,229** | **26,248** | **16,471** | **4,977** | **-348.0** | **194.1** |
| | **97,194** | **54,228** | **35,547** | **21,575** | **907.0** | **2,183.9** |

Derivatives are exposed to default risks equivalent to their positive fair values. These risks are minimized by the stringent demands on our counterparties' creditworthiness. Default risk exposure was negligible in the year under review and in the previous year. Risks resulting from changes in the value of derivative financial instruments due to market fluctuations are generally not relevant for assessing the group's net worth, financial or earnings position, due to their hedging purpose.

As a rule, RWE AG centrally handles the refinancing of cash and capital market liabilities that come due. In addition to the extension of current money market programmes and short-term debt, some €0.7 billion in capital market debt and €0.9 billion in bank debt will come due in 2006. Capital is generally provided in the form of cash and cash equivalents, current marketable securities totalling €11,775 million, bilateral bank credit lines and a fully committed syndicated credit line of €4 billion, as well as US$ 1.2 billion / €1.0 billion in unused funds from a US$ 5 billion global commercial paper programme and the €20 billion debt issuance programme. This keeps the liquidity risk very low.

# *(30) Contingent liabilities and financial commitments*

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| Contingent liabilities resulting from general, draft and check guarantees | 164 | 598 |
| Contingent liabilities from warranties | 84 | 122 |
| Contingent liabilities from granting collateral for third-party liabilities | 22 | 145 |
| | **270** | **865** |

Contingent liabilities from warranties includes €38 million in guarantees, €1 million in guaranty commitments, €13 million in surety bonds, €2 million in binding letters of comfort and €30 million in other contingent liabilities.

The group had €1,996 million in capital commitments (previous year: €718 million). Moreover, as of December 31, 2005, assurances as regards acquisitions of investment existed in the amount of €386 million (previous year: €501 million).

The outside shareholders of enviaM Mitteldeutsche Energie AG (Chemnitz, Germany) and Süwag Energie AG (Frankfurt am Main, Germany) were granted put options on the shares in these companies. The financial liability that would arise if they exercised all of the put options totals €1.2 billion.

Pursuant to the shareholders' agreement of December 22, 2003, RWE Energy will purchase all of RWE Westfalen-Weser-Ems AG's outstanding shares that were granted to the former shareholders of RWE Gas AG in connection with the split-up of RWE Gas AG for €800 million, effective December 31, 2008. RWE AG accepted the obligation to pay the purchase price through an assumption of debt.

Rütgerswerke mbh, a subsidiary of RAG AG, was granted a €400 million line of credit at fair market conditions, which can be drawn down until June 29, 2007.

Commitments from operating leases refer largely to long-term rental arrangements for power generation and supply plants as well as rent and lease obligations for storage and administration buildings.

Minimum lease payments have the following maturity structure:

| **Operating leases**<br>€ million | **Nominal value**<br>**12/31/05** | Nominal value<br>12/31/04 |
|---|---|---|
| Due within 1 year | 76 | 81 |
| Due within 1 - 5 years | 226 | 252 |
| Due after 5 years | 254 | 314 |
| | **556** | **647** |

Payment obligations for non-current financial assets amounted to €59 million (previous year: €61 million). As in the previous year, there was no joint liability for third-party payment obligations under Sec. 24 of the German Limited Liability Companies Act.

The RWE Power Division has long-term purchase and service agreements for uranium, conversion, enrichment, production and waste management. RWE bears customary commercial liability for long-term contracts in the plant construction business.

We bear the legal and contractual liability from our membership in various associations which exist in connection with power plant projects, profit- and loss-pooling agreements and for the provision of liability cover for nuclear risks, among others.

By signing a mutual benefit agreement, RWE AG and other parent companies of German nuclear power plant operators undertook to provide €2,244.4 million in funding to liable nuclear power plant operators to ensure that they are able to meet their payment obligations in the event of nuclear damages. RWE AG has a 24.834 % (25.879 % from January 1, 2006 onwards) contractual share in the liability, plus 5 % for damage settlement costs.

RWE Group companies are involved in litigations and arbitration proceedings connected with their operations. However, RWE does not expect any material 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.

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 accounting firms are adequate and will stand up to scrutiny in court.

## (31) Segment reporting

In the RWE Group, segments are distinguished on the basis of the services provided by the group's divisions. The segmentation of divisions and geographical regions is based on the reporting system used by the management.

RWE Power is the segment comprising the entire Continental European power generation business as well as the group's lignite, gas and petroleum production business. This segment also includes the upstream operations of RWE Dea and the activities of the Harpen Group, which specializes in renewables-based and distributed power generation. As of fiscal 2005 the trading activities of RWE Trading will no longer be reported as an independent segment as they will be subsumed under the segment RWE Power, in reflection of the closely intertwined business activities of these two divisions. The figures for the previous years have been adjusted accordingly. In the previous fiscal year the following figures were reported for RWE Trading: Segment assets €7,118 million; segment liabilities €5,844 million; segment result €67 million

RWE Energy is the segment comprising distribution, transmission and sales for the Continental European electricity and gas businesses as well as parts of the Continental water business. RWE Solutions is also subsumed under RWE Energy.

RWE npower is the segment dedicated to the UK electricity and gas business.

The majority of the Group's water operations are reported in the segment RWE Thames Water, with a focus on the UK and North America.

Consolidation effects, the Group Centre and other activities not allocable to the divisions presented separately are disclosed under "Other / consolidation". This primarily includes the general services provided by RWE Systems. The figures for the previous year also include the business activities of RWE Umwelt and Heidelberger Druckmaschinen, which have been disposed of.

# Segment reporting

| Divisions | RWE Power | | RWE Energy | | RWE npower | |
|---|---|---|---|---|---|---|
| € million | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 |
| **External revenue** | **6,832** | **6,741** | **24,318** | **22,450** | **6,382** | **5,605** |
| Intra-group revenue | 6,323 | 5,684 | 865 | 706 | 3 | 0 |
| Total revenue | 13,155 | 12,425 | 25,183 | 23,156 | 6,385 | 5,605 |
| **Operating result** | **2,112** | **1,846** | **2,507** | **2,192** | **437** | **604** |
| Income from operating activities = segment result | 2,211 | 2,560 | 2,168 | 1,978 | 92 | 261 |
| Income from operating investments | 95 | 69 | 265 | 239 | 2 | -1 |
| Income from investments accounted for using the equity method | 117 | 41 | 358 | 193 | 2 | -1 |
| Depreciation and amortization | 750 | 762 | 902 | 946 | 455 | 423 |
| Operating depreciation and amortization | 783 | 794 | 900 | 974 | 126 | 93 |
| Impairment losses on goodwill | 0 | 0 | 0 | 0 | 0 | 0 |
| Impairment losses | 37 | 73 | 14 | 50 | 0 | 0 |
| Other major non-cash expenses relating to the segment result | 1,109 | 735 | 2,067 | 1,946 | 328 | 85 |
| **EBITDA** | **2,800** | **2,571** | **3,142** | **2,927** | **561** | **698** |
| Capital employed (as per the value management concept) | 7,468 | 7,979 | 11,962 | 11,963 | 6,645 | 6,378 |
| Carrying amount of shares in investments accounted for using the equity method | 291 | 206 | 2,122 | 1,863 | 0 | 0 |
| Segment assets | 28,324 | 15,760 | 19,652 | 18,935 | 10,635 | 10,019 |
| Segment liabilities | 33,992 | 22,107 | 13,624 | 12,948 | 2,609 | 2,204 |
| Capital expenditure on intangible assets, property, plant and equipment and investment property | 842 | 666 | 1,064 | 947 | 315 | 150 |

| Regions | EU | | | | | |
|---|---|---|---|---|---|---|
| | Germany | | UK | | Other EU | |
| € million | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 |
| External revenue | 23,038 | 23,101 | 8,638 | 8,425 | 6,753 | 6,299 |
| Segment assets | 30,150 | 26,989 | 34,990 | 27,051 | 6,861 | 6,523 |
| Capital expenditure on intangible assets, property, plant and equipment and investment property | 1,434 | 1,405 | 1,210 | 1,087 | 359 | 290 |

| RWE Thames Water | | Other, consolidation | | RWE Group | |
|---|---|---|---|---|---|
| **2005** | 2004 | **2005** | 2004 | **2005** | 2004 |
| **4,210** | **4,065** | **77** | **3,276** | **41,819** | **42,137** |
| 4 | 0 | -7,195 | -6,390 | 0 | 0 |
| 4,214 | 4,065 | -7,118 | -3,114 | 41,819 | 42,137 |
| **1,416** | **1,389** | **-271** | **-55** | **6,201** | **5,976** |
| 1,192 | 1,063 | -917 | -288 | 4,746 | 5,574 |
| 99 | 114 | 17 | -9 | 478 | 412 |
| 74 | 91 | 6 | -26 | 557 | 298 |
| 728 | 704 | 56 | 290 | 2,891 | 3,125 |
| 728 | 704 | 64 | 271 | 2,601 | 2,836 |
| 814 | 200 | 0 | 292 | 814 | 492 |
| 814 | 200 | 6 | 317 | 871 | 640 |
| 152 | 171 | 425 | 803 | 4,081 | 3,740 |
| **2,045** | **1,979** | **-224** | **225** | **8,324** | **8,400** |
| 19,047 | 18,971 | -2,983 | -811 | 42,139 | 44,480 |
| 204 | 302 | 0 | 294 | 2,617 | 2,665 |
| 25,792 | 24,113 | 471 | 3,280 | 84,874 | 72,107 |
| 4,116 | 3,348 | 5,887 | 7,653 | 60,228 | 48,260 |
| 1,388 | 1,465 | 58 | 201 | 3,667 | 3,429 |

| Rest of Europe | | Americas | | Other | | RWE Group | |
|---|---|---|---|---|---|---|---|
| **2005** | 2004 | **2005** | 2004 | **2005** | 2004 | **2005** | 2004 |
| 593 | 708 | 2,267 | 2,605 | 530 | 999 | 41,819 | 42,137 |
| 577 | 366 | 11,689 | 10,573 | 607 | 605 | 84,874 | 72,107 |
| 69 | 81 | 525 | 529 | 70 | 37 | 3,667 | 3,429 |

***Notes on segment data.*** Intra-group revenue reflects the level of revenue between segments and is priced at arm's length. The segment revenue is the sum of external and intra-group revenue.

Depreciation and amortization concern intangible assets, property, plant and equipment and investment property.

The definition of capital employed is derived from the value management concept. These figures are compatible with the operating result, which is also used for control purposes within the group (cf. pages 74 to 75). In addition to capital employed, the divisions' segment assets and liabilities are also disclosed. The following table shows the reconciliation of gross assets and gross liabilities to segment assets and segment liabilities:

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| Gross assets as per the balance sheet | 108,122 | 93,370 |
| Investments accounted for using the equity method | -2,617 | -2,665 |
| Other non-current financial assets | -1,842 | -1,939 |
| Marketable securities | -10,344 | -11,013 |
| Financial receivables | -4,655 | -2,403 |
| Deferred tax assets | -3,790 | -3,243 |
| **Segment assets** | **84,874** | **72,107** |

| € million | 12/31/05 | 12/31/04 |
|---|---|---|
| Gross liabilities as per the balance sheet | 95,005 | 82,177 |
| Tax provisions | -2,452 | -2,400 |
| Financial liabilities | -27,452 | -27,383 |
| Deferred tax liabilities | -4,873 | -4,134 |
| **Segment liabilities** | **60,228** | **48,260** |

Capital expenditure includes spending on intangible assets, property, plant and equipment and investment property.

Income from investments accounted for using the equity method covers income and expenses from profit- and loss-pooling agreements, and prorated corporate results. It also includes amortization and impairment losses on goodwill as well as on shares in companies accounted for using the equity method.

# Operating result

| € million | 2005 | 2004 |
|---|---|---|
| Income from operating activities | 4,746 | 5,574 |
| + Income from investments | 767 | 846 |
| + / – Non-operating result | 688 | –444 |
| **Operating result** | **6,201** | **5,976** |

The reconciliation addresses the following points: Income from investments includes all expenses and income that have arisen in connection with operating investments. Income from investments thus constitutes an integral part of the Group's operating activity.

Income and expenses that are unusual from an economic perspective, or are the result of exceptional events, prejudice the assessment of operating activities. They are reclassified to the non-operating result. In the event that impairment losses are recognized on the goodwill of fully consolidated companies, such losses are contained in the non-operating result.

In the year under review, the group's income from operating activities and income from investments were adjusted by the non-operating result of €688 million (previous year: –€444 million).

Gains on disposals included in the non-operating result in the reporting period amount to €326 million, and relate to the disposal of shares in Stadtwerke Düsseldorf, among other things. In the previous year, the gains on disposals amounted to €678 million and related primarily to the sale of shares in Heidelberger Druckmaschinen, Motor-Columbus / Atel, HOCHTIEF and the last tranche of shares in CONSOL.

## (32) Notes to the cash flow statement

The cash flow statement classifies cash flows according to operating, investing and financing activities. Cash and cash equivalents in the cash flow statement correspond to total cash and cash equivalents on the balance sheet. Cash and cash equivalents consist of cash on hand, demand deposits and fixed-interest marketable securities with a maturity of three months or less from the date of acquisition.

Flows of funds from the acquisition and sale of consolidated companies are included in cash flows from investing activities. Effects of foreign exchange rate changes are stated separately.