



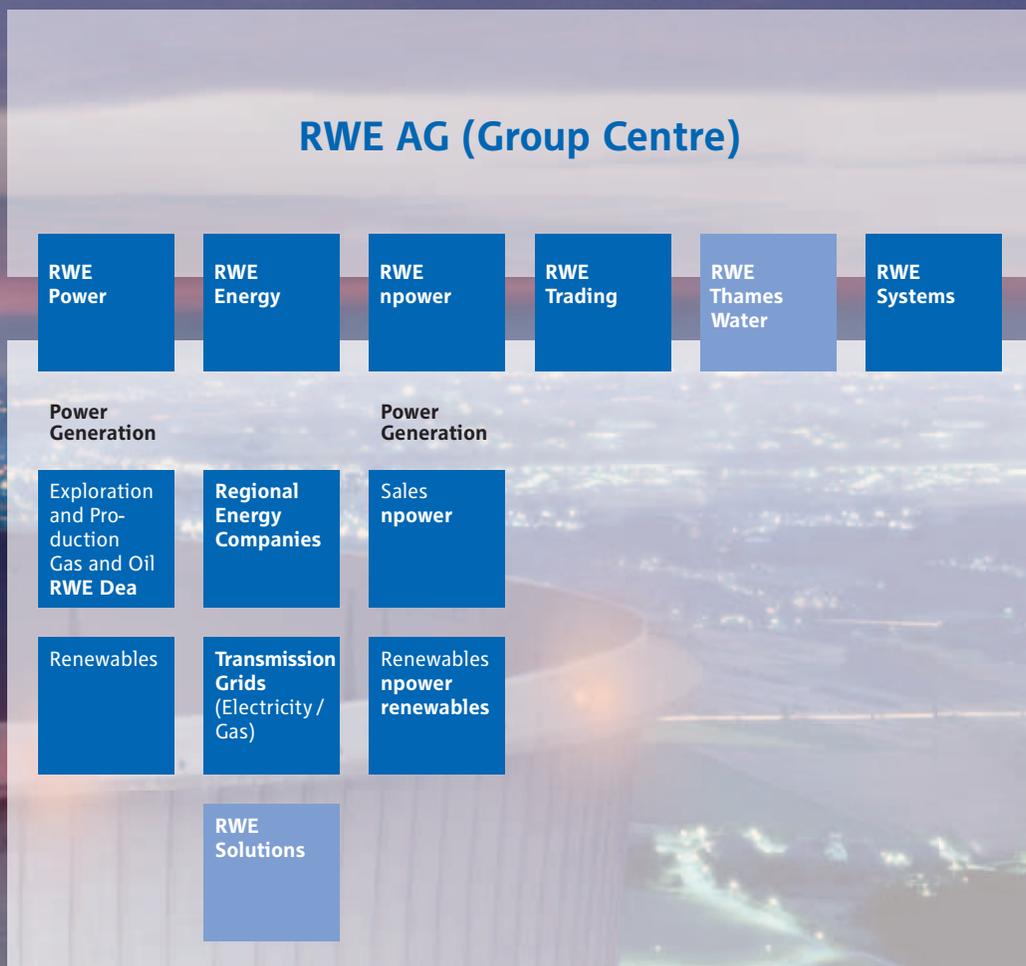
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# Annual Report 2005



# The RWE Group – a brief portrait

We are one of Europe's leading electricity and gas companies. Last year, our 86,000-strong workforce generated some €42 billion in external revenue. Our major power generation, sales and trading markets are in Germany, the UK and Central Eastern Europe. In the future, we will focus even more on the energy business. Therefore, we intend to sell our water activities in the UK and North America by 2007. RWE supplies 20 million customers with electricity and 10 million with gas. Our drinking water and wastewater services are part of the everyday lives of nearly 14 million people in Continental Europe.



## *RWE's divisions*



**RWE Power** is Germany's biggest power producer. The company produces lignite and generates electricity from coal, nuclear fuel, gas and renewables. Its subsidiary RWE Dea produces gas and oil.



**RWE Energy** is our sales and grid company for customers in Continental Europe. The company supplies electricity, gas and water from a single source in twelve regions within and outside Germany.



**RWE npower** is responsible for our UK energy business. The company has an integrated business model. Operations include the generation of electricity from coal, gas, oil and renewables as well as the sale of electricity and gas.



**RWE Trading** ranks among Europe's leading energy traders. We trade electricity, gas, coal and mineral oil as energy sources in their physical state as well as energy derivatives to hedge price risks.



**RWE Thames Water** encompasses our water and wastewater management activities outside Continental Europe. We plan to sell this division by the end of 2007, in order to focus even more on our European energy business.



**RWE Systems** is our internal service provider. Its tasks run the gamut from IT, real estate management and central purchasing to personnel and infrastructure services.

## 2005 key figures at a glance

- *Operating result up 4% and up 8% net of one-off effects*
- *Net income 4% higher despite impairment loss for American Water*
- *ROCE target for 2006 (14%) already exceeded*
- *Net financial debt reduced to €11.4 billion*
- *€1.75 per share dividend proposal 17% up on previous year*

<b>RWE Group</b>		<b>2005</b>	<b>2004</b>	<b>+/- in %</b>
External revenue	€ million	41,819	42,137	-0.8
EBITDA	€ million	8,324	8,400	-0.9
Operating result	€ million	6,201	5,976	3.8
Income from continuing operations before tax	€ million	3,828	3,935	-2.7
Net income	€ million	2,231	2,137	4.4
Recurrent net income <sup>1</sup>	€ million	2,257	1,794	25.8
Return on capital employed (ROCE)	%	14.7	13.5	-
Weighted average cost of capital (WACC) before tax	%	9.0	9.0	-
Value added	€ million	2,408	1,998	20.5
Capital employed	€ million	42,139	44,480	-5.3
Cash flows from operating activities	€ million	5,304	4,928	7.6
Capital expenditure	€ million	4,143	3,737	10.9
Property, plant and equipment	€ million	3,667	3,429	6.9
Financial assets	€ million	476	308	54.5
Free cash flow <sup>2</sup>	€ million	1,637	1,499	9.2
Earnings per share	€	3.97	3.80	4.5
Dividend per share	€	1.75 <sup>3</sup>	1.50	16.7
		<b>12/31/05</b>	<b>12/31/04</b>	
Net financial debt	€ million	11,438	12,385	-7.6
Workforce <sup>4</sup>		85,928	97,777	-12.1

1 Net income excluding the non-operating result and excluding non-recurrent effects in the financial result and in the tax expense.

2 Cash flows from operating activities minus capital expenditure on property, plant and equipment.

3 Dividend proposal for RWE AG's 2005 fiscal year, subject to approval by the April 13, 2006 Annual General Meeting.

4 Full time equivalent.

***»Security of supply is a huge  
commitment that must be fulfilled  
anew every single day.***

***24 hours a day | 365 days. That's our  
mission. RWE — there for you.«***

**To Our Investors**

**Executive Board Report**

**Our Responsibility**

**Consolidated Financial  
Statements  
Additional Information**

**Icon legend:**

\*  Cross reference

\*  Navigation around [www.rwe.com](http://www.rwe.com)

Negligible amount

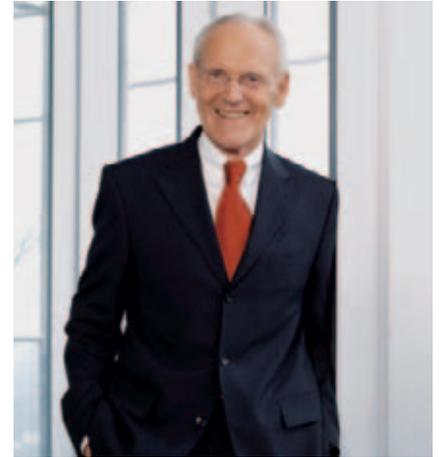
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\* Part of the Review of Operations.



**Harry Roels**, born in the Netherlands in 1948, obtained a degree in physical chemistry in 1971. Worked for the Royal Dutch / Shell Group for 30 years. In July 1999 appointed Managing Director of Royal Dutch Petroleum Company and Group Managing Director of the Royal Dutch / Shell Group of companies. Since February 1, 2003, Chief Executive Officer of RWE AG. Group-level responsibilities: Corporate Development, Legal / Board Affairs, Group Corporate Information Office, Energy and Environmental Policy, Communications, Executive Resources Development, Mergers & Acquisitions, Auditing.



**Dr. Klaus Sturany**, born in 1946 in Wehrda (Hesse), studied mathematics. From 1997 to 1999 Spokesman of the Board of Management of GEA AG. Since December 1999 Executive Vice-President of RWE AG. Group-level responsibilities: Controlling, Finance, Risk Management, Investor Relations, Accounting, Tax, Insurance.

*Dear Investors,*

Today my letter will focus on strategic issues. The reason for this is the planned sale of our water business outside Continental Europe. We will continue to be active as a water utility only in the regions in which we have a strong presence with our energy business. I am sure that many of you were surprised by the news of the divestment. This is why I would like to reiterate some of the reasons for the sale as well as the opportunities this pivotal step offers us.

Electricity and gas supply in Europe are our long-established core competencies. We strengthened them considerably in the last few years, turning RWE into a much more focused and market-oriented company. In the future, we want to concentrate on these core competencies even more. This is where we will achieve the highest returns in the long run, as evidenced by the value contributed by RWE Power and RWE Energy. As a result, the regulated water business is less important as a stabilizing factor in our Group portfolio today than it was during the difficult initial phase of the German energy market's deregulation. Furthermore, even without the water activities in the UK and North America, we still generate one out of every three euros of our Group's operating result from stable, regulated business. And there is another major reason for the sale: The water business requires very high, non-discretionary expenditure on property, plant and equipment, which often exceeds operating cash flow. Without the water business we will have greater financial flexibility when considering investment in power plants, gas and electricity grids and our ability to increase your dividend. In addition, we believe that the increased financial strength of our water business is not fully reflected in RWE's share price. Water activities are currently valued higher as stand-alone companies.



**Jan Zilius**, born in 1946 in Marburg, studied law. Joined the RWE Group in 1990, initially as Executive Vice-President and Labour Director of RWE Rheinbraun AG. Since April 1998 Executive Vice-President of RWE AG. Since February 2005 also CEO of RWE Power AG.



**Berthold A. Bonekamp**, born in 1950 in Billerbeck (Coesfeld County), studied mechanical engineering and business management. Since 1998 Executive Vice-President of RWE Rheinbraun AG. Since 2000 Executive Vice-President of RWE Power AG. Until March 2004 CEO of RWE Power AG. Since April 2004 CEO of RWE Energy AG and Executive Vice-President of RWE AG.



**Alwin Fitting**, born in 1953 in Westhofen (Rhine-Hesse). Has worked in the RWE Group since 1974. Trained master electrician. In 1996 appointed Chairman of the Combined Works Council of RWE Energie AG. Since 2000 Executive Vice-President and Labour Director of RWE Power AG. Since August 2005 Executive Vice-President and Labour Director of RWE AG. Group-level responsibilities: Human Resources Management, Security.

When announcing the sale, we also explained how we intend to use the proceeds. Depending on the progress of each of the sales processes, we plan to pay to you, our investors, an increased dividend for both this and the next financial year. We have summarized the relevant details on page 34 of this annual report.

After the divestment, we will have additional room for manoeuvre, which we can use to grow our business profitably through acquisitions on Europe's energy market. In recent months, many investors have asked me how we intend to focus our acquisitions and whether we believe we can make acquisitions at reasonable prices, given the numerous bidders for European energy activities. In response, I would like to emphasize two points:

First, our strategic map is clear and limited to regions offering a relatively high degree of stability. It mainly consists of our existing core markets in Germany, the UK and RWE's four markets in Central Eastern Europe to date: Poland, the Czech Republic, Hungary and Slovakia. Regions of potential interest to us must be within the reach of these markets. Here I would like to highlight the Netherlands as well as the future EU member states in Central Eastern Europe. In which elements of the value chain that we do not yet occupy do we intend to establish a presence? Power generation tops our list of priorities. Our main competitive advantage is that we can build and operate power stations as well as market electricity effectively. Exporting our power plant management expertise that has proven itself in Germany and the UK to new markets will open the door to new opportunities for generating

profitable growth. This also holds true for the distribution and sales of electricity and gas to end customers in industry, commerce and households. We also intend to grow our business with supraregional gas pipelines, gas storage facilities and liquefied natural gas (LNG). Due to the increasing deregulation of the European gas sector and mounting demand, we anticipate new opportunities in these sectors for experienced gas companies such as RWE.

This brings me to the second point: the bidding process for the acquisition of stakes in electricity and gas companies. Consolidation of the energy market has regained steam. This is a European process that does not stop at country borders. If we want to rank among the leading utilities, we must take advantage of this development. Even though more can be achieved, RWE is one of the most competitive electricity and gas companies with multi-regional operations in Europe. We are thus well-equipped to play a major role as the consolidation process unfolds. After all, we want your company to be positioned among the top five utilities in Europe's energy landscape in the future as well, especially in terms of earnings and innovation ability. This also includes our ability to adjust to new situations in the market despite the size of our company. This skill is and must remain one of our core competencies besides electricity and gas. It is the prerequisite for being a reliable partner to our customers in RWE's various regions over the long term, while remaining an attractive employer of talented and committed staff members.

We will travel this route with discipline and moderation, making sure we grow through acquisitions only if they meet our ambitious strategic and financial criteria. Evidence of the fact that we take this seriously can be seen in several privatization rounds in Central Eastern Europe, from which we withdrew our bids early on owing to exorbitant prices. We are not in a rush. We will probably not receive the proceeds from the planned sale of our water activities until 2007. As a result, we are not under pressure to reinvest in the short term. Furthermore, increasing returns to our investors always remains an option.

RWE, your company, is thus working with undiminished energy to secure its future competitive position. I am convinced that we will make good progress. This year, however, we will concentrate on preparing for the disposal of our water activities. You can justifiably expect from us that we secure a reasonable price.

I am also convinced about the robustness of our financial development. Last year, we improved our operating result by 8%, net of special items. Despite an impairment in connection with the sale of American Water, we increased net income by 4% and will propose to the Annual General Meeting that the dividend be raised by 17%. Our equity capital rose by 17%. The new fiscal year got off to a good start as well. We expect a further improvement in the operating result and believe we stand a good chance of achieving the goals for 2006 that you are familiar with.

Our solid business prospects are clearly reflected in RWE's share price. At 59%, the total return of our ordinary shares exceeded that of the comparison indices DAX, Dow Jones EURO STOXX 50 and Dow Jones STOXX Utilities.



However, 2005 was also characterized by an increasingly intense debate on energy prices—both by politicians and the public at large. RWE participates openly and actively in this discussion. Our business is complex. This is why transparency is all the more important. It is the only way we can lastingly counter the displeasure about rising energy prices, which I can personally understand. It is also important that we continue the intense dialogue regarding Europe's future energy policy in light of our greatest ambition: security of supply. Here objectivity is indispensable. After all, we need a broad energy mix that includes all fuel sources free of ideological considerations. In this context, one must not lose sight of the balance between security of supply, economic reason and environmental compatibility.

We are committed to fulfilling our mission as a utility in our regions. It is against this backdrop that we were all the more concerned about the weather disaster in the northwest of Germany at the end of November and the consequences it had for our customers. I sincerely regret the serious inconvenience caused by the power outages. But I am also proud of the hundreds and hundreds of employees, who were on duty, working tirelessly day and night during those November days to re-establish the supply of electricity to our customers. That was a real team effort, which demonstrated that we take our pledge to supply electricity seriously at all times. Seven days a week, around the clock.

Therefore, I would like to take this opportunity to say a personal word of thanks to all of our employees for their commitment and reliability. Working as one team, I am optimistic about being able to successfully tackle the challenges of the new fiscal year.

Sincerely yours,

A handwritten signature in blue ink, appearing to read 'H. J. M. Roels'.

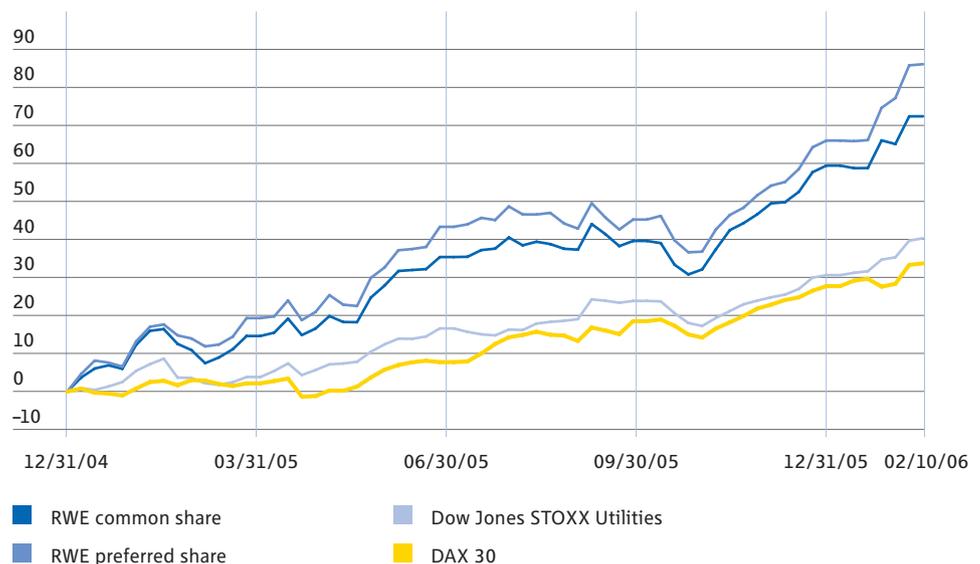
H. J. M. Roels  
CEO of RWE AG

Essen, February 14, 2006

## Shares and bonds continue exceptional performance

*RWE shares posted another substantial gain in value. Our common stock delivered a total return of 59%, with preferred shares recording an even higher return of 65%. By comparison, the DAX was up 27%. Our ratings remained high on the credit markets.*

**Performance of RWE shares compared with the DAX 30 and the Dow Jones STOXX Utilities Indices**  
in %



The DAX achieved its highest yearend close since 2000.

**DAX achieves 27% gain.** In the first few months of 2005, the German Stock Exchange traded sideways, characterized by the steep climb in oil prices. A strong upward trend began in May. Main drivers were merger speculation in several sectors, improved export possibilities owing to the decline of the euro, and the early elections for the Bundestag, Germany's lower house of parliament. On September 9, 2005, the German lead index, DAX 30, surpassed the psychologically important 5,000-point mark for the first time in three years. Political uncertainty following the elections to Germany's lower house of parliament on September 18 only had a short-lived impact on the positive sentiment. The DAX was buoyed by more widespread optimism among foreign investors above all in the fourth quarter. It closed the month of December at 5,408 points, recording the highest yearend close in five years. The DAX's performance places it in the premier group of indices on an international level.

RWE shares outperform benchmark indices again.

**RWE common stock generates 59% return.** RWE's common shares again clearly bested the market's performance in the fiscal year being reviewed. They closed 2005 at €62.55, exceeding the prior year's closing price by 54%. Including the dividend, this corresponds to a total return of 59%. Our common stock substantially outperformed the Dow Jones STOXX Utilities index (+30%) as well. RWE's preferred share price increased even more, rising by 59% to €54.44, a total return of 65%. The encouraging development in RWE's share price was primarily due to the positive earnings outlook of the German electricity generation business. The announcement of our intention to sell the water business and focus even more on the European energy market in the future also led to a significant rise in our share price. However, debate surrounding the German energy market's future political framework gave rise to some unease.

In early 2006 the stock market's upward trend continued. On February 1 the DAX surpassed the 5,700-point mark again for the first time since August 2001. RWE shares also maintained their momentum. In early February, RWE's common stock occasionally traded above €68.

**Weighting of RWE stocks and RWE bonds in important indices**  
as of December 31, 2005

Stock index	Weighting	Bond index	Weighting
DAX	5.0 %	iBoxx Euro Utilities	9.6 %
Dow Jones EURO STOXX 50	1.6 %	iTraxx Europe Energy	5.0 %
Dow Jones STOXX	0.5 %	MSCI Euro Credit Corporate	1.4 %
Dow Jones STOXX Utilities	8.6 %	MSCI Eurosterling Credit Corporate	3.5 %

**Long-term return of RWE shares considerably higher than the market.** Long-term investors who invested €10,000 in RWE ten years ago and reinvested their dividends saw their investments grow to €30,416 (common shares) or €36,498 (preferred shares) by December 31, 2005. This corresponds to an annual average return of 11.8% and 13.8% respectively. The DAX advanced 9.1% per annum over the same period of time.

**Comparative performance of RWE shares and important indices up to the end of 2005**  
in % p. a.

	1 year	5 years	10 years
RWE common share	58.6	8.8	11.8
RWE preferred share	65.0	13.4	13.8
DAX 30	27.1	-3.4	9.1
Dow Jones EURO STOXX 50	24.3	-3.6	11.3
Dow Jones EUROPE STOXX 50	24.2	-3.7	10.5
Dow Jones STOXX	26.7	-0.6	10.6
Dow Jones STOXX Utilities	29.9	6.0	12.8
REXP <sup>1</sup>	4.1	5.9	5.9

<sup>1</sup> Index for the performance of government securities on the German bond market.

RWE share indicators <sup>1</sup>		2005	2004	2003	2002	2001 TFY <sup>2</sup>
Earnings per share <sup>3</sup>	€	3.97	3.80	1.69	1.87	1.10
Cash flows from operating activities per share	€	9.43	8.76	9.41	10.55	1.82
Dividend per share	€	1.75 <sup>4</sup>	1.50	1.25	1.10 <sup>5</sup>	1.00 <sup>6</sup>
Common share prices						
End of fiscal year	€	62.55	40.70	31.37	24.70	42.20
High	€	63.24	43.50	31.97	43.80	49.95
Low	€	41.10	29.70	17.68	24.12	37.10
Preferred share prices						
End of fiscal year	€	54.44	34.21	27.95	20.75	31.25
High	€	55.09	36.94	28.20	34.49	38.50
Low	€	34.79	25.96	16.48	20.01	26.20
Dividend payment	€ million	984 <sup>4</sup>	844	703	619	562 <sup>6</sup>
Number of shares at end of fiscal year	million	562.4	562.4	562.4	562.4	570.0
Common shares	million	523.4	523.4	523.4	523.4	531.0
Preferred shares	million	39.0	39.0	39.0	39.0	39.0
Market capitalization at end of fiscal year	€ billion	34.9	22.6	17.5	13.7	23.6

1 In relation to the weighted average number of shares outstanding.

2 Truncated fiscal year for the Group from July to December 2001.

3 Due to the change in IFRS, figures after 2003 no longer include goodwill amortization.

4 Dividend proposal for RWE's 2005 fiscal year, subject to the approval of the April 13, 2006 AGM.

5 Includes €0.10 bonus.

6 Dividend for RWE AG's 2001 fiscal year (January to December).

We will propose to the AGM to pay a dividend of €1.75 per share for fiscal 2005.



**17% rise in dividend payment.** The Supervisory and Executive Boards will propose a dividend of €1.75 per share for fiscal 2005 to the Annual General Meeting on April 13, 2006. This represents an increase of 17% compared with the previous year. Using recurrent net income\* as a yardstick, our payout ratio is 44%. Based on the closing share prices in 2005, this corresponds to a 2.8% dividend yield on common shares and a 3.2% yield on preferred shares.

**International shareholder structure.** Shareholders outside Germany currently hold about 27% of RWE's capital (end of 2004: 24%). Our shareholder base in North America and the UK rose from a combined 17% to 19%. The remaining 8% is predominantly held in Continental Europe. Including big German investors, 53% of RWE's capital is held by institutional investors, 31% by municipalities and 16% by private and employee shareholders. The RWE common share's free float amounts to 89%.

**Development of RWE's five-year credit default swap (CDS) compared with the CDS sector index iTraxx Europe Energy in basis points**



Low credit default swap prices reflect RWE's strong creditworthiness.



**Low credit default swap prices.** In 2005 sentiment on the world's credit markets was characterized by interest-related fears. Moreover, negative news from the US automotive sector led to uncertainty on the bond market. This was reflected in higher spreads for corporate bonds, which also affected RWE bonds. In contrast, prices paid on the market to hedge RWE's credit risk via credit default swaps\* (CDSs) remained largely stable. Our consistently solid financial situation and strong Single A credit rating\* made a large contribution to this cause. Therefore, at the end of the fiscal year, the five-year CDS for RWE was just one basis point above the level achieved at the end of 2004. In the same period, the iTraxx Europe Energy, the European CDS sector index, fell by three basis points.

Issues of energy policy and the planned sale of the water division were the main topics in communications with investors and analysts.

**RWE receives awards for investor relations work.** In 2005 our communications work focused on commenting on current affairs in the field of energy policy as well as the planned sale of our North American and UK water activities. We assisted investors and analysts in making realistic assessments regarding these topics by providing information and arranging discussions with RWE specialists. We met with investors in 32 financial centres during 50 road shows and ten conferences as well as numerous one-on-one discussions during which we made presentations and answered questions. In so doing, we expanded the activities for our bond investors considerably.

We received yet another award for the quality of our communications work. Among other things, RWE was ranked first in the European utilities category in the two major investor relations market surveys conducted among investors and analysts by Thomson Financial Extel and the trade magazine "Institutional Investor."

There for you—24 hours | 365 days

# »Tomorrow's security of supply starts today.«



## RWE Power

2006–2010:

€1.8 billion in capital expenditure  
on average every year

It is earmarked primarily to build new power plants in Germany and expand RWE Dea's oil and gas production in the years ahead.



## RWE Energy

2006–2010:

€1.1 billion in capital expenditure  
on average every year

Security of supply requires care: we constantly modernize and expand our electricity and gas grids.

*Today's decisions determine tomorrow's world: RWE has a long-standing tradition of investing in the future. Be it the world's largest hydroelectric power station in 1905 or Germany's longest high-voltage line in the 1920s, be it the most modern lignite power plant of present times or the first major offshore wind farm in the UK — we have always worked hard to rise to the challenges of the future.*

*Today we are laying the groundwork for the security of supply tomorrow — by investing in high-performance power plants and grids as well as in our most valuable asset: our employees. This ensures that we will continue to be a reliable regional partner to our customers. Around the clock, every day of the year.*



## **RWE npower**

**2006–2010:**

**€600 million in capital expenditure  
on average every year**

**In the UK we are modernizing our power plant  
portfolio, reducing emissions in the process.**

There for you—RWE Power

**»The accomplishment:  
40 years of supply security.  
And 30% less CO<sub>2</sub>.«**



RWE Power



Removal of excavated earth



Workers on a construction site



Excavation works in Neurath (GER)



**Neurath in the vicinity of Cologne (Germany): this is where the world's most cutting-edge lignite power plant is being built. From 2010 onwards, it will be connected to the grid, with an installed capacity of up to 2,100 MW. Thanks to its high efficiency, it will use less coal and thus emit less CO<sub>2</sub>. This is an indispensable contribution to ensuring supply security in the future and protecting our climate—using lignite, which is at home here.**



RWE Energy



Gas cross border station (CZE)



Grid surveillance approach flight



Ruhrwasserwerk (Ruhr waterworks)  
Mülheim an der Ruhr (GER)



There for you—RWE Energy

*»Bird's eye view: monitoring grids by helicopter.«*

Through endless power lines, crossing thousands of high-voltage pylons: supply security exists when energy safely reaches its point of use. Today we monitor our grids with helicopters as well. Technical defects and construction work below the lines can be detected and evaluated better from above. The forces of nature are difficult to predict—but surveillance flights ensure that maintenance problems don't fall through the cracks. This is a mission we aspire to fulfil in our gas and water business as well.

There for you – RWE npower

*»Supply security has many facets. Customer proximity is one of them.«*



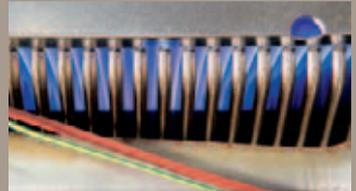
RWE npower



Employee in the Peterlee call centre (UK)



Serving private customers



Gas boiler in operation



Supply security can also be obtained through an affordable “insurance policy”: RWE npower’s “gas boiler breakdown service” provides rapid and flexible assistance in remedying problems. In the event of boiler malfunction, a simple call is all it takes for a technician to come around—24 hours | 365 days a year. This gives our UK customers peace of mind at a fixed price—and a warm home around the clock.

## More focus on energy

*Fiscal 2005 was marked by continuity and change. Our Continental European power and gas businesses continued their positive earnings trends. This is reflected in the further improvement of the operating result, which rose by 4% year on year and by 8% net of one-off effects. The 2005 financial year was also a year in which new courses were charted: in early November, we announced our plan to sell our UK and North American water operations by 2007 in order to focus our resources even more where they add the most value—in our core business, energy.*

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## Strategy and structure

Our goal is to rank among Europe's leading energy companies in the future.

**Clear strategic goal in sight.** RWE already ranks among Europe's leading integrated electricity and gas companies. And we intend to maintain this status. The economic environment in the years ahead is unlikely to become any easier. We expect fierce competition and growing customer needs as well as complex political and regulatory conditions. At the same time, European gas and electricity markets continue to converge. Our multiregional company offers us additional prospects in this context. We want to secure our good market position and take advantage of opportunities for growth in this challenging environment. To this end, we have established five strategic maxims:

- We are concentrating our activities predominantly on electricity and gas.
- We are focusing on our European core markets.
- We intend to occupy leading market positions wherever we have business operations.
- We strive to be successful in all elements of the value chain and supply our customers with electricity and gas from a single source ("integrated business model").
- We aim to increase the value of our company.

Our focus on energy in select European markets will enable growth and stability.

**Focusing on electricity and gas.** In early November 2005, we made the strategic decision to withdraw from the water sector in the UK and North America. This will enable us to focus our core competencies on Europe's converging electricity and gas markets. Water will remain part of our business model wherever we already offer our Continental European customers integrated electricity, gas and water services.

**Focusing on Europe's core markets.** Our regional focus stretches from the UK to Eastern Europe. This is where we intend to safeguard and further expand market shares. Concentrating on these countries enables us to establish a well-balanced presence in mature and growing markets as well as a wide diversification of business risks. In light of the long investment cycles prevalent in our fields of business, we are only active in markets offering attractive earnings prospects as well as a reliable business and regulatory environment over the long term.

**Leading market positions.** Our major power generation, trading and sales markets are currently in Germany, the UK and Central Eastern Europe. In these markets, in terms of sales, we rank among the top three suppliers of at least one of our main

In our main markets, we rank among the top three suppliers of at least one of our products.

products, i. e. electricity or gas. The advantage lies in the fact that leading market positions translate into volume and cost benefits. This enables us to enhance our company's value even in a competitive environment.

Market positions	Electricity	Gas
Germany	No. 1	No. 2
UK	No. 3	No. 3
Central Eastern Europe	No. 2 in Hungary No. 3 in Slovakia Starting position in Poland	No. 1 in the Czech Republic Leading position in Hungary
Europe	No. 3	No. 6

**Integrated business model.** Our operations are vertically integrated, i. e. we cover all of the major elements of the value chain. In the electricity business, for instance, we are not just power producers, but traders, grid operators and a sales company as well. Our vertical alignment affords us greater flexibility in offsetting market fluctuations at the individual stages of the value chain and enables us to realize synergies. Thanks to our horizontal integration, e. g. the sale of electricity and gas via one and the same Group company, we achieve additional synergies. We have bundled our power and gas grids at the distribution network level and placed them under single companies as well. Furthermore, since these sales and distribution grid companies have a regional orientation, we can establish and nurture very close ties to our customers.

#### Active along the entire energy value chain

	Upstream		Energy Trading	Supraregional and Regional Electricity and Gas Grids	Electricity and Gas Sales
	Power Generation	Gas and Oil Production			
Continental Europe	RWE Power	RWE Dea	RWE Trading	RWE Energy	
UK	RWE npower			RWE npower	

We want to continue to increase the value of our company by enhancing efficiency, making long-term investments, and making selective acquisitions.

**Growing the value of our company sustainably.** Increasing the value of our business in the interests of our investors takes centre stage in RWE's strategy. Our aim is to raise our enterprise value using three levers:

- The first lever entails constantly optimizing our existing business. Projects pursued in this area fall under the heading "operating excellence." They are designed to make business processes more efficient, reduce costs, and identify key value drivers in order to put potential for improvement into action.

- Second, value can be increased over the long term only if we invest in the future at the right time. If we want to continue to achieve stable and attractive returns in the next few years, we must make investments today to safeguard our market positions tomorrow. Here the focus lies on our power plant and grid operations as well as on our oil and gas production activities.
- The third lever involves making select acquisitions that create value. We constantly sift through options for expanding our existing portfolio via acquisitions. In so doing, we adhere to our strict strategic and financial acquisition criteria. Acquired activities must at least earn their cost of capital no later than in the third year of their full inclusion. Moreover, these activities may not jeopardize our goal of maintaining a strong Single A credit rating. However, given present market conditions, patience is of the order. Privatization in Eastern Europe is progressing at a moderate pace. Potential for external growth is limited in other regions and other bidders are exhibiting keen interest.

Value added and free cash flow are the yardsticks of the performance-oriented compensation of RWE's executives.



**Value management\* as a central controlling instrument.** We always gauge the success of our divisions based on their return on capital employed, minus the cost of capital. This results in the value added. This, in addition to free cash flow and further, individually agreed goals, is a yardstick for determining the performance-linked compensation of our executives and salaried employees. Regular reviews of target agreements make transparent the contribution made by each area and its management to the success of the business.

**Divisions.** Six divisions oversee the RWE Group's operations and subordinate business units.

- **RWE Power** encompasses our Continental European power generation activities, including lignite production, as well as RWE Dea's gas and oil production.
- **RWE Energy** is our sales and grid company for Continental Europe and supplies customers in this region with electricity, gas and water. Six integrated regional companies operate under this division in Germany, with another six active in our other Continental European markets. Independent companies handle supraregional electricity and gas grid operations as well as the storage of gas.
- **RWE npower** is responsible for power generation as well as electricity and gas sales on the UK market.
- **RWE Trading** is our energy trading arm, acting as our hub for all tradable commodities such as electricity, gas, coal and oil.
- **RWE Thames Water** encompasses the water business outside Continental Europe. We intend to divest this activity by the end of 2007.
- **RWE Systems** provides internal services for the other RWE companies.

Review of Operations  
**Strategy and structure /**  
**Economic environment and**  
**events**

RWE Power and RWE Trading are combined in our financial reporting. RWE Systems is included in "Other, consolidation."

RWE AG performs central management tasks. The operating companies are involved when fundamental decisions are made.



**RWE AG**, the Group Centre, is the RWE Group's management holding company, which as such carries out management tasks, e.g. corporate development, mergers & acquisitions, finance, controlling, executive development and communications. Fundamental strategic and operating decisions are prepared by the Group Business Committee\* (GBC). The GBC consists of the Group Executive Board, the CEOs of our operating companies (excluding RWE Systems) and of RWE Dea as well as of the Head of Corporate Development.

#### *The RWE Group's area of strategic focus*



■ Markets in which RWE has a presence

# Economic environment and events

## Economic environment

**World economy defies rising oil prices.** The global economy stayed its course for growth in 2005. Although the upswing recently lost steam, the world economy remained strong, increasing gross domestic product (GDP) by approximately 3 % in real terms. Despite the dampening effect of oil prices, the economy had significant room for manoeuvre in terms of liquidity, an increase in the asset base, and largely solid corporate earnings.

Germany's economy posted 0.9% real growth in 2005. The UK, our second-largest market, recorded a rise of 1.8%.

**Slowing growth on RWE core markets.** The economic upturn displayed in Eurozone countries continued, albeit at a moderate pace. High oil prices and the difficult situation on various labour markets dampened consumer and investor spending. Initially, growth in orders received from abroad merely improved industrial capacity utilization. Only from the third quarter onwards did foreign demand stimulate investing activity. The economic trend regained some momentum. All in all, real GDP in the Eurozone was up 1.2 % year on year.

Germany's economic development lagged the European average. GDP advanced by 0.9%. Positive stimuli from foreign trade were unable to energize the domestic economy to a noteworthy extent. Consumers continued to display restrained spending. Due to tight budgets, the state was also unable to produce any major stimulus. Domestic demand was buoyed by the increase in capital expenditure on equipment.

The UK economy cooled down. Investment growth and consumer spending were initially weak in 2005, owing to interest rate hikes introduced in the previous year. By lowering the base rate, the UK central bank (Bank of England) provided for a more positive economic environment in the second half of the year. Nevertheless, GDP only rose by 1.8 % in 2005, as compared with 3.2 % a year earlier.

The economies of Central Eastern Europe also suffered a slowdown in growth. The industry-specific boom in some of these countries resulting from their accession to the European Union in 2004 slowed slightly. Positive stimuli came from expansionary monetary policy and improved conditions for foreign trade. Slovakia recorded the strongest growth among RWE markets in Central Eastern Europe, posting a rise of 5.1 %. GDP in the Czech Republic rose by 4.8 %, with Hungary and Poland reporting increases of 3.7 % and 3.4 % respectively.

The US economy's upward trend was very robust on the back of 3.5 % GDP growth, despite interest rate increases and higher oil prices. The natural disasters that occurred in the third quarter did not have a noteworthy impact on the economy, since they only affected production capacity to a limited extent. Favourable conditions on the capital market, high corporate profits and the strong labour market continued to have a positive effect.

However, fluctuations in the economic cycle have little effect on our business trend. Energy consumption generally shows relatively small reactions to changes in GDP. Economic dynamism is primarily reflected in demand from industrial enterprises. Household energy consumption predominantly depends on temperatures. The economy has even less of an effect on the water sector.

In our core markets, electricity consumption recorded a slight rise. In some regions, gas demand declined.

**Electricity consumption slightly higher.** Energy consumption in our core markets increased marginally vis-à-vis the previous year. While moderate economic growth was reflected in additional demand, weather conditions, which were a little milder in Continental Europe, and higher energy prices dampened demand.

Demand for electricity in Germany was up roughly 1 %. This was primarily due to the export-driven resurgence of industrial production. In contrast, demand for electricity for heating purposes was slightly down because temperatures were a little milder than in the prior year. Gas consumption was almost unchanged from 2004.

Energy consumption growth in the UK lost momentum. Electricity usage was up 1 % due to marginal cyclical stimuli and weather effects. Unlike on the Continent, average temperatures in the UK were slightly down on the previous year, thus marginally restimulating demand for heating power. In contrast, gas consumption slipped by about 2 %, despite positive cyclical effects. This was mainly due to the fact that gas usage in power production operations decreased owing to high gas prices.

Positive economic developments in our Central Eastern European markets stimulated power consumption. As in Germany, this was contrasted by weather effects, which curtailed demand. Electricity consumption was up 1 % in Hungary and Slovakia. In Poland, it was roughly on par with the year-earlier level. Demand for gas in our main Central Eastern European market, the Czech Republic, was down 2 %. Owing to high gas prices, numerous companies and households reduced consumption or switched to alternative fuels. By contrast, gas usage in Hungary advanced by 3 %.

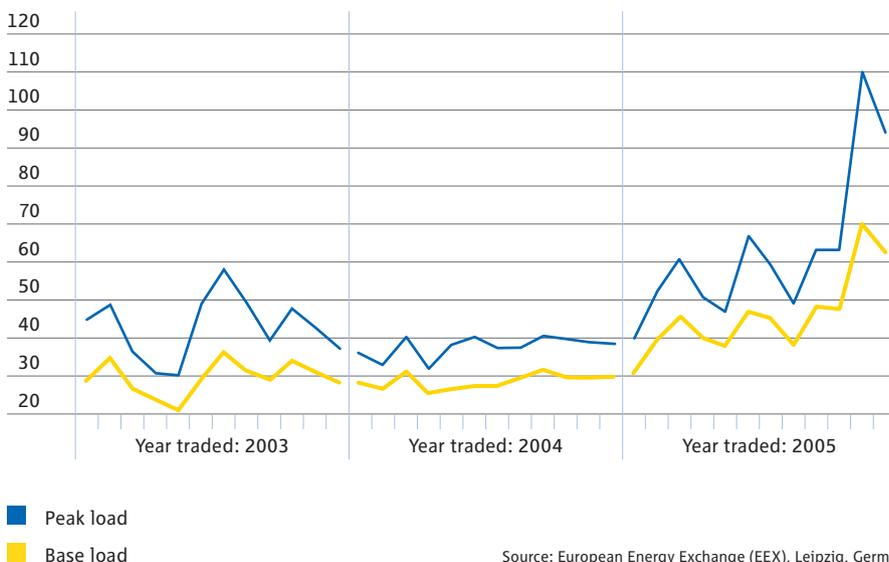
**Rising electricity prices—a Europe-wide trend.** Europe's electricity markets were marked by rapidly rising prices in 2005. One of the main drivers was the addition of a major cost factor in power production arising from the introduction of CO<sub>2</sub> emissions trading. This development was exacerbated by high prices on the fuel markets.

High fuel prices and the emissions trading scheme caused electricity prices to rise throughout Europe. Tight capacity was also a factor.



The average annual base-load power price was up 61 % to €46 / MWh in spot trading\* on the German-based European Energy Exchange (EEX\*). Spot prices for peak-load electricity averaged €63 / MWh—up 67 % year on year. Spot trading was significantly affected by higher fuel costs, CO<sub>2</sub> emissions trading and tight capacity. Power plant outages in Germany and some of its neighbouring countries caused prices to jump again towards the end of the year.

**Development of wholesale electricity spot prices in Germany**  
in €/MWh



Source: European Energy Exchange (EEX), Leipzig, Germany.

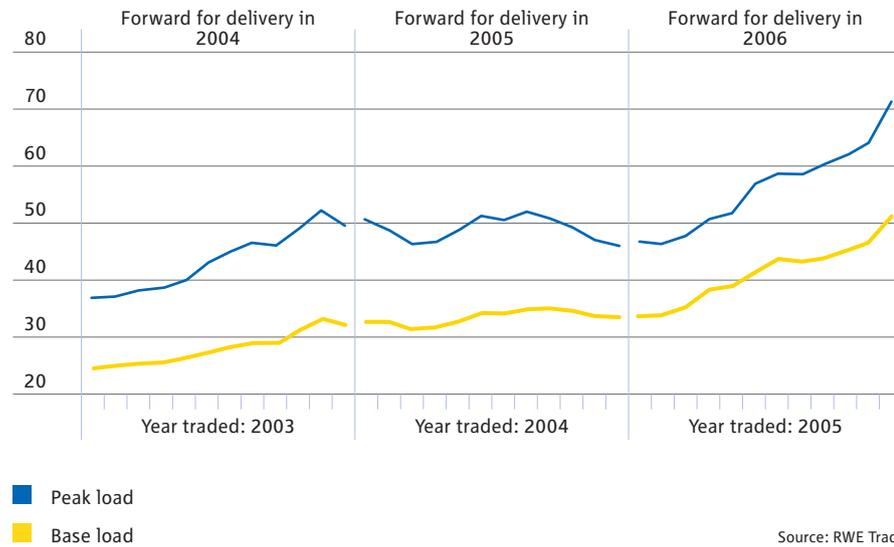


The same factors had an impact on German forward trading\* markets as well. Wholesale forward contracts also became more expensive, albeit not to the same extent as on the spot market\*. Base-load electricity deliveries scheduled for the following year were sold for an average of €41.3 / MWh in 2005. This was 23 % more than the same type of forward contracts fetched in the previous year. One-year peak-load forwards rose by 15 % to €56.3 / MWh. However, these contracts will not have an effect on the result until 2006, i. e. once these contractual amounts of electricity have been delivered. In fiscal 2005, the earnings situation of our German power generation operations (RWE Power) was still characterized by the forward prices of the 2003 and 2004 trading periods.



The electricity price trend in the German end customer and distributor segments reflected the rise in wholesale prices. Utilities lifted tariffs owing to the significant rise in power procurement costs. Furthermore, they passed through the heavier burdens arising from laws which subsidize renewables-based energy and combined heat and power\* technology. Prices paid by households and small commercial operations in Germany were up an average of 4 %. Industrial enterprises saw prices increase by nearly 12%. However, excluding state surcharges, prices for household customers were some 13 % below the level recorded in 1998, the year in which the deregulation of Germany's energy market began. Average net electricity prices for industrial customers were 16% lower in 2005 than they were in 1998.

**Development of one year forward wholesale electricity prices in Germany**  
 in €/ MWh



UK electricity price growth was higher than the EU average. The substantial increase in gas prices was the main driver.

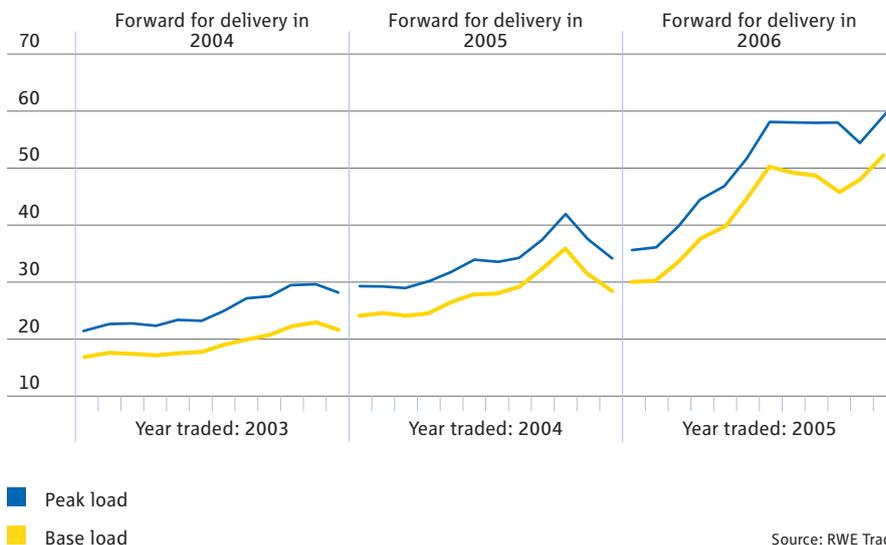
**UK electricity prices rise far above European average.** In the UK, electricity prices posted an even steeper climb than in Germany. This is principally due to the considerable rise in gas prices in the UK. Gas-fired power stations have a much larger influence on electricity prices in the UK than in most Continental European markets. The high gas prices caused UK utilities to step up the use of hard coal power plants, leading to an increase in demand for CO<sub>2</sub> certificates. This made a substantial contribution to the increase in prices of traded emissions allowances. Spot prices for base-load and peak-load power averaged for the year were each up 70% on the previous year's level. These prices rose extremely towards the end of the year. The main cause for this was the expectation of a cold winter coupled with scarce power plant capacity.

**Development of wholesale electricity spot prices in the UK**  
 in £/ MWh



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

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



Source: RWE Trading.

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

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

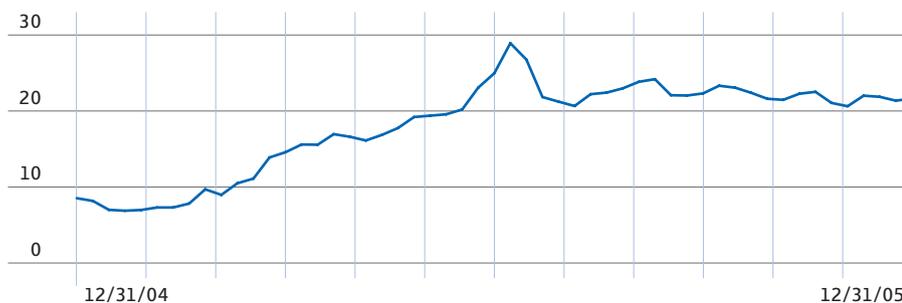
Emissions trading has a direct impact on electricity prices in EU markets. Prices for CO<sub>2</sub> certificates have risen considerably compared with the beginning of 2005.

**Introduction of emissions trading affects electricity price trend.** As explained before, price developments on Europe's electricity markets were influenced by the emissions trading system which started on January 1, 2005. Prices for CO<sub>2</sub> certificates for the first allocation period (2005–2007) advanced considerably until the middle of the year. After starting at €7–8 in January, they posted record highs of nearly €30 per metric ton of CO<sub>2</sub> in early July. Over the course of the year, the price leveled off to between €20–24. The increase in the price of emissions certificates is partially due to the steep climb in gas prices in the UK, triggering a fuel switch in the electricity generation sector to hard coal, which caused higher emissions. The dry spell in Spain resulted in a similar effect, since this curtailed the

CO<sub>2</sub>-free production of electricity in hydroelectric power stations in favour of power stations running on fossil fuels. Market participants thus expected CO<sub>2</sub> certificates to become increasingly scarce. In addition, they saw their fears confirmed by the EU's restraint in approving the UK, Polish and Czech national allocation plans.

#### Development of CO<sub>2</sub> certificate prices traded in 2005

in €/metric ton



Source: RWE Trading.

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



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

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

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



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

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

## Change in political environment

The political environment is a key factor for our business. Far-reaching energy policy measures were taken in 2005, altering our room for manoeuvre as a power utility and presenting us with new challenges. Milestones were the introduction of the EU-wide CO<sub>2</sub> emissions trading system as of January 1, 2005 and the new German Energy Act (EnWG) that entered into force in July.

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

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

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



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

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

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

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



**European CO<sub>2</sub> emissions trading system introduced.** Fiscal 2005 saw the beginning of the European CO<sub>2</sub> emissions trading scheme. State emissions certificates have been mandatory for the operation of large-scale industrial furnaces with a thermal rating in excess of 20 MW\* since January 1, 2005. These certificates are distributed by the government via national allocation plans (NAPs) and are free of charge during the first trading period (2005–2007).

European emissions trading is an additional cost factor in the generation of electricity. We had to buy a large number of CO<sub>2</sub> certificates for our power plants in both Germany and the UK.

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

The UK, our second key market, is awaiting a final decision on its national allocation plan (NAP). The UK government submitted a revised NAP to the EU Commission in February of 2005. It envisions a free allocation in the first trading period of 252 million metric tons of CO<sub>2</sub> per annum. This is nearly 7 million metric tons more than in the first draft of the UK NAP. However, the Commission rejected the increase. The UK government took the matter to court, and was successful. The court now requires the Commission to reconsider the UK's amended plan and to make a fresh decision on it. According to the original NAP, RWE npower would have received an allocation for 14.9 million metric tons of CO<sub>2</sub> per year. Furthermore, in the year under review, we purchased a UK gas power station including the CO<sub>2</sub> certificates it was allocated. Therefore, RWE npower had a total of 15.3 million metric tons of CO<sub>2</sub> in emissions allowances allocated free of charge. In 2005, 22.7 million metric tons of carbon dioxide were emitted. RWE npower thus has a shortfall of 7.4 million metric tons in CO<sub>2</sub> certificates.

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

## Major events

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



### **Sale of UK and North American water operations announced—rise in dividend payout ratios planned for 2006 and 2007.\***

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

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

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

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

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

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

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



We will reduce CO<sub>2</sub> emissions by nearly 9 million metric tons through two new large-scale power stations.

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

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



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

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

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

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

## *Notes on reporting*

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

- RWE Trading is no longer presented separately in our financial reporting. Instead, RWE Trading is now subsumed under RWE Power's Power Generation Business Unit. The rationale for this change lies in the fact that, as an integral component of the energy value chain, RWE Trading's primary function is to contribute to sustaining the value of our power production operations. The change in our reporting structure does not affect our operations.
- Harpen, which specializes in renewables-based and distributed power generation, has been assigned to the Power Generation Business Unit.
- At the end of February 2005, we sold 70% of RWE Umwelt's business volume. The sale of the remaining 30% was completed in early October. In the financial statements for 2005, we have classified the environmental services activities as "discontinued operations." The environmental services business is thus no longer included in revenue, EBITDA, the operating result, capital expenditure or the workforce. These items exclusively relate to our continuing operations.
- On January 1, 2005 we started disclosing some of RWE Thames Water's peripheral activities as "assets / liabilities held for sale." This applies to our activities in Chile, the United Arab Emirates, China, Thailand and Australia. Some of them were sold during the fiscal year.

# Business performance

## Production and sales

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

1 Figures for RWE Power also include capacities of power stations not owned by RWE that we can deploy at our discretion on the basis of long-term agreements, totaling 6,487 MW (hard coal), and 2,261 MW (hydro, oil, other).

2 Including RWE Energy's capacity in Germany amounting to 691 MW.

3 This does not take into account the fact that RWE npower has a 33 % share in a joint venture that had 268 MW of installed wind power capacity in the year under review.

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

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

RWE Power generated 183.2 billion kWh of electricity, accounting for more than 80 % of the RWE Group's total output. This includes electricity generated from power plants not owned by RWE that we can deploy at our discretion on the basis of long-term agreements. The amount of electricity produced by RWE Power was 10 % lower than in 2004. This was in part due to the deconsolidation of our Portuguese power plant activities Turbogas / Portugal as well as the fact that we produced less energy from hard coal and lignite compared with last year owing to high CO<sub>2</sub> costs. In addition, Block B of the Biblis nuclear power plant was taken offline for several months for maintenance.

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

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

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

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

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

1 Figures for RWE Power include electricity procured from power plants not owned by RWE that we can deploy at our discretion on the basis of long-term agreements. In 2005 they break down into 29.5 billion kWh (hard coal) and 2.5 billion kWh (hydro, oil, other).

2 Including generation and electricity purchases of RWE Energy's regional companies.

3 Electricity purchased by RWE npower largely via RWE Trading.

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

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

**Electricity sales volume down 5 % on previous year.** RWE's external electricity sales totaled 299.1 billion kWh. They are typically somewhat lower than the amount

of power generated (317.8 billion kWh). This is due to grid losses as well as our in-house consumption by lignite production and hydro-storage power plants. Electricity sales volumes were down 5% on 2004.

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

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

<sup>1</sup> Including RWE Trading.

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

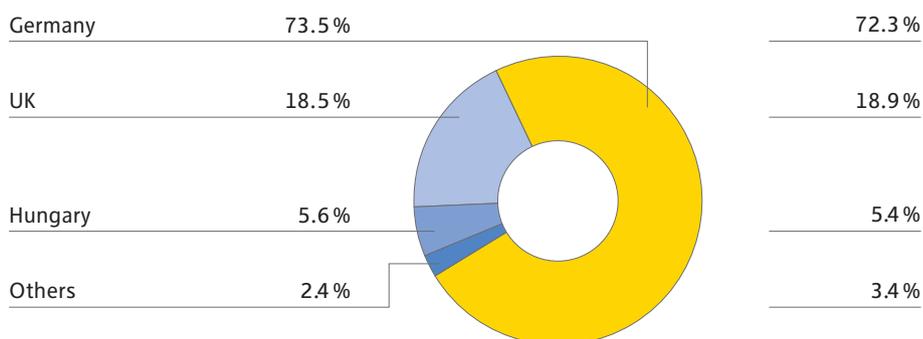
RWE Energy supplies  
15.8 million customers with  
electricity, 11.9 million of  
which are in Germany.

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

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

### Electricity sales volume of the RWE Group by region in 2005

2004



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

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

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

1 Including RWE Trading.

2 Including gas trading.

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

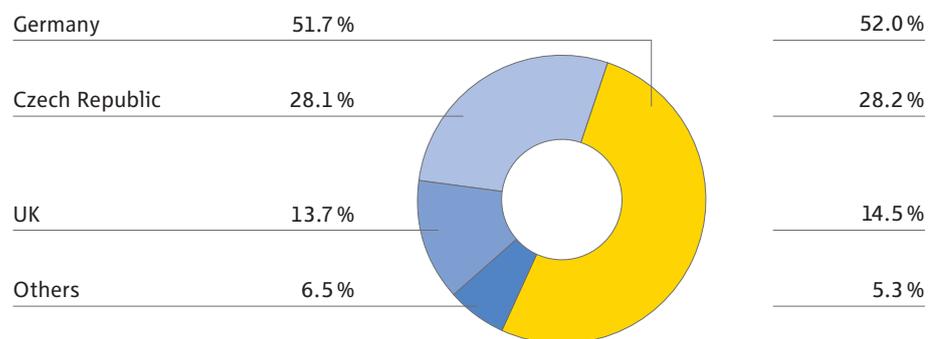
Gas sales made by RWE Energy amounted to 288.8 billion kWh, falling just shy of the prior year's level. In Germany, mild autumn temperatures dampened private household consumption. Furthermore, the rise in prices caused consumers to be more thrifty in their use of gas. In addition, RWE Energy lost a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

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

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

#### Gas sales volume of the RWE Group by region in 2005

2004



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

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

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

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

- In 2005 RWE Umwelt is accounted for as a “discontinued operation.” Therefore, this company is no longer included in the Group’s revenue (2004 revenue: €1,830 million).
- RWE Solutions, a business unit of RWE Energy, shed its transformer (deconsolidated as of October 1, 2004), power conditioning (January 1, 2005) and mechanics (April 1, 2005) operations as well as some other peripheral activities. This eliminated a total of €320 million in revenue compared to the prior year.

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

1 Including RWE Trading and Harpen.

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

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



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

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

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

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

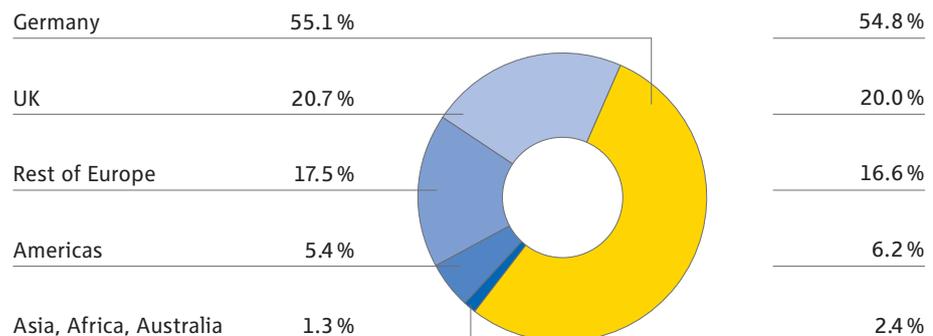
External revenue recorded by the **RWE Energy** Division was up 8 % to €24,318 million. Electricity revenue rose 9 %, because higher procurement costs were passed through to sales prices. Regulatory price adjustments were the reason in Hungary. Our gas revenue improved by 26 %. This was also largely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

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

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

#### RWE Group revenue by region in 2005

2004





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

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

1 Including RWE Trading and Harpen.

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

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

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

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



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

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

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

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

<sup>1</sup> Including RWE Trading and Harpen.

<sup>2</sup> Including RWE Umwelt (€76 million) and Heidelberger Druckmaschinen (€34 million).

In 2005 organic earnings were markedly affected by the price trend in the electricity wholesale market, tariff increases in the water business and continued efficiency enhancements in all our divisions. This was contrasted by the additional expenses incurred for fuels and power plant maintenance, among other things. Furthermore, for the first time, we incurred costs associated with the CO<sub>2</sub> emissions trading scheme introduced as of January 1, 2005. As explained earlier, we did not receive enough free emissions allowances from the government in 2005 to cover our CO<sub>2</sub> emissions. This reduced the Group's operating result by €169 million. Additional expenses arose from our share-based remuneration programmes—especially from those originating from the earlier years. This is due

to the considerable rise in the share price in 2005. At the Group level, share-based remuneration programmes resulted in €310 million in staff costs (previous year: €87 million). This includes provisions for probable payments after 2005. €221 million of the total amount of €310 million is allocable to our divisions and €89 million is attributable to RWE AG and RWE Systems, which are included in the item "Other, consolidation."

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

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

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

- **Power Generation:** This business unit, which includes RWE Trading and Harpen, increased its operating result by 12 %. Our trading activities closed the fiscal year clearly up on the prior one. Most notably, our UK trading operations experienced a successful year. In the power generation business, we benefited from the price trend on the wholesale market. However, adverse effects were felt from a decrease in output due to unscheduled power plant outages. Higher fuel prices (–€250 million) and power plant maintenance (–€120 million) also increased costs compared with 2004. The shortfall of CO<sub>2</sub> emissions allowances had an effect of –€40 million. The deconsolidation of Turbogas / Portugén subtracted €36 million from the operating result.
- **RWE Dea:** The operating result generated by this business unit was up 25 %. Our February 2005 forecast envisioned a slight decline. Developments exceeded expectations owing to the price boom on the oil and gas markets. However, RWE Dea was unable to fully benefit from this because oil prices were hedged early on. Declines in oil production also dampened the earnings trend.

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

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

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

- International regions: We improved the operating result of our Continental European sales business outside Germany by 18 %. Drivers here were cost reductions and price-induced margin improvements in the regulated Czech gas sector. In addition, the appreciation of major Central European currencies vis-à-vis the euro produced positive currency effects.
- Electricity & Gas Transmission: This business unit oversees our German extra high-voltage electricity grid, our German gas transmission grid, and Czech-based RWE Transgas' gas transmission and gas trading operations. Furthermore, this unit now also includes the newly founded RWE Key Account GmbH, to which we transferred RWE Solutions' electricity key account business effective April 1, 2005. The operating result recorded by the Electricity & Gas Transmission Business Unit was down 21 %. RWE Transgas experienced a decline in margins in business with regional distributors due to the regulatory requirements. Moreover, less income was generated from the cross-border gas transmission business, above all due to currency effects. In Germany, there was a rise in costs incurred for balancing power to compensate for short-term fluctuations of wind energy fed into the grid. Furthermore, additional costs were incurred to improve the grid infrastructure.
- RWE Solutions: Our subsidiary that specializes in energy-related services improved its operating result by €63 million to €113 million. This was due to the absence of provisions built in 2004 to cover uncertainties surrounding plant construction projects. Moreover, individual activities improved their organic earnings situation.

RWE npower closed fiscal 2005 with a 28 % drop in its operating result. High CO<sub>2</sub> certificate and fuel costs were the main reasons. They could only partially be passed on to the market.

**RWE npower** saw its operating result decline by 28 %. This decrease is exclusively attributable to its power generation activities. The shortfall of CO<sub>2</sub> emissions allowances had an adverse effect to the tune of €129 million, which was more than we anticipated. This was because the price of emissions certificates increased significantly compared with the beginning of 2005. We were thus unable to meet the earnings forecast we issued in February 2005 which envisioned a decline in earnings of no more than 20 %. Furthermore, RWE npower experienced higher fuel costs. The rise in wholesale electricity prices did not offset these factors, since RWE npower had already sold forward part of 2005's electricity production at markedly lower prices in earlier years. The decline in earnings from the power generation business was contrasted by the improved earnings situation in the supply business, where we benefited from the aforementioned increases in electricity and gas prices in 2004.

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

**RWE Thames Water's** operating result advanced by 2 % to €1,416 million. Net of the one-off effects of balance sheet reclassification, foreign exchange rates and deconsolidations, this division's operating result was up 7 %. Tariff increases in the regulated UK business were the most significant organic factor. These enabled the company to more than offset the rise in the cost of maintaining the Greater London

water pipe infrastructure. The operating result posted by American Water was 6 % up on the prior year, net of consolidation and currency effects. Tariff increases in the regulated business, efficiency enhancements and positive volume-related effects were the main drivers. In total, however, they lagged behind our expectations.

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

1 Including RWE Trading.

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

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

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

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

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

- Value added by **RWE Power** rose by €320 million to €1,328 million. This manifests itself especially in the improved earnings situation of our German power generation operations and of RWE Dea's upstream activities. Moreover, capital employed decreased.
- RWE Energy** made a value contribution of €1,311 million. Compared to 2004, this represents an increase of €315 million, and reflects the positive organic performance achieved in the past financial year.

- In line with the negative earnings development, value added by **RWE npower** decreased by €194 million to –€227 million. RWE npower is expected to earn its cost of capital for the first time in 2007.
- **RWE Thames Water** posted a substantial improvement, increasing value added by €116 million to –€13 million. We thus essentially achieved our goal of breaking even on the capital costs of our water division in 2005. However, we had expected American Water to record a stronger improvement.

## Reconciliation to net income

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

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

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

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

- In 2005 capital gains totaled €326 million. They were thus €352 million down on the high level achieved in the prior year. In 2004 capital gains still included earnings contributed by the sale of shares in US hard coal producer CONSOL Energy (€220 million), Heidelberger Druckmaschinen (€200 million) as well as in Swiss-based Motor-Columbus and Atel (€136 million). The book gains achieved in 2005 principally stem from the sale of our 20% stake in Stadtwerke Düsseldorf, real estate formerly belonging to RWE Systems, and of water activities in Thailand and Australia.
- Impairment losses increased by €322 million to €814 million. An impairment loss of €759 million was recognized for American Water as a result of the impairment test performed on the goodwill carried for RWE Thames Water North America / American Water on our balance sheet in the fourth quarter of 2005. We made a downward adjustment to our growth expectations in this business in light of current developments on the market. Privatization of US

water businesses is progressing more sluggishly than expected. This also applies to the outsourcing of water services by municipalities. Moreover, selling costs were included in the impairment loss in light of American Water's probable public offering. Another impairment loss was recognized for one of RWE Thames Water's peripheral activities. It amounted to €55 million.

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

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

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

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

Income before tax from our continuing operations thus amounted to €3,828 million. This corresponds to a 3% decline compared with 2004. Our effective tax rate dropped from 39% to 32%. The decrease was mainly due to the fact that we were able to make use of tax loss carryforwards in the RWE AG tax group, for which deferred taxes have not been capitalized thus far. Furthermore, we capitalized deferred taxes for losses carried forward, which we expect to be able to make use

of in the future. Impairment losses recognized for the water business had a counteracting effect, because they reduce the result, but not the tax burden. Otherwise, the effective tax rate would have decreased even more.

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

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

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

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

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

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

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

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

- €500 million are allocable to measures taken by the first programme linked to the reorganization of the RWE Group, which was initiated in 2003. Here, the German energy business, the water activities, and our IT operations are the prime targets. We had already achieved €310 million in savings from this programme by the end of 2005.
- With the second programme, launched in 2002, we capitalized on synergies from the large-scale acquisitions made in the last few years. Targeted savings total €180 million. €100 million of this sum was allocable to the combining of the back office functions of our UK-based companies RWE npower and RWE Thames Water. We intend to achieve €80 million in savings at our Czech gas companies. By December 31, 2005, we had already realized a total of €140 million in synergies.

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

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

## Key figures by division at a glance

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

1. Including RWE Trading.

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

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

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

## Finance and capital expenditure

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

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



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

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



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

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

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

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

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

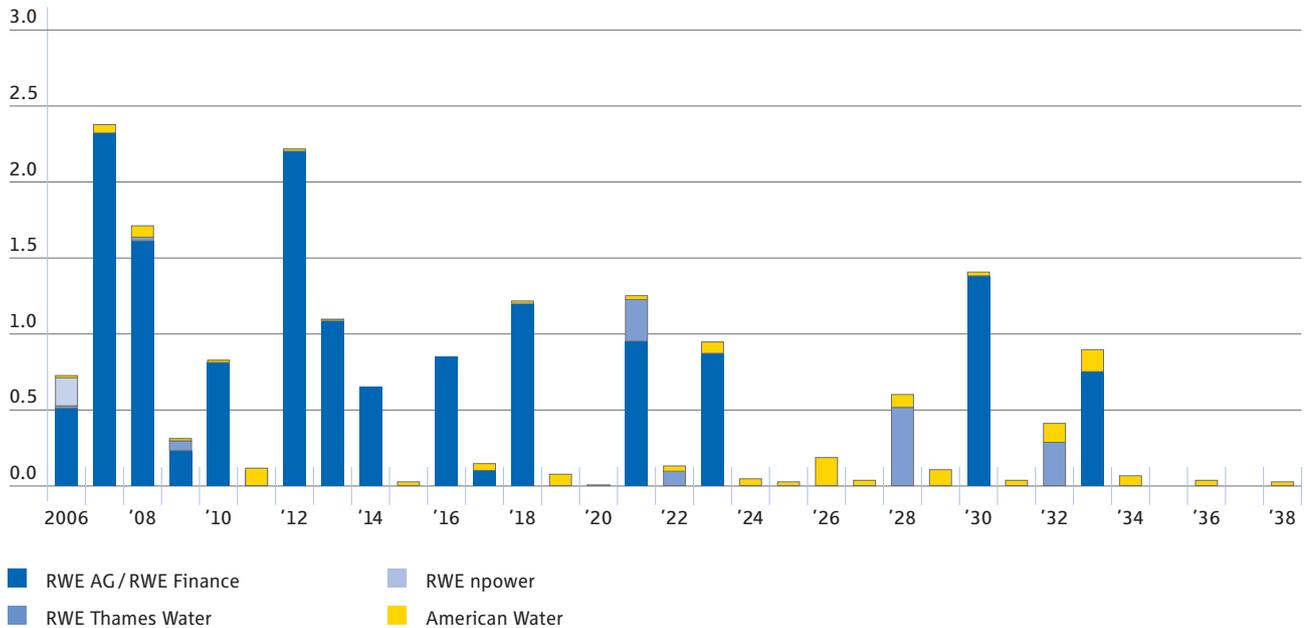
<b>Net financial debt</b> € million	<b>12/31/05</b>	<b>12/31/04</b>	<b>+/- in %</b>
Cash and cash equivalents	1,431	1,526	-6.2
Marketable securities	11,356	12,049	-5.8
Other financial assets	3,603	1,423	153.2
<b>Gross financial assets</b>	<b>16,390</b>	<b>14,998</b>	<b>9.3</b>
Bonds, notes payable, bank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

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

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

### Maturity profile of the RWE Group's capital market debt

€ billion



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

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

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

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

<sup>1</sup> Including RWE Trading.

<sup>2</sup> Including RWE Umwelt (€108 million) and Heidelberger Druckmaschinen (€53 million).

Capital expenditure on financial assets was up year on year, but remained low.



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

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

1 Including RWE Trading.

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

The following is an overview of investing activity by division:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Review of Operations

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

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

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

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



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

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

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

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

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



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

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

# Workforce, research and development, procurement

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

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

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

1 Converted to full time equivalent.

2 Including RWE Trading.

3 Including RWE Systems; the previous year's figure also includes RWE Umwelt (10,408 employees).

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

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

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

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

In the medium to long term, our R&D activities will centre on refining methods for CO<sub>2</sub> sequestration in power station processes as well as subsequent CO<sub>2</sub> compression and safe underground storage. Our involvement in EU-subsidized multi-party projects makes a contribution to this cause. We are exploring technologies for CO<sub>2</sub> separation before and after combustion in power stations within the scope of the "ENCAP" and "CASTOR" projects. As part of the "CO<sub>2</sub>SINK" project, we are conducting tests today to explore whether large amounts of carbon dioxide can be stored underground safely. The project is being carried out in Ketzin in the German state of Brandenburg. About 100 metric tons of CO<sub>2</sub> will be buried 700 metres under the ground at this site per day in the next two years.

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

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

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

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

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



The amount of hard coal purchased to generate electricity dropped from 23 million metric tons of hard coal units\* (HCU) in 2004 to approximately 21 million metric tons in 2005. This includes coal used in power plants not owned by RWE that we can deploy at our discretion on the basis of long-term agreements. At RWE Power, hard coal usage decreased by 2.7 million metric tons of HCU to 14.7 million metric tons. The decline is attributable to third-party power plants whose capacity utilization decreased considerably as a result of high coal and CO<sub>2</sub> costs. Their hard coal consumption dropped from 12.2 million metric tons to 9.5 million metric tons of HCU. Hard coal consumption in RWE's in-house power stations matched the prior-year level, at 5.2 million metric tons of HCU. RWE npower used 6.1 million metric tons of HCU to run its power stations. This represents a slight increase over the prior year.



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

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

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

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

# Risk management

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

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

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

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

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

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

- **Business risk:** At present, there are no identifiable risks that could jeopardize the continued operation of RWE AG or the RWE Group.
- **Changes in the general economic climate:** Economic trends in our core markets can affect the degree of capacity utilization, having either a positive or negative impact on revenue and results.
- **Changes in the price of commodities:** Certain risks and opportunities are inherent in our production operations, and above all in our electricity generation business. The latter is significantly influenced by the development of market prices for electricity, fossil fuels—especially hard coal and gas—as well as by the development of the price of CO<sub>2</sub> certificates. A risk arises, e. g., if higher commodity prices cannot be passed on by increasing electricity prices. Opportunities stem from the widening of the spread between electricity prices and prices for fossil fuels. In addition to production, sales operations are also exposed to risks. Such risks arise, e. g., as a result of unexpected fluctuations in demand owing to changes in temperature. Our price risks on purchasing and sales markets are determined using special evaluation models, while taking current forward prices and expected price volatility into account. Among other things, we use financial derivatives to mitigate risks associated with sales and procurement. Additional risks and opportunities arise from our oil and gas production operations. Unexpected disadvantageous changes in price in this area are also minimized through the strategic use of derivative hedges.

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

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



- Operating risks:** We operate technologically complex and interconnected production plants all along our value chain. Earnings risks can arise from uninsured damage to our lignite mining equipment, production plants, or power plant components. Risks associated with possible outages caused by the ageing of components in our power stations will increase. Our grid business is exposed to the risk of facilities being destroyed by force majeure such as severe weather conditions. We address these risks through high safety standards as well as regular audit, maintenance and servicing work. As appropriate, insurance policies also limit possible effects of damage.
- Changes in prices in the finance sector:** Within the scope of our operations, we are also exposed to currency, interest-rate and share-price fluctuation risks. Due to our international presence, currency risk management is very important. The pound Sterling and US dollar are our major foreign currencies. RWE conducts sizeable operations in these currency zones. Furthermore, fuel prices are quoted in these currencies. Group companies outside the Eurozone are generally obliged to hedge all local currency risks via the Group's holding company, RWE AG. The parent company determines the net financial position for each currency and hedges it with external market partners if necessary. Risks are quantified using the value-at-risk (VaR) method, as is the case with commodity price risks. The Executive Board of RWE AG has established a system that limits risks. On December 31, 2005, the VaR for RWE AG's foreign currency position was €0.2 million. Interest rate management is also ascribed significant importance. Our interest-rate risk primarily stems from our financial debt and interest-bearing investments. Interest-rate risks arise whenever the interest curve rises or falls. Negative changes in value caused by unexpected interest-rate movements are hedged with non-derivative and derivative financial transactions. At the end of 2005, the VaR from interest obligations connected to our financial debt and associated hedges was €56.1 million. The VaR from interest-bearing investments including hedges amounted to €21.5 million. We are also exposed to both risks and opportunities associated with share investments. The VaR for share price risks was €19.4 million. Opportunities and risks from changes in the value of securities are controlled by a professional fund management system.

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



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

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

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



- **Regulatory risks:** The RWE Group's exposure to the constant change in the political, legal and social environment in which it does business can be expected to have an impact on earnings. Lignite and hard coal power plants account for a significant portion of our electricity generation portfolio. This represents a risk due to the EU-wide CO<sub>2</sub> emissions trading system. Risks can arise from changes made to the allocation rules and national emissions plans for the second trading period (2008–2012) and from unexpected increases in the price of CO<sub>2</sub> certificates. Therefore, CO<sub>2</sub> price risk management is an integral component of our centralized risk management system. We intend to continue reducing specific CO<sub>2</sub> emissions and make our overall portfolio more flexible by investing in power plants in the future.

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

- **IT risks:** RWE has established a mandatory groupwide process for engineering, managing and auditing IT projects in order to manage IT risks during the development of IT solutions designed to support business processes. IT operations are handled by modern computing centres which continuously update both hardware and networks. They are subject to a groupwide security directive, compliance with which is regularly monitored.
- **Capital expenditure and divestments:** Decisions approving acquisitions and capital expenditure on property, plant and equipment must take into account both the opportunities and risks associated with tying up capital for extensive periods of time. At RWE, such decisions are prepared and implemented in adherence with specific accountability rules and approval processes. The same applies to divestments such as the planned sale of our UK and North American water activities.
- **Legal risks:** RWE Group companies are involved in litigations and arbitration proceedings connected with their operations. However, RWE does not expect any major negative repercussions from these proceedings on the RWE Group's economic or financial position. Additionally, companies belonging to the RWE Energy Division are directly involved in various administrative and regulatory procedures (including approval procedures) or are directly affected by their results.

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

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

## Outlook for 2006

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

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

Due to the oil price boom, prices for other primary energy sources and CO<sub>2</sub> certificates are expected to remain high.

**Prices for primary energy sources and CO<sub>2</sub> remain high.** The high level of prices on the world's energy markets is expected to persist in 2006. In light of the continued scarcity of production capacity, crude oil prices are not anticipated to drop significantly in the near future. Furthermore, energy prices are exposed to additional risks from unstable political situations—above all in the Middle East. Gas prices will remain high as long as the boom on the oil market persists. Hard coal prices in northwestern Europe were on a downward trend in 2005 following the records posted in 2004. They have risen somewhat of late. As explained earlier, prices established by the German Federal Office for Economics and Export Control (BAFA), which are of key importance for Germany, track spot prices on the European market with a lag of several months. Therefore, we expect they will be below 2005 levels averaged over the year.

Power production costs are affected by the development of prices on fuel markets as well as pan-European emissions trading. Certificates currently trade for €26.70 per metric ton of CO<sub>2</sub> (as of February 10, 2006). They are thus much more expensive than the average for 2005 (€18). As mentioned above, due to the persistently

high level of gas prices, power stations—especially those operated by UK utilities—made extensive use of hard coal, which produces higher emissions than gas. Therefore, market observers anticipate that CO<sub>2</sub> certificates will become more scarce in the first trading period (2005–2007).

**Electricity price trend: no change in sight.** Due to the aforementioned situation, power production costs are expected to rise above last year's level, which was already high. This is likely to be reflected in the development of prices on European wholesale markets. Besides generation costs, weather-related effects could also lead to a further increase in electricity prices. Last year was one of the warmest years in recent history. If temperatures return to normal levels, energy consumption could rise compared with 2005, causing generation capacity to become even more scarce. This type of weather change was already observed at the beginning of 2006.

We intend to strengthen our earning power again in fiscal 2006 above all through organic growth. Our highly competitive German power generation operations will play a central role.

**Adding even more value to the company.** In the last few years, we laid the groundwork for achieving continuous organic growth. We intend to increase the operating result organically by an average of at least 5 % per year. Both in this financial year and the next one, the key to this accomplishment will be the competitiveness of our German power generation business. In addition, a variety of regulated activities in our core markets make stable contributions to our earnings. These include the UK and North American water operations which we intend to sell by the end of 2007. However, even without these water activities, we generate about one third of our consolidated operating result from regulated business above all in Germany and the Czech Republic. Cost-cutting measures will provide more positive stimuli. We want to realize €230 million in savings this year. This will bring us to the end of the programme underway since 2003 designed to reduce our annual cost position by €680 million. Burdens on earnings will continue to stem from the price of fuel purchased for our power plants. Moreover, we will be exposed to risks from political intervention. We emphasized this point repeatedly in both this and earlier publications. For instance, we anticipate negative effects will arise above all from the regulation of Germany's electricity and gas grids. The European emissions trading system continues to pose a challenge. We gained our first experience with it last year. However, we expect that risks will be manageable until the end of the first three-year trading period in 2007. We will continue to address them through the flexible deployment of power stations and optimized electricity and fuel procurement. In sum, we are optimistic about being able to achieve our value target for 2006: a return on capital employed (ROCE) of at least 14 %. We already surpassed this goal in 2005.

**Substantial capital expenditure on power plants and grid facilities.** Both the German and UK power generation sectors are at the beginning of a long-term investment cycle. We started planning for the replacement of old power plants with more efficient and environmentally friendly technologies early on. At the end of 2005 we commenced the construction of a large-scale lignite-fired 2,100 MW power plant in Germany. This year, we will initiate preparatory work for another major project in Germany, involving a hard coal power station with an installed capacity of 1,500 MW. We are also investigating the possibility of modernizing our power plant portfolio in the UK. These projects will make a substantial contribution to improving the Group's emissions balance.

After the sale of our water activities, we will have more financial leeway for capital expenditure in the energy business.

Germany's power and gas grids also require extensive upgrades. However, we will not be able to implement any major measures until the details for German grid regulation have materialized further. We expect this to happen no later than next year. Our exit from the capital-intensive water business in the UK and North America will free up funds for our energy operations. Nevertheless, our investment budget will be lower than it is at present, including the water activities. We expect that RWE's capital expenditure on property, plant and equipment for 2006 to 2010 in the energy business will average €3.5 billion per year, give or take 15%.

**Divestment of UK and North American water activities.** Besides concentrating on our operating targets, this year we have set our sights on preparing for the sale of RWE Thames Water and American Water. A public offering is likely as far as American Water is concerned. Options under consideration for RWE Thames Water include a sale to long-term financial investors as well as a placement on the stock market. The run-up to the sale of American Water will be lengthy due to the extensive approval process with water regulators in the US. In light of the favourable environment on the capital market, we are confident that we will be able to complete our exit from both activities at an appropriate price by the end of next year.

No major acquisitions are planned at present. The sale of our water activities has priority.

**A measured acquisition strategy.** Currently, we are not planning to make any major acquisitions. The planned divestments in the water sector have priority. Projects of interest to us are predominantly in Eastern Europe. We expect that the consolidation of the European electricity and gas sectors will become more intense in the medium term. However, there are still only a handful of investments available for sale, since the deregulation and privatization process in Eastern Europe is making slow headway. In light of the large number of interested potential buyers, prices are at the upper end of the range. We join bidding processes only if our strict profitability criteria are met. Acquired investments must earn their cost of capital no later than in the third full year following the date of their consolidation.

Excluding divestments and currency effects, revenue will grow by a single-digit percentage rate.

**Group revenue expected to be stable.** Revenue is expected to roughly match last year's level. This and the following prognoses are based on assumed exchange rates of US\$ 1.20 / € and £ 0.70 / € in 2006. We assume that the planned sale of RWE Thames Water and American Water will not impact our consolidated financial statements before 2007. Minor divestments at RWE Energy and RWE Trading will eliminate about €2 billion in revenue. Excluding consolidation and currency effects, however, we expect revenue to grow by a single-digit percentage rate. The main drivers will be rising procurement costs, which will be passed on in higher electricity and gas prices, and higher water tariffs, reflecting increasing investment in infrastructure.

Outlook	2005 € million	2006 Forecast
<b>External revenue</b>	<b>41,819</b>	→
<b>Operating result</b>	<b>6,201</b>	↗
RWE Power <sup>1</sup>	2,112	↗
RWE Energy	2,507	→
RWE npower	437	→
RWE Thames Water	1,416	→
<b>Net income</b>	<b>2,231</b>	↗

1. Including RWE Trading.

We expect our operating result to grow by 5 % to 10 %. Net income is expected to rise by between 10 % and 20 %.

**Earnings expected to post further growth.** We are confident that we will succeed in improving our key earnings figures. According to our forecast, EBITDA will rise by a single-digit percentage and the operating result will grow between 5 % and 10 %. Net income is expected to post a rise of between 10 % and 20 %. This will principally stem from an improvement in the non-operating result, which was characterized by considerable negative one-off effects in 2005.

Earnings trend by division:

We expect **RWE Power** to close 2006 with a marked improvement in its operating result. We anticipate that the growth will be in double-digit percentage territory. The rise will be driven by the Power Generation Business Unit. Price increases on the German wholesale market will be the main contributing factor. We have already sold most of the 2006 electricity production. Moreover, we expect to see a rise in the availability of generation capacity following the extensive maintenance carried out in 2005. The higher cost of procuring CO<sub>2</sub> emissions certificates and fuel will have a counteracting effect. Furthermore, margins on the market for balancing power to offset short-term fluctuations in supply and demand on the power grid are likely to shrink. Moreover, we do not anticipate that RWE Trading will be able to reproduce the high level of earnings it achieved in 2005. The RWE Dea Business Unit is expected to close the fiscal year up on the last one. Contrasting effects will be felt as persistently high oil and gas prices will be countered by mounting production and exploration costs.

**RWE Energy** will probably achieve an operating result that matches the 2005 level. With stable earnings in the Continental European sales business, we believe earnings risks will arise especially from the new regulation of Germany's electricity and gas grids. We intend to largely offset the resulting negative effects in 2006 by taking additional measures to cut costs and enhance efficiency throughout the RWE Energy Group. Naturally, however, there is still some uncertainty as regards the extent of the impact of regulation.

We expect the operating result recorded by **RWE npower** to stabilize at the level achieved in 2005. We will lift earnings from the UK generation business by increasingly benefiting from higher wholesale electricity prices. However, we will not fully benefit from this rise for all of our power sales. This is because RWE npower had already sold forward part of 2006's electricity production several years previously, and we are therefore not able to entirely pass through the rise in fuel prices and the cost of CO<sub>2</sub> emissions certificates to customers. In addition, the failure of two power plant blocks in Aberthaw will have adverse effects. Although our market share in the supply business is developing positively, we anticipate that the UK sales business will see mounting pressure on margins. This is due mainly to increased costs for suppliers, resulting from rising wholesale gas prices. Another major driver of costs will be the UK Government Energy Efficiency Commitment initiatives to reduce household carbon emissions and alleviate fuel poverty. We anticipate that RWE npower will succeed in posting a substantial improvement in its results in 2007.

The operating result achieved by **RWE Thames Water** is expected to be roughly on par with last year's. Our regulated UK and North American activities are anticipated to experience opposing effects from tariff increases and higher operating costs.

We stand a good chance of exceeding our 14 % ROCE target for 2006.

**Value management reflects good operating performance.** Our improved earnings situation will also be clearly mirrored in our return on capital employed. We thus expect to exceed our ROCE target of 14 % once again. Most of the increase in value will come from the German energy business. According to our forecasts, RWE npower will be able to recover its cost of capital by 2007. The reasons for this were explained earlier in this report.

Depending on the progress of the sale of our water activities, we want to increase the dividend for 2006 to between 70 % and 80 % of recurrent net income.

**Dividend payment raise planned for fiscal 2006.** In light of our solid earnings outlook, we are confident that the dividend will also fare well. Our dividend proposal for fiscal 2006 will be linked to a payout ratio for the first time. In so doing, we intend to show our shareholders that a certain percentage of earnings will be reserved for the dividend every year. We generally aim for a payout ratio of 50 %. The basis for the calculation will be recurrent net income\*, which is already adjusted for one-off effects. This is how we want to link the dividend directly to the development of our operating activities. Depending on the progress of the sale of RWE Thames Water and American Water, we intend to increase the payout ratio to between 70 % and 80 % for the 2006 financial year.



**Capital expenditure on property, plant and equipment up year on year.**

We will clearly step up capital expenditure on property, plant and equipment this year. The greatest rise is planned for RWE Power's German power plant business. The construction of a dual lignite block in Neurath is the main activity. Furthermore, preparatory work on the 1,500 MW hard coal power plant in Hamm will begin in 2006. More funds will be spent on our oil and gas production activities as well. RWE Thames Water will considerably expand its investment budget in order to meet the requirements of the five-year regulatory period that began in 2005. RWE Energy will maintain its sizeable capex budget. More than 80 % of RWE Energy's capex will be earmarked to upgrade and expand our electricity and gas grids. RWE npower will modernize and enlarge its power plant portfolio, which will attract more spending than in 2005. In sum, we expect that capital expenditure on property, plant and equipment, including the RWE Thames Water Division, will be in the order of €4.5 billion.

We established a new cap of between €10 billion and €12 billion for net financial debt.

**Net financial debt remains low.** Based on our estimates, our net financial debt will again be in the order of €11 billion to €12 billion in 2006. We want to keep debt at this level even once we have sold our water business. We have defined a new cap ranging between €10 billion and €12 billion. Prior to the announcement of the planned divestment, it was €17 billion. The new cap takes into account major acquisitions which we would only make in the medium term. Furthermore, we want to maintain our current A1 and A+ credit ratings. Thanks to the good reputation we have as bond issuer, we always have access to short- and long-term financing sources. €0.7 billion in bonds, which we do not intend to refinance, will mature in 2006.

**Employee headcount: decrease due to the sale of companies.** In fiscal 2006 our workforce will continue to shrink principally due to the planned sale of RWE Solutions and of peripheral activities of RWE Thames Water. Excluding these effects, however, we expect the Group's labour force to increase.

**Procurement: added cost owing to higher CO<sub>2</sub> prices.** As mentioned earlier, we sold forward nearly all of our 2006 electricity production. In principle, our approach involves purchasing the fuel required to generate contracted amounts when the supply agreements are signed, hedging fuel prices at the same time. This also applies to the CO<sub>2</sub> certificates needed to produce this power. The hard coal and gas prices we will incur in 2006 will be high once again. We have no price risk exposure from our lignite-based generation of electricity since we produce this fuel in our own opencast mines. Uranium required to run our nuclear power stations has been secured under firm conditions via long-term purchasing agreements. Conversely, purchases of emissions allowances will generate higher costs than in 2005. This is due to the rise in the price of certificates. However, it is only possible to make limited forecasts for our procurement costs since the actual usage of fuel and demand for emissions certificates may deviate from our plans considerably. Unscheduled power plant outages and fluctuations in spot prices can lead to sudden adjustments in the capacity utilization of individual plants. We believe that savings can be realized when purchasing materials and services in 2006 again. We will expand pool purchasing and thus achieve price advantages.

**Research and development: focus on reducing emissions.** We stepped up our R&D budget for the current fiscal year to €68 million. Once again, in 2006, measures will centre on improving efficiency and reducing emissions in the power generation business. Since we are one of Europe's largest producers of CO<sub>2</sub> emissions, we believe we shoulder a special responsibility in the development of climate-friendly technologies. This year, we have set aside two thirds of our R&D budget for this task. As mentioned before, we support projects exploring ways of sequestering CO<sub>2</sub> produced in power plants either before or after the combustion phase. Our medium-term goal is to identify the most efficient technologies and test them in pilot plants. At the same time, we are looking into ways to store carbon dioxide safely. We want to take a proactive approach and establish the prerequisites for the construction of a "CO<sub>2</sub>-free power plant." Since CO<sub>2</sub> sequestration reduces efficiency substantially, it is important to continually improve the efficiency of power plants beforehand. This is the objective behind the commissioning of a pilot plant with lignite drying methods upstream of the combustion process scheduled for 2007. We are currently building it in Niederaussem (Germany). Furthermore, we will continue our involvement in research for the "700 degree power station," which—similarly to lignite drying—enables efficiency enhancements of up to four percentage points.

In addition, we will again dedicate some of our research spending to distributed power generation in 2006. We also intend to make inroads in the usage of biomass. Renewables-based energy is one of the pillars of RWE's climate-friendly energy policy. Regardless of political requirements, we want to increase the share of electricity accounted for by biomass in our generation portfolio.

**Forward-looking statements.** This annual report contains forward-looking statements regarding the future development of the RWE Group and its companies as well as economic and political developments. These statements are assessments that we have made based on information available to us at the time this document was prepared. In the event that the underlying assumptions do not materialize or additional risks arise, actual performance can deviate from the performance expected at present. Therefore, we cannot assume responsibility for the accuracy of these statements.



*Dr. Thomas R. Fischer*  
Chairman of the Supervisory Board of RWE AG

## *Supervisory Board Report*

### *Dear Shareholders,*

In fiscal 2005 the Supervisory Board oversaw and closely monitored the Executive Board's activities in line with the duties imposed on it by German law and the company's articles of association. The Supervisory Board convened six meetings, two of which were extraordinary, during which it received reports from the Executive Board on business trends as well as on issues relating to the RWE Group's strategic and operational development. All of the Supervisory Board members attended at least half of the meetings. The average participation rate per session exceeded 90%. When in session, the Supervisory Board passed all required resolutions on the basis of detailed information. Between meetings, the Supervisory Board was informed of projects and transactions that were especially important or urgent to the company in a timely manner. When necessary, it was asked for approval by circular. The Chairman of the Supervisory Board was constantly in touch with the members of the Executive Board in order to discuss as soon as possible events of material importance to the company's situation and development.

***Focus on strategic issues.*** Our strategy of focus and constantly optimizing the RWE Group's portfolio is a major pillar of the company's past and future success. The exploration of a new strategy for the water business presented by the Executive Board in early November was a pivotal point. Another focal topic involved budgets for a far-reaching capital expenditure programme in RWE's power plant and grid business. As in 2004, some of the Supervisory Board's sessions dealt in depth with select aspects of RWE's strategy. Such discussions were held, e.g. regarding RWE Energy's sales operations and RWE Trading's strategy.



***Change of strategy in the water business.***\* On November 4, the Supervisory Board convened an extraordinary meeting to discuss the aforementioned plans to withdraw from the UK and North American water sectors. The Executive Board explained to the Supervisory Board that this step would allow the Group to follow its aim of focusing its core competencies above all on Europe's convergent electricity and gas markets. The Executive Board presented further reasons for the proposed move. The potential sale process was also explained. The Supervisory Board reviewed the proposals submitted by the Executive Board intensively and will continue to be kept informed on this topic.

***Activities with €3.9 billion in revenue sold.*** In the period under review, the Supervisory Board held in-depth consultation sessions on the divestment of operations generating a combined €3.9 billion in revenue. It repeatedly discussed the sale of RWE Umwelt, which was initiated in 2004 and was largely completed in October 2005. Furthermore, RWE shed several small water investments outside RWE's core markets as well as some RWE Solutions subsidiaries.

***Far-reaching investments in power plants and grids.*** Both the German and UK power generation sectors are at the beginning of a long-term investment cycle. The Executive Board involved the Supervisory Board early on in its plans to replace old power stations with more efficient and environmentally friendly technology. In its September 16 session, the board inspected the development area in Neurath in the vicinity of Cologne (Germany) where a second lignite power plant with optimized plant technology is being built. In its extraordinary meeting on November 4, the Supervisory Board approved the acquisition of a gas-fired power plant in Great Yarmouth, UK.

Following the blackouts caused by the natural disaster on November 25, 2005 in Greater Osnabrück and the Münsterland (both in Germany), the Executive Board informed the Supervisory Board at its December 8 session on all of the measures necessary to restore power and support people in the affected areas. The ongoing programme for overhauling old pylons was also discussed in this context. This programme was launched as far back as 2000. Measures mainly aim at ensuring grid safety. Required resources are at our disposal.

***Other main topics of deliberation.*** Discussions regularly considered reports received on the Group's revenue and result trends as well as on measures to reduce costs. In addition, the Executive Board furnished information on the development of energy prices. The Supervisory Board also regularly discussed the Group's financial situation. In its December 8 session, the Supervisory Board dealt in detail with the medium-term budget for 2006 to 2008 submitted by the Executive Board. The Executive Board explained deviations from previous budgets and goals in detail.

Moreover, the plenum dealt repeatedly with the change in political conditions on the energy markets in which the company is active as well as the impact they could have on the development of the company's business. The main issues discussed in this context were the initial experience gained from the European CO<sub>2</sub> emissions trading scheme, the new German regulator's plans to regulate domestic electricity and gas grids, and the new federal government's concepts as regards energy policy.

Furthermore, during the reporting period, the Supervisory Board often addressed issues of corporate governance. Topics discussed in this context include the review of the Supervisory Board's efficiency set forth in the German Corporate Governance Code as well as the Code of Conduct for RWE employees.



**Committees.** The Supervisory Board formed four committees. Their members are listed in the chapter on "Boards and Committees.\*" During the Supervisory Board meetings, committee chairmen delivered in-depth reports on the committees' work.

The **Executive Committee** convened three times in the 2005 financial year. Its activity primarily consisted of preparatory work for the Supervisory Board debates. Two of the main subjects of the committee's deliberations were the corporate budget and the Group's strategy.

The **Audit Committee** convened four times in the same period. It discussed the interim reports and financial statements of the parent company (RWE AG) and the Group at great length and prepared the award of the audit contract to the independent auditor. The independent auditor was present at some of the meetings. Debates also centred on the impact of major divestments on the company's balance sheet and tax position, risk management, impairment test methods, the treatment of nuclear and mining provisions as well as internal audits.

The **Human Resources Committee** held five sessions. Debates primarily addressed the compensation system for members of the Executive Board including the long-term incentive plan (LTIP). Furthermore, it passed necessary resolutions regarding the employment contracts of Executive Board members.

Once again, in fiscal 2005, there was no reason to convene the **Mediation Committee**, which complies with Sec. 27, Para. 3 of the German Co-Determination Act.

**Financial statements for fiscal 2005.** The financial statements of the parent company, which were prepared by the Executive Board in compliance with the German Commercial Code; the financial statements of the Group, which were prepared in compliance with International Financial Reporting Standards (IFRSs); the combined review of operations for RWE Aktiengesellschaft and the Group; and the accounts were scrutinized by PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft and were issued an unqualified auditor's opinion. The auditors were elected by the AGM on April 14, 2005, and commissioned by the Supervisory Board to audit the financial statements of RWE AG and the Group. Documents supporting the annual financial statements, the annual report and the auditor's

audit report were submitted to all the members of the Supervisory Board in good time. The Executive Board also commented orally on the documents in the Supervisory Board's balance sheet meeting of February 21, 2006. The auditors, who signed the audit report, attended the meeting, presented the material results of their audit, and were available to answer questions. In the run-up to the balance sheet meeting, during its session on February 20, 2006, the Audit Committee concerned itself in depth with the financial statements and audit reports and recommended that the Supervisory Board approve the financial statements as well as the appropriation of profits proposed by the Executive Board.

The Supervisory Board thoroughly reviewed the financial statements of RWE AG and the Group, the combined review of operations for RWE Aktiengesellschaft and the Group, and the proposed appropriation of distributable profit. No objections were raised as a result of this review. As recommended by the Audit Committee, the Supervisory Board approved the auditor's results of the audit of both financial statements, and they adopted the financial statements of RWE Aktiengesellschaft and the Group for the period ended December 31, 2005. The annual financial statements are thus adopted. Furthermore, the Supervisory Board concurs with the appropriation of profits proposed by the Executive Board, which envisions a dividend payment of €1.75 per share.

***Changes in personnel on the Supervisory and Executive Boards.*** Mr. Ralf Hiltenkamp retired from the Supervisory Board effective April 10, 2005. Pursuant to a resolution adopted by the Essen District Court on April 11, 2005, Ms. Simone Haupt was appointed to succeed him as member of the Supervisory Board. Mr. Erwin Winkel vacated his seat on the Supervisory Board as of the end of the day on July 31, 2005. Mr. Dieter Faust was appointed Mr. Winkel's successor as of August 1, 2005. The Supervisory Board extends its appreciation to Messrs. Hiltenkamp and Winkel for their commitment and successful performance for the benefit of the company.

Mr. Alwin Fitting was appointed to the Executive Board of RWE Aktiengesellschaft as of August 1, 2005. He fulfils the duties of a labour director in accordance with Sec. 33 of the German Co-Determination Act.

The Supervisory Board thanks the Executive Board and the RWE Group's entire staff for their successful work. With their commitment and expertise, they laid the cornerstone for success in fiscal 2005.

Essen, February 21, 2006

The Supervisory Board



Dr. Thomas R. Fischer

–Chairman–

# Corporate Governance

*Steady progress determines our corporate governance practices. This often keeps us a step ahead of adjustments made to the German Code. The ambitious standards that we impose on the transparency of corporate governance and the behaviour of our employees is set forth in the new RWE Code of Conduct.*

We continue to fully comply with the German Corporate Governance Code's recommendations.

**Unqualified statement of compliance.** Several amendments to the Code passed by the German Government Corporate Governance Code Commission entered into force on July 20, 2005. They are primarily designed to strengthen the independence of supervisory board members. RWE fully complies with all of the recommendations of the new version of the Code. As in prior years, we can thus issue an unqualified declaration of compliance for 2005. In addition, RWE complies with the suggestions for voluntary action included in the Code with one exception. We do not envision electing or re-electing supervisory board members at different dates or for varying periods of tenure. Our current and past statements of compliance as well as past corporate governance reports can be found on the RWE website\*. Information on the activities of RWE's Executive Board, Supervisory Board and other RWE AG committees as well as on the RWE Annual General Meeting are also included on this site.



**Other aspects of Code compliance.** During our constant monitoring of corporate governance practices, we paid special attention to the relations between the Supervisory Board, the Executive Board and the company, even before the Code was amended. The following is a list of noteworthy issues in 2005:

- In the period under review, no material transactions were concluded between RWE AG or a Group company and an Executive Board member or related party. Furthermore, no contracts were concluded between the company and members of the Supervisory Board. Executive Board and Supervisory Board members had no conflicts of interest.
- In the year under review, the Supervisory Board of RWE AG debated the structure of the Executive Board compensation system in accordance with Item 4.2.2 of the Code.
- In 2005 the Supervisory Board performed another efficiency check pursuant to Item 5.6 of the Code. This examination looks, among other things, into the cooperation between the Executive Board and the Supervisory Board committees as well as the Supervisory Board itself and scrutinizes the work done during their meetings.
- All listed companies affiliated with the Group which are obliged to issue a statement of compliance again fulfilled this obligation in 2005. Details of the companies' affiliation with the Group and company size were taken into account.



- Securities dealings by Executive Board members reportable under Sec. 15a of the German Securities Trading Act were reported in an orderly fashion and published on RWE's website\*. Obligatory stock purchases within the scope of the new BEAT long-term incentive plan introduced in 2005 are shown in the following table:

Transaction date	Name	Position	Financial instrument	ISIN	Purchase/Sale	Price per share in €	Number of shares
05/27/2005	Roels, Harry	CEO	RWE common share	DE 0007037129	Purchase	47.26	12,415
05/27/2005	Bonekamp, Berthold A.	EVP	RWE common share	DE 0007037129	Purchase	47.26	4,138
05/27/2005	Dr. Sturany, Klaus	EVP	RWE common share	DE 0007037129	Purchase	47.26	4,211
05/27/2005	Zilius, Jan	EVP	RWE common share	DE 0007037129	Purchase	47.26	4,138
07/26/2005	Roels, Harry	CEO	RWE common share	DE 0007037129	Purchase	55.58	4,600
07/26/2005	Bonekamp, Berthold A.	EVP	RWE common share	DE 0007037129	Purchase	55.58	475
07/26/2005	Dr. Sturany, Klaus	EVP	RWE common share	DE 0007037129	Purchase	55.58	2,150
07/26/2005	Zilius, Jan	EVP	RWE common share	DE 0007037129	Purchase	55.58	1,200

None of the board members held securities with a combined value high enough to fall under mandatory disclosure pursuant to Item 6.6 of the Code as of the balance-sheet date.

**Service for our shareholders.** Our capital market communications abide by the principle of informing investors as comprehensively and punctually as possible of the Group's developments at any given time. We have published our annual report in February for the third straight year, and thus continue to rank among the "fastest" DAX companies. Moreover, we have a long-standing practice of providing live webcasts of our analyst conferences, keeping them posted as recordings for three months after the event. By publishing our financial calendar in our financial reports and on the Internet early on, placing financial advertisements and posting far-reaching content on our website, we afford our shareholders the opportunity to stay abreast of all major events and news relating to RWE. Good AGM turnouts are also of importance to us. In 2005, 56.52 % of the company's voting stock and voting rights was represented. For several years, we have been providing our shareholders the option of voting by proxy in order to increase AGM turnout even more. Anyone who issues instructions via the Internet using our online proxy system can make changes until the end of the debate. As set forth in the new law on corporate integrity and modernization of the right of contestation (UMAG), we adapted and simplified the registration and verification process for the Annual General Meeting by passing an amendment to the company's articles of association at last year's AGM. This should encourage shareholders—especially foreign investors—to participate in the AGM and exercise their voting rights.

**Breakdown of Supervisory Board compensation.** RWE has already complied with the German corporate governance requirement to publish Executive Board remuneration by member for three years. The same applies to the compensation of the Supervisory Board. Pursuant to Sec. 12 of the bylaws, Supervisory Board members receive a fixed compensation of €40,000 for their services after the end of each



fiscal year. The compensation increases by €225 for every €0.01 by which the dividend exceeds €0.10 per common share. Anyone who takes additional office on the Supervisory Board or any of its committees\* receives one-and-a-half to three times the aforementioned sums, in accordance with the recommendations included in the Code. The following table shows how this affects the total compensation of each member.

<b>Supervisory Board compensation in 2005</b> € '000	Fixed component	Variable component	<b>Total</b>
Dr. Thomas R. Fischer, Chairman	120	111	231
Frank Bsirske, Deputy Chairman	80	74	154
Dr. Paul Achleitner	60	56	116
Carl-Ludwig von Boehm-Bezing	80	74	154
Wilfried Donisch	40	37	77
Dieter Faust (as of August 1, 2005)	23	21	44
Simone Haupt (as of April 11, 2005)	29	27	56
Ralf Hiltenkamp (until April 10, 2005)	16	15	31
Heinz-Eberhard Holl	60	56	116
Berthold Huber	40	37	77
Dr. Dietmar Kuhnt	60	56	116
Dr. Gerhard Langemeyer	60	56	116
Dagmar Mühlenfeld (as of January 4, 2005)	40	36	76
Dr. Wolfgang Reiniger	57	53	110
Günter Reppien	60	56	116
Bernhard von Rothkirch	60	56	116
Dr. Manfred Schneider	60	56	116
Klaus-Dieter Südhofer	60	56	116
Uwe Tigges	60	56	116
Prof. Karel Van Miert	40	37	77
Jürgen Wefers	40	37	77
Erwin Winkel (until July 31, 2005)	35	32	67
<b>Total</b>	<b>1,180</b>	<b>1,095</b>	<b>2,275</b>



**Executive Board compensation components.\*** The remuneration of RWE Executive Board members largely consists of a fixed and variable components. The fixed portion accounts for about 40 % of total cash compensation, with the performance-linked variable component accounting for the remaining 60 %. The variable portion consists of a company bonus (70 %) and an individual bonus (30 %). The amount of the company bonus depends on the development of value added and free cash flow. The amount of the individual bonus depends on the degree to which the goals agreed by the Chairman of the Supervisory Board and the Executive Board member at the beginning of the financial year have been met. In addition, in common with 1,000 other managers in the RWE Group, Executive Board members participate in a long-term incentive plan that rewards them based on performance over extended periods of time. In the fiscal year, we created a new programme called BEAT 2005, harmonized it throughout the Group, and adapted it to the more stringent corporate governance requirements. Exercise hurdles were raised once again. The waiting period was extended to three years

and the redemption of the 2005 tranche was limited to three times the original value theoretically realizable at grant. For the 2006 tranche, the limit is double the original allocation value theoretically achievable on the capital market. Moreover, the BEAT Programme, which is based on virtual shares, requires Executive Board members to invest their own money in RWE shares to cover one third of the post-tax value at grant. These shares must be held for the entire waiting period of each respective BEAT tranche. The predecessor programmes had also adhered to the principle of rewarding sustained success in comparison to competitors in the company's peer group. The following provides an overview of the older programmes.



- 2002 LTIP: This plan was initiated in 2002 pursuant to a Supervisory Board resolution for Executive Board members and about 1,050 additional managers through the issuance of stock appreciation rights\* (SARs). The SARs issued in three tranches between September 20, 2002, and May 25, 2004, have a waiting period of two years and a total term to maturity of five years.
- 1999 AOP-F: The Executive Board of RWE AG was authorized to issue non-transferable subscription rights to members of the Executive Board and other managers in the RWE Group within the scope of AOP-F until March 8, 2004. A total of four tranches were initially issued. They have since been exercised by members of RWE AG's Executive Board or have been forfeited.

Our new Code of Conduct lays down the rules of behaviour for internal cooperation and external dealings.

**Code of conduct for RWE employees.** The Code of Conduct adopted in the autumn of 2005 establishes rules of behaviour in compliance with the principles of corporate governance for RWE staff throughout the Group. This set of rules ensures that employees behave within a pre-defined framework both when cooperating within the organization as well as in dealing with customers, shareholders, suppliers and consultants. In light of the public debate on the consulting activities of professional politicians, we decided to lay down some clear rules in this area as well. RWE welcomes its employees' occupying honorary political positions and becoming involved in social volunteering. However, anyone who holds a public office full-time or exercises a political mandate, is not eligible for employment with RWE as a staff member or consultant.

**Statement of compliance in accordance with Sec. 161 of the German Stock Corporation Act.** Following an orderly audit, the Executive and Supervisory Boards of RWE AG issued the following declaration of compliance: RWE Aktiengesellschaft complies with all of the recommendations of the German Government Corporate Governance Code Commission issued in the July 20, 2005, version of the Code. Likewise, from the last statement of compliance on February 22, 2005, to July 20, 2005, RWE Aktiengesellschaft has complied with all of the recommendations of the version of the Code issued on July 4, 2003, and has complied with all of the recommendations of the July 20, 2005, version of the Code since July 21, 2005.

Essen, February 21, 2006  
RWE Aktiengesellschaft

On behalf of the Supervisory Board  
Dr. Thomas R. Fischer

On behalf of the Executive Board  
Harry Roels      Alwin Fitting

## Securing talent for the long term

**Both today and tomorrow, our employees are the most important asset our company has. We utilize and cultivate their potential through an ambitious personnel and executive development programme. Providing the next generation of professionals with certified training plays a central role. Only by making this investment can we secure talent in the face of demographic change.**

About 1,000 young adults signed a training contract with RWE in 2005.



**More than your run-of-the-mill professional training.** We secure well-qualified budding professionals from within our own ranks by training 3,115 young people\*, which also makes a contribution to professional qualification and job security in RWE's regions. RWE's training programmes impart knowledge and skills for more than 50 recognized training occupations groupwide, and has nearly 60 training centres in Germany. Some 1,000 young adults signed a training agreement in 2005. After the first year of training, some top performers attend a university of applied sciences or an academy during their training programme, enabling them to obtain two degrees in four-and-a-half years. This option is available for both technical and general commercial apprenticeable trades, depending on the location and company in question. The "Dream Team" contest targets the brightest of our trainees. Participants undertake their projects of choice on issues of relevance to the company autonomously, covering everything from planning to presentation before a panel of judges. This allows them to acquire key competencies such as team working, responsible action and time management at an early stage.

In 2004 we launched the "I'll Make It!" initiative that prepares people for training. The project admits up to 100 young people every year, who do not have the prerequisites for a successful apprenticeship, providing them with the competencies they need in the working world. At the same time, practical activity builds participants' confidence in their own skills and provides for exercises in teamwork. The high referral rate rewards us for this commitment: 70 % of the participants in the class of 2004 / 2005 received apprenticeship positions, 52 % of which were outside the RWE Group. In January 2006 the project received an award within the scope of the "Deutscher Förderpreis Jugend in Arbeit," the German competition for promoting young people in the working environment.

**Employee survey 2005.** In the year under review, we carried out RWE's first group-wide staff survey to gain insight into employee satisfaction as well as the company's strengths and weaknesses. Carried out locally in our various divisions, the opinion poll generated responses from two thirds of the eligible employees, who furnished information on work, development, relationships and leadership. The

results were evaluated with the staff members in workshops, and change measures were derived from the discussions. The employee opinion poll is to be used as a management and controlling tool and become an integral component of our corporate culture.



***Creating long-term performance incentives\****. BEAT 2005, the new long-term incentive plan introduced in the fiscal year, provides a homogeneous, groupwide framework for long-term compensation incentives, promoting the development of a common leadership culture. Long-term incentives for executives have gained importance worldwide. They constitute an effective tool for bringing the interests of shareholders and management more in line with each other and for increasing the value of the company. Our new programme supports the alignment of management with this corporate goal by rewarding RWE's success when compared to its peers.

During the last round of collective bargaining negotiations, we were able to let our wage earners partake of the Group's success as well. By paying them an appropriate one-time bonus, we gave them an additional reward for the contribution they made to the company's positive development.

More than 19,000 RWE staff members purchased employee shares in 2005.

Employee shares are yet another tool we can use to let our employees directly reap the benefits of their company's success while promoting personal wealth building. Moreover, this gives our staff an additional performance incentive. In the year under review, 19,145 Group employees bought 419,413 common shares. Our workforce owns 2% of RWE's subscribed capital.

***Generation change and succession management.*** Demographic change will have an incisive impact on our personnel structure. In addition, the early retirement regulations effective in recent years will have a major impact on the way our employee structure develops. This is why we are setting our long-term staffing needs against the development of employee demographics with a view to identifying shortages and excesses and balancing them in a timely manner.

Succession management, which has been integrated groupwide, is a topic of equal importance. One of the components is the potential assessment process introduced throughout the organization in 2004. This is how we ensure that every vacant management position is staffed on time and with the most suitable person. Potential candidates are prepared for promotions through tailor-made career development programmes, most of which take them through various areas throughout the Group. Studies have shown that strategic succession planning reduces undesired staff turnover and lowers the cost of external recruitment.

## Sustainable action – securing our future

***Our comprehensive sustainability strategy is firmly ingrained in our profile as utility, employer and corporate citizen. We assume responsibility in all of these roles. Our priorities address six fields of activity: climate protection and resource conservation, social responsibility, stakeholder dialogue, environmental protection and nature conservation, and sustainability management.***

We see a chance of increasing the efficiency of coal power plants beyond 50%.

***Climate protection projects and resource conservation.*** Combining optimal energy efficiency, progress in power plant technology and an energy mix that makes economic sense is the best way for us to reduce CO<sub>2</sub> emissions and resource usage continuously, while living up to our commitment to security of supply. Our lignite power plant with optimized plant technology currently has the highest efficiency (43 %) possible from a technological and economic standpoint, thus producing the lowest CO<sub>2</sub> emissions in its class. We believe it is possible to make use of the lignite drying methods we have developed in-house as well as highly heat-resistant materials capable of withstanding 700 °C to increase efficiency beyond 50% in the near future. We are already capable of achieving efficiencies of 46 % using hard coal. In the future, we will run plants with this energy source at efficiencies exceeding 50 % as well. By comparison, the current world average is 31 %. Our ambition to engineer a fossil fuel-fired “CO<sub>2</sub>-free power plant” picks up on this progress.\* These types of power stations include CO<sub>2</sub> sequestration processes that will be performed either upstream or downstream of combustion, depending on the process used. Captured CO<sub>2</sub> must then be stored safely. Old oil and gas storage facilities are possible storage options.



Renewables are an integral part of our power generation portfolio. At the end of 2005, our installed capacity from renewables was 1,189 MW. We intend to spend additional amounts of capital to increase their share in our generation mix. To this end, we invest preferably in wind power as well as dedicating parts of the budget to hydroelectric and biomass projects.

***Our responsibility in our regions of activity.*** We want to be a reliable partner to the communities and municipalities of our Group’s locations. Since the operation of opencast mines, power plants and high-voltage grids changes the appearance of the surroundings considerably, any related work requires the acceptance of local residents. Consequently, great care must be taken in planning and operating these facilities. Therefore, in the Rhenish lignite mining region, necessary relocation programmes are developed in year-long dialogue with the affected people, who plan their new homes with our experts.

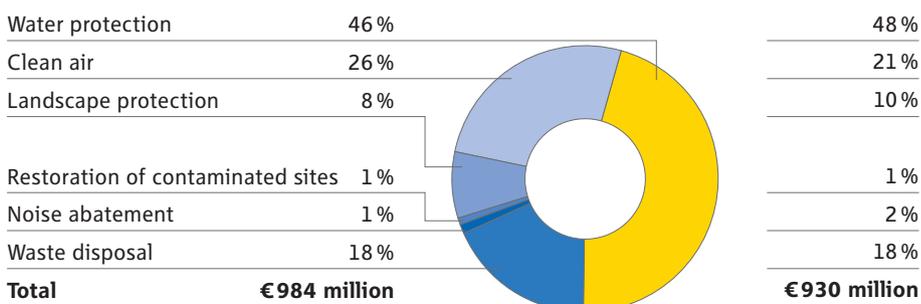
One of the objectives of the realignment of our activities, with which we assume social responsibility, is to more firmly root our company in the regions in which RWE does business. Here, providing assistance to young, socially disadvantaged people is the focal point. In 2005 we spent a total of nearly €17 million on charitable projects, compared with €15 million in the previous year.

**Balancing stakeholder interests.** We try to do justice to the well-founded interests of all stakeholder groups relating to RWE as best we can. This is not always easy. For our customers, for instance, prices and the security of supply are the topmost priorities. Non-government organizations attach importance to nature conservation and climate protection. To us, it is important to maintain dialogue with all parties involved in an open and objective manner.

We spent €984 million on environmental protection in 2005—6% more than in 2004.

**High competence in environmental protection and nature conservation.** The modern filtering units installed in our power stations and the extensive noise-abatement and dust-protection measures taken in our lignite opencast mines have met the most stringent environmental standards for many years. RWE is addressing issues related to the conservation of nature and the protection of landscapes with the same care at all its Group sites. This is reflected in numerous activities, including our environmentally friendly grid maintenance scheme and the recultivation projects carried out at our opencast mines, which enjoy world renown. These tasks are handled by a team of internationally acclaimed reclamation experts. In 2005 we spent a total of €984 million on environmental protection measures. This expenditure was 6% higher than in 2004.

**RWE Group—expenditure for environmental protection in 2005** **2004**



**Good grades for our sustainability management.** By joining the UN “Global Compact” initiative at the end of 2003, the RWE Group made a pledge to improve environmental protection and labour conditions worldwide as well as help uphold human rights. Our sustainability management work received top grades as “Industry Leader” in the renowned Dow Jones Sustainability Index (DJSI). Our sustainability reporting also receives praise. We occupied leading positions in the national study conducted by the German magazine “Capital” as well as in the international ranking of “Fortune” magazine. The next sustainability report, which will be fully certified by an auditor for the first time, will be published in April of 2006, as usual, and appear on RWE’s website.\*



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\* Part of the Review of Operations.

## Consolidated Income Statement of the RWE Group

€ million	Note	2005	2004
<b>Revenue (including natural gas tax / electricity tax)</b>	(1)	<b>41,819</b>	<b>42,137</b>
Natural gas tax / electricity tax	(1)	1,301	1,141
<b>Revenue</b>		<b>40,518</b>	<b>40,996</b>
Changes in finished goods and work in progress		38	-87
Other own work capitalized		264	321
Other operating income	(2)	2,437	3,260
Cost of materials	(3)	24,500	22,975
Staff costs	(4)	5,370	6,122
Depreciation, amortization, and impairment losses	(5)	3,762	3,765
of which: impairment losses on goodwill		(814)	(492)
Other operating expenses	(6)	4,879	6,054
<b>Income from operating activities of continuing operations</b>		<b>4,746</b>	<b>5,574</b>
Income from investments accounted for using the equity method	(7)	557	298
Other income from investments	(7)	210	548
Financial income	(8)	2,305	1,955
Finance costs	(8)	3,990	4,440
<b>Income from continuing operations before tax</b>		<b>3,828</b>	<b>3,935</b>
Taxes on income	(9)	1,221	1,521
<b>Income from continuing operations</b>		<b>2,607</b>	<b>2,414</b>
Income from discontinued operations		-20	-
<b>Income</b>		<b>2,587</b>	<b>2,414</b>
Minority interest		356	277
<b>Net income / income attributable to RWE AG shareholders</b>		<b>2,231</b>	<b>2,137</b>
<b>Basic earnings and diluted per common and preferred share (€)</b>	(28)	<b>3.97</b>	<b>3.80</b>
of which: from continuing operations (€)	(28)	(4.01)	(3.80)
of which: from discontinued operations (€)		(-0.04)	(0.00)

## Consolidated Balance Sheet of the RWE Group

Assets € million	Note	12/31/05	12/31/04
<b>Non-current assets</b>			
Intangible assets	(10)	17,215	17,718
Property, plant and equipment	(11)	36,089	34,518
Investment property	(12)	476	507
Investments accounted for using the equity method	(13)	2,617	2,665
Other non-current financial assets	(14)	1,842	1,939
Financial receivables	(15)	1,500	1,301
Other receivables and other assets	(16)	6,815	3,515
Deferred taxes	(17)	3,790	3,243
		<b>70,344</b>	<b>65,406</b>
<b>Current assets</b>			
Inventories	(18)	2,257	2,043
Financial receivables	(15)	3,155	1,102
Trade accounts receivable	(19)	8,325	7,419
Other receivables and other assets	(16)	11,112	4,550
Current tax assets		276	311
Marketable securities	(20)	10,344	11,013
Cash and cash equivalents	(21)	1,431	1,526
Assets held for sale		878	0
		<b>37,778</b>	<b>27,964</b>
		<b>108,122</b>	<b>93,370</b>
<b>Equity and Liabilities</b>			
€ million	Note	12/31/05	12/31/04
<b>Equity</b>			
	(22)		
RWE Group interest		11,474	9,656
Minority interest		1,643	1,537
		<b>13,117</b>	<b>11,193</b>
<b>Non-current liabilities</b>			
Provisions	(24)	28,064	27,830
Financial liabilities <sup>1</sup>	(25)	21,458	22,488
Other liabilities	(27)	9,907	5,869
Deferred taxes	(17)	4,873	4,134
		<b>64,302</b>	<b>60,321</b>
<b>Current liabilities</b>			
Provisions	(24)	4,784	5,330
Financial liabilities	(25)	5,994	4,895
Trade accounts payable	(26)	7,497	6,066
Current tax liabilities		86	128
Liabilities held for sale		533	0
Other liabilities	(27)	11,809	5,437
		<b>30,703</b>	<b>21,856</b>
		<b>108,122</b>	<b>93,370</b>

1 Including €21,255 million in non-current interest-bearing liabilities (previous year: €20,559 million).

## Consolidated Cash Flow Statement of the RWE Group

€ million	Note (32)	2005	2004
Income from continuing operations		2,607	2,414
Depreciation, amortization, impairment losses, write-backs		3,795	3,780
Changes in provisions		-279	-307
Changes in deferred taxes		148	482
Income from disposal of non-current assets and marketable securities		-1,005	-720
Other non-cash income / expenses (mainly equity accounting method)		-34	-90
Changes in working capital		72	-623
Changes in other balance sheet items		0	-8
<b>Cash flows from operating activities of continuing operations</b>		<b>5,304</b>	<b>4,928</b>
Intangible assets / property, plant and equipment / investment property			
Capital expenditure		-3,667	-3,429
Proceeds from sale of assets		197	683
Acquisitions and investments			
Capital expenditure		-471	-308
Proceeds from sale of assets / divestitures		635	2,637
Changes in securities and cash investments		1,257	-1,157
<b>Cash flows from investing activities of continuing operations</b>		<b>-2,049</b>	<b>-1,574</b>
Net change in equity incl. minority interest		-3	-43
Dividends paid to RWE AG shareholders and minority interests		-1,070	-939
Issuance of financial debt		4,361	2,087
Repayment of financial debt		-6,672	-5,114
<b>Cash flows from financing activities of continuing operations</b>		<b>-3,384</b>	<b>-4,009</b>
Net cash change in cash and cash equivalents of continuing operations		-129	-655
Effects of changes in foreign exchange rates and other changes in value on cash and cash equivalents		34	0
<b>Net change in cash and cash equivalents</b>		<b>-95</b>	<b>-655</b>
Cash and cash equivalents at beginning of the reporting period		1,526	2,181
<b>Cash and cash equivalents at end of the reporting period</b>		<b>1,431</b>	<b>1,526</b>

## Consolidated Statement of Changes in Equity of the RWE Group

Note (22)	Subscribed capital of RWE AG	Additional paid-in capital of RWE AG	Retained earnings and distributable profit	Accumulated other comprehensive income		RWE Group interest	Minority interest	Total
				Currency translation adjustment	Fair value measurement of financial instruments			
€ million								
<b>Balance at 01/01/04</b>	<b>1,440</b>	<b>1,288</b>	<b>4,856</b>	<b>-756</b>	<b>185</b>	<b>7,013</b>	<b>2,052</b>	<b>9,065</b>
Repayment of equity							-43	-43
Dividends paid			-703			-703	-236	-939
Other comprehensive income				630	579	1,209	101	1,310
Income			2,137			2,137	277	2,414
Other changes							-614	-614
<b>Balance at 12/31/04</b>	<b>1,440</b>	<b>1,288</b>	<b>6,290</b>	<b>-126</b>	<b>764</b>	<b>9,656</b>	<b>1,537</b>	<b>11,193</b>
Repayment of equity							-3	-3
Dividends paid			-844			-844	-245	-1,089
Other comprehensive income				282	-110	172	56	228
Income			2,231			2,231	356	2,587
Other changes			259			259	-58	201
<b>Balance at 12/31/05</b>	<b>1,440</b>	<b>1,288</b>	<b>7,936</b>	<b>156</b>	<b>654</b>	<b>11,474</b>	<b>1,643</b>	<b>13,117</b>

## Statement by the Executive Board

The Executive Board of RWE AG is responsible for the completeness and accuracy of the consolidated financial statements and the review of operations of the group, which has been combined with the review of operations of RWE AG.

The consolidated financial statements for the period ended December 31, 2005 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as applicable in the EU. The previous year's figures have been calculated according to the same principles.

Internal control systems, the use of uniform directives throughout the group, and our programmes for basic and advanced staff training ensure that the consolidated financial statements and combined review of operations are adequately prepared. Compliance with legal regulations, the internal guidelines as well as the reliability and viability of the control systems are continuously monitored throughout the group.

In line with the requirements of the German Corporate Control and Transparency Act (KonTraG), our risk management system enables the Executive Board to identify potential risks at an early stage and initiate countermeasures, if necessary.

The consolidated financial statements, the combined review of operations and the report of the independent auditors are discussed in detail by the Audit Committee and at the Supervisory Board's meeting on financial statements with the independent auditors present. The results of the Supervisory Board's examination have been included in the report of the Supervisory Board (pages 80 to 83) of this annual report.

Essen, February 14, 2006

The Executive Board

Roels

Bonekamp

Fitting

Sturany

Zilius

## *Basis of presentation*

The consolidated financial statements have been prepared in accordance with the IFRSs, as applicable in the EU, as well as in accordance with the supplementary accounting regulations applicable pursuant to Sec. 315a, Para. 1 of the German Commercial Code (HGB). The consolidated financial statements also comply with all IFRSs effective up to the balance-sheet date.

Changes in equity have been disclosed in addition to the income statement, the balance sheet and the cash flow statement. Statements made in the notes to the financial statements also include segment reporting.

Several balance sheet and income statement items have been combined in order to improve clarity. These items are stated and explained separately in the notes to the financial statements. The income statement has been prepared using the nature of expense method.

The consolidated financial statements have been prepared in euros. All amounts (unless specified otherwise) are stated in millions of euros (€ million).

These consolidated financial statements were prepared for the 2005 fiscal year (January 1 to December 31).

## *Scope of consolidation*

In addition to RWE AG, the consolidated financial statements contain all material German and foreign companies which RWE AG controls directly or indirectly. Principal associates and joint ventures are accounted for using the equity method.

Investments in subsidiaries, joint ventures or associates which are of secondary importance from a group perspective are accounted for in accordance with IAS 39. Subsidiaries which are not included in the scope of consolidation account for less than 1 % of the Group's revenue, income and debt. Subsidiaries with negative income or equity are generally fully consolidated.

A collective listing of the Group's investments in accordance with Sec. 313, Para. 2, Nos. 1 to 4 and Para. 3 of the German Commercial Code (HGB) will be filed in the Commercial Register of the Essen District Court. Material consolidated investments, investments accounted for using the equity method,\* and other investments are listed on pages 173 to 175 of this annual report.

\*  184

Eighteen companies domiciled in Germany and 18 companies domiciled outside of Germany were consolidated for the first time in the year under review. One hundred and twenty-four companies, 46 of which are headquartered outside of Germany, were excluded from the scope of consolidation. Twelve companies, two of which are based outside of Germany, were merged. Six associates or joint ventures, including three outside of Germany, were accounted for using the equity method for the first time. Sixty-seven investments, which had been accounted for using the equity method in the previous year, including eleven outside of Germany, were sold, merged or were fully consolidated for the first time. First-time consolidation and deconsolidation generally take place when control is transferred.

	German 12/31/05	Foreign 12/31/05	Total 12/31/05	Total 12/31/04
Fully consolidated companies	161	328	489	589
Investments accounted for using the equity method	79	79	158	219

With regards to subsidiaries, the following share acquisitions or increases were significant:

- Great Yarmouth Power Ltd, United Kingdom, acquisition of a 100% stake; €227 million in acquisition costs
- STOEN S. A., Poland; increased stake by 14.09 percentage points to 99.09%; €52 million in acquisition costs
- Stredoceská plynárenská a. s., Czech Republic; increased stake by 30.96 percentage points to 82.14%; €34 million in acquisition costs
- Severoceská plynárenská a. s., Czech Republic; increased stake by 20.21 percentage points to 72.03%; €33 million in acquisition costs
- Harpen Aktiengesellschaft, Dortmund; increased stake by 4.94 percentage points to 100.00%; €31 million in acquisition costs

A total of €227 million was used to acquire stakes in companies which were consolidated for the first time (previous year: €81 million).

**Assets and liabilities held for sale.** At RWE Thames Water, preparation for the sale of peripheral activities in 2006 was commenced, with the result that these are now classified as a disposal group and are disclosed as "Assets/liabilities held for sale":

€ million	12/31/05
Assets	878
Liabilities	533

**Discontinued operations.** RWE sold approximately 70% of RWE Umwelt to Rethmann per contract signed on September 28, 2004. The German Federal Cartel Office approved the deal on February 24, 2005. Sale of the 30% which initially remained

with RWE was completed in October 2005. As a result, the former segment RWE Umwelt is disclosed in these statements as a discontinued operation, the key figures of which are presented in the following tables:

€ million	12/31/05
Assets	0
Liabilities	0

€ million	2005
Revenue	614
Expenses / Income	-585
Income from discontinued operations before tax	29
Taxes on income	-15
Income from the disposal before tax	-34

€ million	2005
Cash flows from operating activities	341
Cash flows from investing activities	-402
Cash flows from financing activities	19

Furthermore, with regard to subsidiaries and investments accounted for using the equity method, the following share disposals were significant:

#### ***Subsidiaries:***

- SSM Coal B. V. Group, the Netherlands
- RWE Umwelt Ost GmbH, Halle (Saale), Germany
- RWE Umwelt West GmbH, Grevenbroich, Germany

#### ***Investments accounted for using the equity method:***

- Stadtwerke Düsseldorf AG, Düsseldorf, Germany
- Severočeská energetika a. s., Czech Republic
- RWE SCHOTT Solar GmbH, Alzenau, Germany

All in all, a net –€761 million in non-current assets (including deferred taxes), –€712 million in current assets (excluding cash and cash equivalents), –€41 million in cash and cash equivalents and –€1,736 million in non-current and current liabilities were assumed or transferred as a result of the acquisition or disposal of consolidated enterprises.

The total selling price of divested subsidiaries amounted to €205 million (previous year: €1,180 million), which was paid in cash or cash equivalents.

Further information on major share disposals is provided on pages 34 to 36 in the review of operations.

Effects of changes in the scope of consolidation have been stated in the notes insofar as they are of particular importance.

## ***Consolidation principles***

The financial statements of German and foreign companies included in the scope of consolidation are prepared using uniform accounting policies. On principle, subsidiaries with a different balance-sheet date prepare interim financial statements as of the Group's balance-sheet date.

Business combinations are reported according to the purchase method. Pursuant to this method, at the time of acquisition, capital consolidation takes place by offsetting the purchase price against the acquired subsidiaries' revalued prorated net assets. Subsidiaries' identifiable assets, liabilities and contingent liabilities are measured at full fair value, regardless of the amount of the minority interest. Intangible assets are reported separately from goodwill if they are separable from the company or if they stem from a contractual or other right. No new restructuring provisions are recognized within the scope of the purchase price allocation. Acquisition costs not allocated to assets, liabilities, or contingent liabilities are capitalized as goodwill. Negative goodwill from first-time consolidation is included in income.

Capitalized goodwill is no longer amortized. It is tested for impairment once a year or more frequently if there are indications of impairment. In the deconsolidation, residual carrying amounts of capitalized goodwill are taken into account when calculating income from disposals.

Expenses and income as well as receivables and payables between consolidated companies are eliminated. Intra-group profits and losses are eliminated as long as they are not of minor significance.

The same consolidation principles apply to investments accounted for using the equity method, in respect of which recognized goodwill is reported on the balance sheet under investments. This goodwill is also not amortized. If necessary, impairment losses on the equity value are reported under income from investments accounted for using the equity method. The financial statements of all investments accounted for using the equity method are also prepared using uniform accounting policies.

## Currency translation

Non-monetary foreign-currency transactions disclosed in companies' separate financial statements as of the balance-sheet date are valued at the exchange rate valid when they were recognized initially. Monetary items are converted using the exchange rate valid on the balance-sheet date. Exchange rate gains and losses from the measurement of monetary assets or monetary liabilities in foreign currency occurring up to the balance-sheet date are recognized in the income statement under other operating expenses or income.

Functional currency translation is applied when converting the currencies of foreign companies' financial statements. In the consolidated financial statements, the balance-sheet items of all foreign companies are translated into euros at the average exchange rate prevailing on the balance-sheet date, since principal foreign enterprises included in the consolidated financial statements conduct their business activities independently in their national currencies. When translating the adjusted equity of foreign companies accounted for using the equity method, the same procedure is followed. Differences to previous-year translations are recognized in other comprehensive income without an effect on the income statement. Goodwill is translated at year-end as an asset of the economically autonomous foreign sub-unit. For expense and income items, the annual average exchange rates are used for currency translation. Annual financial statements of Group companies based in a country with hyperinflation are translated according to IAS 29. No material entities were headquartered in a country with hyperinflation in the fiscal or previous year.

The following exchange rates (among others) were used as a basis for currency translations:

Exchange rates	Average		Year-end	
	2005	2004	12/31/05	12/31/04
€				
1 US dollar	0.81	0.80	0.85	0.73
1 British pound	1.46	1.47	1.46	1.42
100 Czech korunas	3.36	3.14	3.45	3.28
100 Hungarian forints	0.40	0.40	0.40	0.41
1 Polish zloty	0.25	0.22	0.26	0.24

## Accounting policies

**Intangible assets** are accounted for at amortized cost. With the exception of goodwill, all intangible assets have finite useful lives and are thus amortized using the straight-line method. Software for commercial and technical applications is amortized over three to five years; concessions and other usage rights in the electricity and gas business generally have useful lives of up to 20 years. Concessions in the water business have terms of up to 50 years. Capitalized customer relations are amortized over a useful life of ten years. Useful lives and methods of amortization are reviewed on an annual basis.

Goodwill is not amortized; instead it is subjected to an impairment test once every year or more frequently if there are indications of impairment.

Development costs are capitalized if a newly developed product or process can be clearly defined, is technically feasible and it is the company's intention to either use the product or process itself or market it. Furthermore, asset recognition requires that there be a sufficient level of certainty that the development costs will lead to future cash inflows. Capitalized development costs are amortized over the time period during which the products are expected to be sold. Research expenses are recognized as expenses in the period in which they are incurred.

An impairment loss is recognized for an intangible asset, if the recoverable amount of the asset is less than its carrying amount. If the asset is part of a cash-generating unit, the impairment loss is calculated based on the recoverable amount of the cash-generating unit. If this results in the carrying amount of a cash-generating unit to which goodwill was allocated exceeding the recoverable amount, the allocated goodwill is initially written down by the difference. Impairment losses which must be recognized in addition to this are taken into account by reducing the carrying amount of the other assets of the cash-generating unit on a prorated basis. If the reason for an impairment loss recognized in prior years has ceased to exist, a write-back is performed, whereby the increased carrying amount resulting from the write-back may not exceed the amortized cost. Impairment losses on goodwill are not reversed.

**Property, plant and equipment** is stated at depreciated cost. The borrowing cost is not capitalized as part of the cost. If necessary, the cost of property, plant and equipment may contain the estimated expenses for the decommissioning of plants or site restoration. Maintenance and repair costs are recognized as expenses.

Exploratory drillings are accounted according to the successful efforts method, i. e. as a rule, the expenses for exploratory drillings are capitalized only in the event of commercial success.

With the exception of land and leasehold rights, property, plant and equipment is generally written down using the straight-line method, unless in exceptional cases another depreciation method is better suited to the usage pattern. The depreciation of typical property, plant and equipment is calculated according to the following useful lives, which apply throughout the group:

Useful life in years	
Buildings	12–80
Technical plants	
Thermal power plants	15–20
Electricity grids	20–35
Water main networks	20–100
Gas and water storage facilities	20–100
Gas distribution facilities	14–20
Mining facilities	4–25
Mechanical and electrical engineering facilities	4–15
Mining developments	33–35
Exploratory wells owned by RWE Dea	up to 28

Property, plant and equipment held under a finance lease is capitalized at the lower of the fair value of the leased asset or the present value of the minimum lease payments, and is depreciated using the straight-line method over its expected useful life or lease term, whichever is shorter.

An impairment loss is recognized for property, plant and equipment, if the recoverable amount of the asset is less than its carrying amount. If the asset is part of a cash-generating unit, the impairment loss is calculated based on the recoverable amount of the cash-generating unit. If this results in the carrying amount of a cash-generating unit to which goodwill was allocated exceeding the recoverable amount, the allocated goodwill is initially written down by the difference. Impairment losses which must be recognized in addition to this are taken into account by reducing the carrying amount of the other assets of the cash-generating unit on a prorated basis. If the reason for an impairment loss recognized in prior years has ceased to exist, a write-back is performed, whereby the increased carrying amount resulting from the write-back may not exceed the depreciated cost.

**Investment property** is all real property held to earn rental income or for long-term capital appreciation rather than for use in production or for administrative purposes. This property is measured at depreciated cost. Transaction costs are included in the initial measurement. Depreciable investment property is written-down over 12 to 80 years using the straight-line method. Fair values of investment property are stated in the notes and are determined using internationally accepted valuation methods such as the discounted cash flow method or are derived from the current market prices of comparable real estate.

An impairment loss is recognized for investment property, if the recoverable amount of the asset is less than its carrying amount. If the asset is part of a cash-generating unit, the impairment loss is calculated based on the recoverable amount of the cash-generating unit. If this results in the carrying amount of a cash-generating unit to which goodwill was allocated exceeding the recoverable amount, the allocated goodwill is initially written down by the difference. Impairment losses which must be recognized in addition to this are taken into account by reducing the carrying amount of the other assets of the cash-generating unit on a prorated basis. If the reason for an impairment loss recognized in prior years has ceased to exist, a write-back is performed, whereby the increased carrying amount resulting from the write-back may not exceed the depreciated cost.

**Investments accounted for using the equity method.** Shares of companies accounted for using the equity method are initially accounted for at cost and thereafter based on their amortized prorated net assets. The carrying amounts are increased or reduced annually by the prorated profits or losses, dividends distributed and other changes in equity. Recognized goodwill is included in the carrying amount and is not amortized. An impairment loss is recognized for companies accounted for using the equity method, if the recoverable amount is less than the carrying amount.

**Other non-current financial assets.** Shares in non-consolidated subsidiaries, in associates and joint ventures not accounted for using the equity method, as well as other investments and non-current marketable securities stated under other financial assets are nearly exclusively classified as "available for sale". Initially and in the following periods, they are measured at fair value as long as such can be determined reliably. They are initially valued on their settlement date. Unrealized gains and losses are stated as other comprehensive income, with due consideration of any deferred taxes. Gains or losses are recognized in the income statement at the time of sale. If there are substantive objective indications of a reduction in the value of an asset, an impairment loss is recognized with an effect on income.

**Accounts receivable and other assets.** Receivables are comprised of financial receivables, trade accounts receivable and other receivables.

With the exception of financial derivatives, accounts receivable and other assets are stated at amortized cost. Allowances for doubtful accounts are based on the actual default risk. Prepayments received from customers for consumption which is yet to be metered and billed are netted out against trade accounts receivable of the utilities.

Company loans reported under financial receivables are stated at amortized cost. Loans with interest rates common in the market are shown on the balance sheet at nominal value; as a rule, non-interest or low-interest loans are disclosed at their present value discounted using an interest rate that is commensurate with the risks involved.

Customer-specific construction contracts are recognized using the percentage of completion method. The capitalizable amount is disclosed under accounts receivable. Negative balances for construction contracts are carried as accounts payable from construction contracts. The percentage of completion is determined according to the ratio between costs incurred and estimated total costs (cost-to-cost method). Expected contract losses are covered with allowances or provisions and are determined taking the identifiable risks into account. Contract revenue comprises the amount of revenue agreed in the contract and is shown under revenue.

CO<sub>2</sub> emission allowances are accounted for as intangible assets and reported under other assets. They are stated at cost and are not amortized.

**Deferred taxes** result from temporary differences in the carrying amount in the separate IFRS financial statements and the tax base, and from consolidation procedures. Deferred tax assets also include tax reduction claims resulting from the expected utilization of existing loss carryforwards in subsequent years. They are capitalized when the realization of these loss carryforwards is guaranteed with sufficient certainty. Deferred taxes are assessed based on the tax rates that are applicable or expected in the individual countries at the time of realization, with due consideration of the tax regulations valid or adopted as of the balance-sheet date. The tax rate used to calculate German deferred taxes is 39.4%. The Group's average local trade tax rate in Germany has been taken into account, in addition to the 25.0% corporate income tax rate and the 5.5% solidarity surcharge. Deferred tax assets and deferred tax liabilities are netted against each other for each company and / or tax group.

**Inventories** include all assets which are held for sale in the ordinary course of business (finished goods and goods for resale), which are in the process of production (work in progress—goods and services) or which are consumed in the production process or in the rendering of services (raw materials including nuclear fuel assemblies and excavated earth for lignite mining).

Inventories are carried at the lower of cost or net realizable value. Production costs include full costs directly related to production and are determined based on the normal capacity. Specifically, in addition to directly allocable costs, production costs include adequate portions of required materials and production overheads, including production-related depreciation. The borrowing cost is not capitalized as part of the cost. Assessment is generally based on average values. The usage of excavated earth for lignite mining is calculated using the FIFO method.

If the net realizable value of inventories written down in earlier periods has increased, the resulting reversal of the write-down is recognized as a reduction of the cost of materials.

Nuclear fuel assemblies are stated at depreciated cost. Depreciation is determined by operation and capacity, based on consumption and the reactor's useful life.

**Marketable securities.** The securities classified as current marketable securities essentially consist of marketable securities held in special funds as well as fixed-interest securities with a maturity of more than three months and less than one year from the date of acquisition. All of these securities are classified as "available for sale" and are stated at fair value. Upon initial recognition, the transaction costs directly associated with the acquisition of the financial asset are taken into account. These securities are initially valued on their settlement date. Unrealized gains and losses are stated as other comprehensive income as part of equity, with due consideration of any deferred taxes. Gains or losses are recognized in the income statement at the time of sale. If there are substantive objective indications of a reduction in the value of an asset, an impairment loss is recognized with an effect on income.

Financial assets are derecognized when the contractual rights to cash flows from the assets expire or the entity transfers substantially all the risks and rewards of ownership of the asset or the entity no longer has control of the asset.

**Cash and cash equivalents** consist of cash on hand, demand deposits and fixed-interest securities with a maturity of three months or less from the date of acquisition.

**Assets and liabilities held for sale.** Assets are stated as “held for sale” if they can be sold in their present condition and if their sale is highly probable. Such assets may be certain non-current assets, asset groups (“disposal groups”) or operations (“discontinued operations”). Liabilities intended to be sold in a transaction together with assets are a part of a disposal group or discontinued operations, and are reported separately under “liabilities held for sale”.

Non-current assets held for sale are no longer amortized; they are recognized at fair value less costs to sell, as long as this is lower than the carrying amount.

Results from the valuation of specific assets held for sale and of disposal groups are stated under income from continuing operations until final completion of the sale.

Gains or losses on the valuation of discontinued operations at fair value less costs to sell and profits or losses from operating activities or from the sale of such operations are reported under income from discontinued operations.

**Share-based payment.** The groupwide stock option plans are accounted for as cash-settled share-based payment transactions. At each reporting date, a provision is recognized in the amount of the prorated fair value of the payment obligation; changes in the fair value are recognized with an effect on income. The fair value of options is determined using generally accepted valuation methodologies.

**Provisions** are recognized for all legal or constructive obligations to third parties which exist on the balance-sheet date and relate to past events, and with regard to which it is probable that an outflow of resources will be required and the amount of which can be reliably estimated. Provisions are carried at the individually most likely outcome and are not offset against reimbursement claims. Provisions based on a large number of similar events are stated at expected amounts.

All non-current provisions are recognized at the most likely outcome that is discounted as of the balance-sheet date. The settlement amount also includes the cost increases to be taken into account as of the balance-sheet date. For decommissioning, restoration and similar provisions, changes in the estimated timing or amount of the payments and changes in the discount rate are taken into account at the same amount in measuring the existing provision as well as the respective asset, for example a power plant. If the decrease in the provision exceeds the carrying amount of the underlying asset, the excess is recognized immediately in profit or loss. Releases of provisions are credited to the same expense account on which the provision was originally recognized.

Provisions for pensions and similar obligations are recognized for defined benefit plans. These are obligations of the RWE Group to pay future and ongoing post-employment benefits to entitled current and former employees and their surviving dependents. In particular, the obligations refer to retirement pensions in the form of both basic and supplementary benefits. Individual commitments are based on the differing industry and country-specific benefit arrangements and are generally calculated according to the employees' length of service and compensation. As benefits, the obligations of US group enterprises for their employees' post-retirement medical expenses are also disclosed under provisions for pensions and similar obligations.

Provisions for defined benefit plans are measured according to the projected unit credit method. This benefit / years-of-service method not only takes into account the pension benefits and benefit entitlements known as of the balance-sheet date, but also increases in salaries and pension benefits to be expected in the future. The calculation is based on actuarial reports, taking into account appropriate biometric parameters. The provision is reduced by the amount of the plan assets. The service costs are disclosed in staff costs, and the interest cost and expected return on plan assets in the financial result.

Actuarial gains and losses exceeding 10 % of the greater of the benefit obligations or the fair value of plan assets are amortized over the entitled employees' average remaining working lives with an effect on income.

In addition to the defined benefit plans, the company pension plan also consists of defined contribution plans. In the case of defined contribution plans, the enterprise's obligation is limited to the amount it contributes to the plan. The contributions to the plan are recognized as expenses and disclosed under staff costs.

Waste management provisions in the nuclear energy sector are based on obligations under public law and restrictions included in operating licenses. The amount recognized for the disposal of spent nuclear fuel assemblies covers the expected costs, in particular reprocessing costs on the basis of contractual agreements and costs for direct final disposal. The cost of transporting, treating and taking back waste, including the cost of temporary storage are included accordingly.

The amount recognized for the decommissioning of nuclear power station facilities is also based on the expected costs. The calculation of expected costs for the post-shutdown phase and dismantling is based on outside expert opinions working on the assumption that the facilities are dismantled completely.

Furthermore, provisions are created for other waste management measures (management of radioactive operational waste).

Waste management provisions also include the cost of final storage and associated pre-financing costs calculated based on data from the German Federal Office for Radiation Protection. It is expected that these provisions will be used up by 2080.

Provisions for mining damage are recognized to cover obligations to restore mining damage that has already occurred or been caused. Such risks and obligations are those that exist as of the balance-sheet date or are identifiable when the balance sheet is being prepared. They must be recognized due to obligations under public law that are based, among others, on the German Federal Mining Act and formulated, above all, in operating schedules and water law permits. Provisions are generally recognized based on the increase in the obligation, e. g. in line with lignite production. Such provisions are measured at full expected cost or according to estimated compensation payments.

Furthermore, provisions are made owing to obligations under public law to dismantle production facilities and fill wells. The amount of these provisions is based on total cost estimates derived from past experience and comparative rates determined by the German Association of Oil and Natural Gas Production Industry. Similar assumptions for foreign subsidiaries are also taken into account.

**Liabilities** consist of financial liabilities, trade accounts payable and other liabilities.

Upon initial recognition, liabilities are stated at fair value. In the periods thereafter, liabilities (except for financial derivatives) are carried at amortized cost. Liabili-

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:

<b>IAS 1 (2003)</b>	"Presentation of Financial Statements"
<b>IAS 2 (2003)</b>	"Inventories"
<b>IAS 8 (2003)</b>	"Accounting Policies, Changes in Accounting Estimates and Errors"
<b>IAS 10 (2003)</b>	"Events After the Balance-Sheet Date"
<b>IAS 16 (2003)</b>	"Property, Plant and Equipment"
<b>IAS 17 (2003)</b>	"Leases"
<b>IAS 21 (2003)</b>	"The Effects of Changes in Foreign Exchange Rates"
<b>IAS 24 (2003)</b>	"Related Party Disclosures"
<b>IAS 27 (2003)</b>	"Consolidated and Separate Financial Statements"
<b>IAS 28 (2003)</b>	"Investments in Associates"
<b>IAS 31 (2003)</b>	"Interests in Joint Ventures"
<b>IAS 32 (2003)</b>	"Financial Instruments: Disclosure and Presentation"
<b>IAS 33 (2003)</b>	"Earnings per Share"
<b>IAS 39 (2004)</b>	"Financial Instruments: Recognition and Measurement"
<b>IAS 40 (2003)</b>	"Investment Property"
<b>IFRS 2</b>	"Share-based Payment"
<b>IFRS 4</b>	"Insurance Contracts"
<b>IFRS 5</b>	"Non-current Assets Held for Sale and Discontinued Operations"
<b>IFRIC 2</b>	"Members' Shares in Co-operative Entities and Similar Instruments"
<b>SIC-12 (2004)</b>	"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<sub>2</sub> emission allowances.** RWE has been subject to the European emissions trading scheme since January 1, 2005. Companies affected by the scheme are allocated CO<sub>2</sub> 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<sub>2</sub> actually emitted during the year. If actual CO<sub>2</sub> emissions exceed the allocation for the year, allowances needed to make up the difference must be bought.

In the consolidated financial statements, purchased CO<sub>2</sub> 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<sub>2</sub> 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
	<b>2,437</b>	<b>3,260</b>

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
	<b>24,500</b>	<b>22,975</b>

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
	<b>5,370</b>	<b>6,122</b>

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
	<b>4,879</b>	<b>6,054</b>

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
<b>Income from investments accounted for using the equity method</b>	<b>557</b>	<b>298</b>
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
<b>Other income from investments</b>	<b>210</b>	<b>548</b>
	<b>767</b>	<b>846</b>

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
<b>Financial income</b>	<b>2,305</b>	<b>1,955</b>
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
<b>Finance costs</b>	<b>3,990</b>	<b>4,440</b>
	<b>-1,685</b>	<b>-2,485</b>

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
<b>Net interest</b>	<b>-985</b>	<b>-1,130</b>

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
	<b>1,221</b>	<b>1,521</b>

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
<b>Income from continuing operations before tax</b>	<b>3,828</b>	<b>3,935</b>
<b>Theoretical tax expense</b>	<b>1,508</b>	<b>1,546</b>
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
<b>Effective tax expense</b>	<b>1,221</b>	<b>1,521</b>
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
<b>Cost</b>						
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
<b>Accumulated depreciation / amortization / impairment losses</b>						
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
<b>Carrying amounts</b>						
Balance at 12/31/05	100	699	2,098	14,169	149	17,215
<b>Cost</b>						
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
<b>Accumulated depreciation / amortization / impairment losses</b>						
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
<b>Carrying amounts</b>						
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
	<b>14,169</b>	<b>14,379</b>

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
<b>Cost</b>						
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
<b>Accumulated depreciation / amortization / impairment losses</b>						
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
<b>Carrying amounts</b>						
Balance at 12/31/05	7,259	27,127	536	96	1,071	36,089
<b>Cost</b>						
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
<b>Accumulated depreciation / amortization / impairment losses</b>						
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
<b>Carrying amounts</b>						
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		€ million	
<b>Cost</b>		<b>Cost</b>	
Balance at 01/01/05	884	Balance at 01/01/04	872
Additions / disposals due to changes in the scope of consolidation	-16	Additions / disposals due to changes in the scope of consolidation	1
Additions	3	Additions	6
Transfers	67	Transfers	39
Currency translation adjustments	1	Currency translation adjustments	3
Disposals	112	Disposals	37
Balance at 12/31/05	827	Balance at 12/31/04	884
<b>Accumulated depreciation / amortization / impairment losses</b>		<b>Accumulated depreciation / amortization / impairment losses</b>	
Balance at 01/01/05	377	Balance at 01/01/04	337
Additions / disposals due to changes in the scope of consolidation	-9	Additions / disposals due to changes in the scope of consolidation	1
Depreciation / amortization / impairment losses in the reporting period	28	Depreciation / amortization / impairment losses in the reporting period	49
Transfers	20	Transfers	8
Currency translation adjustments	□	Currency translation adjustments	□
Disposals	51	Disposals	18
Write-backs	14	Write-backs	
Balance at 12/31/05	351	Balance at 12/31/04	377
<b>Carrying amounts</b>		<b>Carrying amounts</b>	
Balance at 12/31/05	476	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
	<b>6,017</b>
Adjustment to RWE interest and equity method	-3,400
<b>Investments accounted for using the equity method</b>	<b>2,617</b>

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

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
	<b>1,842</b>	<b>1,939</b>

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		12/31/04	
	Non-current	Current	Non-current	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
	<b>1,500</b>	<b>3,155</b>	<b>1,301</b>	<b>1,102</b>

## (16) Other receivables and other assets

€ million	12/31/05		12/31/04	
	Non-current	Current	Non-current	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
	<b>6,815</b>	<b>11,112</b>	<b>3,515</b>	<b>4,550</b>

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		12/31/04	
	Deferred tax assets	Deferred tax liabilities	Deferred tax assets	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
	<b>7,786</b>	<b>9,299</b>	<b>5,404</b>	<b>6,465</b>
Tax loss carryforwards	430		170	
<b>Gross total</b>	<b>8,216</b>	<b>9,299</b>	<b>5,574</b>	<b>6,465</b>
Netting	-4,426	-4,426	-2,331	-2,331
<b>Net total</b>	<b>3,790</b>	<b>4,873</b>	<b>3,243</b>	<b>4,134</b>

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
	<b>430</b>	<b>170</b>

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
	<b>2,257</b>	<b>2,043</b>

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
	<b>1,431</b>	<b>1,526</b>

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		12/31/04		12/31/05	12/31/04
	Number of shares '000	%	Number of shares '000	%	€ million	€ 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
	<b>562,405</b>	<b>100.0</b>	<b>562,405</b>	<b>100.0</b>	<b>1,440</b>	<b>1,440</b>

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
<b>Distributable profit:</b>	<b>€984,279,827.47</b>

**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 <sup>1</sup>		LTIP <sup>2</sup>		
	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	<p>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 exercise 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</p> <p>Four-week exercise periods, starting on the 21<sup>st</sup> trading day following the publication of the revenue and earnings figures for the completed fiscal year and of the semi-annual results</p>		<p>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 %)</p> <p>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.</p>		
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:

<b>Beat</b>	
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	<ol style="list-style-type: none"> <li>1. Determination of the index weighting of the peer group companies which exhibit a lower TSR than RWE at the end of the term</li> <li>2. Performance factor is calculated by squaring this percentage rate and multiplying it by 1.25</li> <li>3. Total number of performance shares applicable is calculated by multiplying the performance shares conditionally granted by the performance factor</li> <li>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)</li> </ol>
Change in corporate control/merger	<ul style="list-style-type: none"> <li>▪ 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.</li> <li>▪ 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.</li> </ul>
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			12/31/04		
	Non-current	Current	Total	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
	<b>24,452</b>	<b>1,053</b>	<b>25,505</b>	<b>23,969</b>	<b>1,244</b>	<b>25,213</b>
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 <sub>2</sub> emission allowances		186	186			
Miscellaneous other provisions	956	1,355	2,311	740	1,522	2,262
	<b>3,612</b>	<b>3,731</b>	<b>7,343</b>	<b>3,861</b>	<b>4,086</b>	<b>7,947</b>
	<b>28,064</b>	<b>4,784</b>	<b>32,848</b>	<b>27,830</b>	<b>5,330</b>	<b>33,160</b>

**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		2004	
	Germany	Foreign	Germany	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
<b>Present value of funded benefit obligations</b>	<b>8,440</b>	<b>7,613</b>
Fair value of plan assets	7,692	6,746
Less: capitalized plan assets of pension plans	-554	-529
<b>Fair value of plan assets (excluding capitalized plan assets)</b>	<b>7,138</b>	<b>6,217</b>
Unrecognized actuarial gains / losses	-868	-1,018
<b>Accrued provision for funded benefit obligations</b>	<b>434</b>	<b>378</b>
<b>Present value of unfunded benefit obligations</b>	<b>12,202</b>	<b>10,946</b>
Unrecognized actuarial gains / losses on unfunded benefit obligations	-639	529
<b>Accrued provision for unfunded benefit obligations</b>	<b>11,563</b>	<b>11,475</b>
<b>Provisions for pensions (funded and unfunded benefits)</b>	<b>11,997</b>	<b>11,853</b>

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
<b>Closing balance</b>	<b>7,692</b>	<b>6,746</b>

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:



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
	<b>21,458</b>	<b>5,994</b>	<b>22,488</b>	<b>4,895</b>

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
<b>Bonds payable (incl. other notes payable)</b>		<b>€19,167 million</b>		

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:

€ million	12/31/05			12/31/04		
	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
	<b>437</b>	<b>156</b>	<b>281</b>	<b>844</b>	<b>250</b>	<b>594</b>

€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

€ million	12/31/05		12/31/04	
	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
	<b>9,907</b>	<b>11,809</b>	<b>5,869</b>	<b>5,437</b>

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

Deferred income breaks down as follows:

€ million	12/31/05		12/31/04	
	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
	<b>3,904</b>	<b>281</b>	<b>3,644</b>	<b>526</b>

## 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 <sup>1</sup>	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 chang-

es 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<sub>2</sub> 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
	<b>24,145</b>	<b>21,809</b>	<b>9,237</b>	<b>10,700</b>	<b>1,240.4</b>	<b>1,899.0</b>
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
	<b>37,965</b>	<b>27,980</b>	<b>19,076</b>	<b>16,598</b>	<b>1,255.0</b>	<b>1,989.8</b>
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
	<b>59,229</b>	<b>26,248</b>	<b>16,471</b>	<b>4,977</b>	<b>-348.0</b>	<b>194.1</b>
	<b>97,194</b>	<b>54,228</b>	<b>35,547</b>	<b>21,575</b>	<b>907.0</b>	<b>2,183.9</b>

Derivatives are exposed to default risks equivalent to their positive fair values. These risks are minimized by the stringent demands on our counterparties' credit-worthiness. 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
	<b>270</b>	<b>865</b>

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 € million	Nominal value 12/31/05	Nominal value 12/31/04
Due within 1 year	76	81
Due within 1–5 years	226	252
Due after 5 years	254	314
	<b>556</b>	<b>647</b>

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 € million	RWE Power		RWE Energy		RWE npower	
	2005	2004	2005	2004	2005	2004
<b>External revenue</b>	<b>6,832</b>	<b>6,741</b>	<b>24,318</b>	<b>22,450</b>	<b>6,382</b>	<b>5,605</b>
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
<b>Operating result</b>	<b>2,112</b>	<b>1,846</b>	<b>2,507</b>	<b>2,192</b>	<b>437</b>	<b>604</b>
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
<b>EBITDA</b>	<b>2,800</b>	<b>2,571</b>	<b>3,142</b>	<b>2,927</b>	<b>561</b>	<b>698</b>
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 € million	EU					
	Germany		UK		Other EU	
	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
<b>4,210</b>	<b>4,065</b>	<b>77</b>	<b>3,276</b>	<b>41,819</b>	<b>42,137</b>
4	0	-7,195	-6,390	0	0
4,214	4,065	-7,118	-3,114	41,819	42,137
<b>1,416</b>	<b>1,389</b>	<b>-271</b>	<b>-55</b>	<b>6,201</b>	<b>5,976</b>
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
<b>2,045</b>	<b>1,979</b>	<b>-224</b>	<b>225</b>	<b>8,324</b>	<b>8,400</b>
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
<b>Segment assets</b>	<b>84,874</b>	<b>72,107</b>

€ 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
<b>Segment liabilities</b>	<b>60,228</b>	<b>48,260</b>

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
<b>Operating result</b>	<b>6,201</b>	<b>5,976</b>

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.

Among other things, cash flows from operating activities include:

- cash flows from interest income of €1,216 million (previous year: €1,108 million) and cash flows used for interest expenses of €2,194 million (previous year: €2,257 million);
- €1,010 million (previous year: €1,050 million) in taxes on income paid (less income tax refunds); and
- cash flows from investments (dividends) amounting to €368 million (previous year: €346 million), net of the portion stemming from accounting using the equity method that does not have an effect on cash flows.

Cash flows from financing activities include €844 million (previous year: €703 million), which was paid out to RWE shareholders, and €226 million (previous year: €236 million) which was distributed to minority shareholders. New issuance of financial debt totaled €4,361 million (previous year: €2,087 million) and was contrasted by repayments of €6,672 million (previous year: €5,114 million).

Changes in the scope of consolidation resulted in a net change in cash and cash equivalents of –€41 million (previous year: –€128 million).

Cash and cash equivalents of €5 million (previous year: €0 million) stemming from acquisitions are offset against capital expenditure on financial assets. Divested cash and cash equivalents of €46 million (previous year: €128 million) are included in proceeds from divestitures.

Major first-time consolidations and deconsolidations did not result in any significant changes in net financial debt (previous year: –€0.9 billion).

There are no restrictions on the disposal of cash and cash equivalents.

The table below shows the RWE Group's net financial debt:

€ million	12/31/05	12/31/04
Cash and cash equivalents	1,431	1,526
Current marketable securities	10,344	11,013
Non-current marketable securities and other loans	1,431	1,339
Other financial assets	3,184	1,120
<b>Financial assets</b>	<b>16,390</b>	<b>14,998</b>
Bonds, other notes payable and bank debt	21,781	23,177
Commercial paper	3,201	1,705
Other financial debt	2,846	2,501
<b>Financial liabilities</b>	<b>27,828</b>	<b>27,383</b>
<b>Net financial debt</b>	<b>11,438</b>	<b>12,385</b>

Other financial debt includes financial liabilities to affiliates, investments accounted for using the equity method as well as other financial liabilities. Net financial debt is the difference between financial assets and financial liabilities.

### **(33) Information on concessions**

A number of concession agreements have been entered into in the fields of electricity, gas and water by RWE Group companies and governmental authorities in the areas supplied by RWE.

Electricity concession agreements relate to the usage of public roads, ways and sites for the laying and operation of utility lines as well as for electric plants and equipment for the supply of electric power. In municipal regions, there is a general obligation to provide network connection and supply electricity to everyone. Electricity concession agreements are generally limited to a term of 20 years. There is an obligation to construct and maintain necessary plants during the terms of the concession agreements. When the concession agreements expire, there is a legal obligation to transfer ownership of the local electricity distribution facilities in exchange for appropriate compensation of RWE by the local authorities.

Water concession agreements contain provisions for the right and obligation to provide water and wastewater services, operate the associated infrastructure, such as water utility plants, as well as to implement capital expenditure. Concessions in the water business generally have terms of up to 50 years.

Gas concession agreements contain provisions for the usage of public roadways for the direct supply of gas to end consumers as well as for the construction and maintenance of gas utility plants. There are also statutory connection obligations. In the gas business, concession agreements generally have terms of 20 years. When the concession agreements expire, there is a legal obligation to transfer ownership of the network in exchange for appropriate compensation of RWE by the local authorities.

### **(34) Related party disclosures**

**Transactions with related parties.** Within the framework of their ordinary business activities, RWE AG and its subsidiaries have business relationships with numerous companies. These include associates, which are classified as parties related to the Group, along with the RWE Energy Division's investments in municipal enterprises accounted for using the equity method, especially municipal utilities.

In the 2005 fiscal year, business transactions concluded with major related parties led to the following items in RWE's consolidated financial statements:

Key items from transactions with associates € million	2005	2004
Revenue	634	465
Expenses	74	96
Receivables	777	776
Payables	56	4

All business transactions are completed at arm's length prices and on principle do not differ from the conditions for supply and services provided to other enterprises. €70 million of the receivables and €61 million of the liabilities fall due within one year. For the receivables there are guarantees of €5 million and other collaterals amounting to €0 million. Guarantees for liabilities amount to €0 million and to €1 million for other collaterals. €730 million of the receivables are interest-bearing; there were no interest-bearing liabilities.

No material business transactions were concluded between the RWE Group and related persons.

Declarations on the members of the Executive and Supervisory Boards in accordance with Sec. 285 No. 10 of the German Commercial Code (HGB) are presented on pages 178 to 181.

**Compensation model for the Executive and Supervisory Boards.** Compensation of the Executive Board members and the structure of such is established by the Human Resources Committee of the Supervisory Board and is reviewed on a regular basis. The objective is to ensure that the Executive Board members are compensated in a manner commensurate with their activities and responsibilities, taking into account their personal performance and the company's business situation, as well as its performance and prospects for the future.

Executive Board members' total cash compensation consists of a fixed component and a variable, performance-related component (short-term compensation components). Their total cash compensation breaks down into roughly 40% for the fixed component and 60% for the variable, performance-related component. The variable component consists of a company bonus (70%) and an individual bonus (30%). The company bonus is based equally on the figures budgeted for value added to the core business and free cash flow I for the fiscal year in question. The budgeted figure represents full achievement of the target. The company bonus can amount to a maximum of 150%. The personal bonus depends on achievement of the goals agreed between the Chairman of the Supervisory Board and the Executive Board member at the beginning of the year. The maximum degree to which this target can be achieved is 120%.

Above and beyond this, Executive Board members receive non-cash compensation and other compensation, consisting primarily sums reflecting the use of company cars according to German fiscal guidelines and insurance premiums for accident insurance. Compensation also includes payment for exercising Supervisory Board mandates at affiliates, which is accounted for as variable compensation in accordance with the contractual regulations.

The compensation paid to members of the Executive Board for fiscal 2005 is as follows:

Executive Board compensation in 2005	Short-term compensation				Total
	Fixed compensation	Variable compensation	Non-cash and other remuneration	Payment for exercise of mandates	
€ ` 000					
Roels	1,400	2,234	24	120	3,778
Bonekamp	680	1,047	48	90	1,865
Fitting (since August 1, 2005)	167	234	5	39	445
Dr. Maichel (until February 22, 2005)	102	170	8	40	320
Dr. Sturany	1,000	1,268	37	63	2,368
Zilius	680	1,013	54	115	1,862
<b>Total</b>	<b>4,029</b>	<b>5,966</b>	<b>176</b>	<b>467</b>	<b>10,638</b>

In addition, members of the Executive Board receive a long-term compensation in the form of stock options granted in previous years and stock appreciation rights as part of the Executive Stock Option Plan (AOP-F) and the Long-Term Incentive Plan (LTIP). The individual amounts are broken down into the respective tranches and grant dates as follows:

Stock options / stock appreciation rights granted	Long-term compensation				Total
	AOP-F 2001 tranche Grant date: 01/15/01	AOP-F 2001A tranche Grant date: 08/02/01	LTIP 2002 tranche Grant date: 09/20/02	LTIP 2003 tranche Grant date: 07/01/03	
€ ` 000					
Roels	0	0	0	5,065	5,065
Bonekamp	878	648	648	528	2,702
Fitting (since August 1, 2005)	439	324	0	0	763
Dr. Sturany	1,318	972	1,197	2,374	5,861
Zilius	879	648	810	1,319	3,656
<b>Total</b>	<b>3,514</b>	<b>2,592</b>	<b>2,655</b>	<b>9,286</b>	<b>18,047</b>

In addition, as a long-term incentive, members of the Executive Board received variable compensation in the form of performance shares, as part of the 2005 long-term incentive plan (Beat). A condition for the granting of performance shares is an investment by the Board members in the form of RWE shares. This investment is equal to one-third of the value of the performance shares granted

after taxes. Any necessary notifications of directors' dealings in relation to this were submitted and published. The Beat programme replaced the previous Long-Term Incentive Plan 2002 (LTIP) as of January 1, 2005. The terms and conditions of the Beat programme and the earlier programmes AOP-F and LTIP are presented in the section on Share-based payment (cf. pages 138 and 142).

Long-term incentive share-based payment	Beat: 2005 tranche	
	No.	Fair value <sup>1</sup> upon grant €' 000
Roels	161,100	3,000
Bonekamp	53,700	1,000
Fitting (since August 1, 2005)	10,000	186
Dr. Sturany	80,600	1,501
Zilius	53,700	1,000
<b>Total</b>	<b>359,100</b>	<b>6,687</b>

<sup>1</sup> Waiting period not yet expired.

Members of the Executive Board still hold stock appreciation rights from the previous year, stemming from the 2004 tranche of LTIP, as the relevant waiting period has not yet expired.

Long-term incentive share-based payment	LTIP: 2004 tranche	
	No.	Fair value <sup>1</sup> upon grant in €' 000
Roels	471,700	3,000
Bonekamp	157,200	1,000
Fitting (since August 1, 2005)	40,000	254
Dr. Sturany	235,800	1,500
Zilius	157,200	1,000
<b>Total</b>	<b>1,061,900</b>	<b>6,754</b>

<sup>1</sup> Waiting period not yet expired.

€1,900,000 of the Executive Board's compensation in fiscal 2005 was paid by subsidiaries for mandates exercised in their Executive Boards.

In total, the Executive Board received €10,638,000 in short-term compensation components in fiscal 2005. In addition to this, long-term compensation components from the 2005 tranche of the Beat programme amounting to €6,687,000 were allocated, and €18,047,000 was paid out for stock options and stock appreciation rights granted in previous years. Total compensation of the Executive Board thus amounts to €35,372,000.

Furthermore, members of the Executive Board received pension commitments (direct commitments), which grant them entitlement to an annual pension and surviving dependents' benefits. The amount of qualifying income and the level of benefits determined based on the duration of service is taken as a basis for each member's individual pension and surviving dependents' benefits. There are some differences in the pension commitments in terms of the calculation of the level of benefits.

Pensions	Age	Expected annual pension benefit at 60 <sup>1</sup> €`000
Roels	57	400
Bonekamp	55	324
Fitting	52	169
Dr. Sturany	59	279
Zilius	59	302

1. Based on compensation qualifying for pensions as of December 31, 2005.

The service cost of pension commitments in the reporting period totalled €1,864,000. As of December 31, 2005, the present value of the defined benefit obligation was €20,215,000.

Until December 31, 2004, Executive Board members had the option to convert parts of their variable compensation into a benefit commitment backed by reinsurance coverage. Within this framework, Dr. Sturany is entitled at the age of 65 to payment of a lump-sum currently amounting to €925,000 and surviving dependents' benefits currently amounting to €916,000. This entitlement stems from conversion of variable compensation components which were reported in the previous years in the annual reports.

Former members of the Executive Board and their surviving dependents received €28,407,000, of which €1,875,000 came from subsidiaries. Of this, exercise of AOP-F and LTIP and severance payments to former Executive Board members accounted for €18,574,000. The total amount also includes compensation for exercise of mandates at subsidiaries amounting to €57,000. €118,509,000 have been accrued for defined benefit obligations to former members of the Executive Board and their surviving dependents, of which €25,087,000 were set aside at subsidiaries.

As of the balance-sheet date former members of the Executive Board held 157,200 stock appreciation rights from the 2004 tranche of LTIP.

Compensation of the Supervisory Board is set forth in the bylaws and is determined by the Annual General Meeting. Supervisory Board members receive a fixed compensation of €40,000 for their services at the end of each fiscal year. The compensation increased by €225 for every €0.01 by which the dividend exceeds €0.10 per common share. The Chairperson of the Supervisory Board receives three times the aforementioned sums paid to ordinary members and the Deputy Chairperson receives twice these amounts. If a committee has been active at least once in a fiscal year, the committee chairperson receives twice the aforementioned sums, and committee members receive one-and-a-half times the aforementioned sums. If a member of the Supervisory Board holds several offices concurrently, he or she receives compensation only for the highest-paid position. Out-of-pocket expenses are refunded.

In total, the emoluments of the Supervisory Board amounted to €2,275,000 in fiscal 2005. Additionally, certain Supervisory Board members were paid compensation of €176,000 for exercising mandates at subsidiaries.

No loans or advances were paid to members of the Executive Board and the Supervisory Board during the year under review.

The Economic Advisory Board was paid €380,000; above and beyond this, the Economic Advisory Board also received compensation for mandates at subsidiaries in the amount of €36,000.

### (35) Auditors' fees

The following fees were recognized as expenses for the services rendered in fiscal 2005 by the auditors of the consolidated financial statements, Pricewaterhouse-Coopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft:

€ million	2005
Audit services	13.1
Other assurance and valuation services	8.6
Tax services	1.5
Other services rendered for RWE AG or subsidiaries	0.5
	<b>23.7</b>

The fees for audit services primarily contain the fees for the audit of the consolidated financial statements as well as for the audit of the financial statements of RWE AG and its subsidiaries. Fees for other assurance or valuation services related principally to due diligence services in relation to acquisitions and disposals. This item also includes fees for review of the internal controlling system, in particular the IT systems and expenses related to statutory or court-ordered requirements. Fees for tax services mainly include fees for consultation in relation to the preparation of tax returns and review of resolutions of the tax authorities as well as national and international tax-related matters. They also include tax consultation for employees living abroad.

### **(36) Application of Sec. 264, Para. 3 and Sec. 264b of the German Commercial Code**

The following German subsidiaries made use of the exemption clause included in Sec. 264 Para. 3 and Sec. 264b of the German Commercial Code (HGB):

- BGE Beteiligungs-Gesellschaft für Energieunternehmen mbH, Essen
- GBV Dreizehnte Gesellschaft für Beteiligungsverwaltung mbH & Co KG, Essen
- GBV Fünfte Gesellschaft für Beteiligungsverwaltung mbH, Essen
- GBV Siebte Gesellschaft für Beteiligungsverwaltung mbH, Essen
- GBV Vierzehnte Gesellschaft für Beteiligungsverwaltung mbH, Essen
- OIE Aktiengesellschaft, Idar-Oberstein
- Rheinische Baustoffwerke GmbH, Bergheim
- rhenag Beteiligungs GmbH, Cologne
- RWE Energy Aktiengesellschaft, Dortmund
- RWE Energy Beteiligungsgesellschaft mbH, Dortmund
- RWE Fuel Cells GmbH, Essen
- RWE Key Account GmbH, Essen
- RWE Kundenservice GmbH, Bochum
- RWE NUKEM GmbH, Alzenau
- RWE Plus Beteiligungsgesellschaft Mitte mbH, Essen
- RWE Power Aktiengesellschaft, Cologne and Essen
- RWE Rhein-Ruhr Aktiengesellschaft, Essen
- RWE Rhein-Ruhr Netzservice GmbH, Siegen
- RWE Rhein-Ruhr Verteilnetz GmbH, Wesel
- RWE Solutions Aktiengesellschaft, Neu-Isenburg
- RWE Systems Aktiengesellschaft, Dortmund
- RWE Systems Computing GmbH, Dortmund
- RWE Systems Consulting GmbH, Essen
- RWE Systems Development GmbH & Co. KG., Dortmund
- RWE Systems Immobilien Alzenau GmbH, Alzenau
- RWE Systems Immobilien GmbH u. Co. KG, Essen
- RWE Trading GmbH, Essen
- RWE Transportnetz Gas GmbH, Essen
- RWE Transportnetz Strom GmbH, Dortmund
- RWE Westfalen-Weser-Ems Aktiengesellschaft, Dortmund
- RWE Westfalen-Weser-Ems Netzservice GmbH, Dortmund
- RWE Westfalen-Weser-Ems Verteilnetz GmbH, Recklinghausen
- RWW Rheinisch-Westfälische Wasserwerksgesellschaft mbH, Mülheim an der Ruhr
- SAG Netz- und Energietechnik GmbH, Langen
- Speicher Breitbrunn / Eggstätt RWE Dea & Mobil, Hamburg
- Thames Water Aqua Holdings GmbH, Essen
- Thames Water Aqua International GmbH, Essen
- Thyssengas GmbH, Duisburg
- VEW Immobiliengesellschaft Castrop-Rauxel mbH, Castrop-Rauxel

### ***(37) Declaration according to Sec. 161 of the German Stock Corporation Act***

The declarations on the German Corporate Governance Code prescribed by Sec. 161 of the German Stock Corporation Act have been submitted for RWE AG and its publicly traded subsidiaries and have been made accessible to the shareholders.

### ***(38) Events after the balance-sheet date***

On February 10, 2006, a binding agreement was reached on the sale of majority stakes in the Chilean water utilities ESSBIO S.A. (51 %) and ANSM S.A. (100%).

More detailed information is presented on page 36 in the review of operations.

This report contains individual forward-looking statements concerning the future course of business such as forecasts on the development of the economic and political environment as well as on our own business. These statements are based on carefully made assumptions on our part. However, due to remaining risks and uncertainties, we cannot guarantee that they will turn out to be correct in part or in their entirety.

**Auditor's report.** We have audited the consolidated financial statements – consisting of income statement, balance sheet, cash flow statements, statement of changes in equity, notes – and the combined review of operations of the RWE Aktiengesellschaft for the business year from January 1, to December 31, 2005. The preparation of the consolidated financial statements and the combined review of operations in accordance with the IFRS, as adopted by the EU, and the additional provisions stated in § 315a Abs.1 HGB as well as the responsibility of the Company's Board. Our responsibility is to express an opinion on the consolidated financial statements and the combined review of operations based on our audit.

We conducted our audit of the consolidated financial statements in accordance with § 317 HGB (German Commercial Law) and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer in Deutschland (IDW) and additionally observed the International Standards on Auditing (ISA). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the combined review of operations are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures.

The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the combined review of operations are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of the companies included in consolidation, the determination of the companies to be included in consolidation, the accounting and consolidation principles used and significant estimates made by the Company's Executive Board, as well as evaluating the overall presentation of the consolidated financial statements and the combined review of operations. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion based on the results of our audit the consolidated financial statements are in compliance with the IFRS, as adopted by the EU, and the additional provisions stated in § 315a Abs.1 HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these provisions. The combined review of operations is in accordance with the consolidated financial statements and provides on the whole a suitable understanding of the Group's position and suitably presents the opportunities and risks of future development.

Essen, Germany, February 15, 2006

PricewaterhouseCoopers  
Aktiengesellschaft  
Wirtschaftsprüfungsgesellschaft

P. Albrecht  
Wirtschaftsprüfer  
(German Public Auditor)

Dr. N. Schwieters  
Wirtschaftsprüfer  
(German Public Auditor)

## Material Investments as of December 31, 2005

I. Affiliates	Investment in acc. with Sec. 16 of the German Stock Corporation Act %	Equity of the last fiscal year	Net income / loss of the last fiscal year	External revenue 2005	Employees <sup>1</sup> 2005 average
		€'000	€'000	€ million	
<b>RWE Aktiengesellschaft, Essen</b>		<b>5,994,743</b>	<b>1,857,989</b>	<b>-</b>	<b>354</b>
<b>RWE Power</b>					
RWE Power Aktiengesellschaft, Cologne and Essen	100	2,116,974	- <sup>2</sup>	6,481	12,746
Harpen Aktiengesellschaft, Dortmund	100	157,220	-33,471	43	135
Kernkraftwerke Lippe-Ems GmbH, Lingen (Ems)	99	165,545	- <sup>2</sup>	78	299
Kernkraftwerk Gundremmingen GmbH, Gundremmingen	75	79,619	3,200	180	687
Mátra Erőmű Rt. (MÁTRA), Visonta / Hungary	51	175,519	34,239	238	2,518
Rheinbraun Brennstoff GmbH, Cologne	100	63,294	- <sup>2</sup>	575	149
RWE Dea AG, Hamburg	100	1,323,905	- <sup>2</sup>	939	703
RWE Trading GmbH, Essen	100	51,100	- <sup>2</sup>	8,865	477
<b>RWE Energy</b>					
RWE Energy Aktiengesellschaft, Dortmund	100	971,000	- <sup>2</sup>	6,833	504
Budapesti Elektromos Művek Rt. (ELMŰ), Budapest / Hungary	55	343,443	66,381	772	1,882
Emscher Lippe Energie GmbH, Gelsenkirchen	79	97,950	28,404	394	654
envia Mitteldeutsche Energie AG, Chemnitz	64	915,874	99,324	2,581	2,322
Észak-magyarországi Áramszolgáltató Rt. (ÉMÁSZ), Miskolc / Hungary	54	144,119	10,558	309	1,083
EWV Energie- und Wasser-Versorgung GmbH, Stolberg	54	37,369	12,172	263	379
Jihomoravská plynárenská a. s., Brno / Czech Republic	50	192,489	27,498	519	1,019
Koblenzer Elektrizitätswerk und Verkehrs-Aktiengesellschaft, Koblenz	58	89,231	23,185	351	546
Lechwerke Aktiengesellschaft, Augsburg	90	220,129	60,259	905	1,174
MITGAS Mitteldeutsche Gasversorgung GmbH, Halle / Saale	60	93,786	25,710	588	290
rhenag Rheinische Energie Aktiengesellschaft, Cologne	100	114,242	- <sup>2</sup>	200	333
RWE NUKEM GmbH, Alzenau	100	36,684	- <sup>2</sup>	255	305
RWE Energy Beteiligungsgesellschaft mbH, Dortmund	100	2,843,009	- <sup>2</sup>	-	-
RWE Obragas N. V., Helmond / Netherlands	100	40,326	24,951	264	164
RWE Rhein-Ruhr Aktiengesellschaft, Essen	100	238,405	- <sup>2</sup>	4,879	4,776
RWE Solutions Aktiengesellschaft, Neu-Isenburg	100	186,856	- <sup>2</sup>	364	134
RWE Transgas a. s., Prague / Czech Republic	100	1,410,836	173,503	2,180	1,108
RWE Transportnetz Gas GmbH, Essen	100	55	- <sup>2</sup>	285	61
RWE Transportnetz Strom GmbH, Dortmund	100	553,025	- <sup>2</sup>	3,886	252
RWE Westfalen-Weser-Ems Aktiengesellschaft, Dortmund	80	283,185	- <sup>2</sup>	4,530	2,647
RWW Rheinisch-Westfälische Wasserwerksgesellschaft mbH, Mülheim an der Ruhr	80	70,238	8,606	106	480
SAG Energieversorgungsleistungen GmbH, Langen	100	11,025	- <sup>2</sup>	187	1,098
SAG Holding GmbH, Langen <sup>3</sup>	100	114,943	285	-	3
SAG Netz- und Energietechnik GmbH, Langen	100	38,872	- <sup>2</sup>	275	2,097
STOEN S. A., Warsaw / Poland	99	195,374	37,032	410	1,345
Süwag Energie AG, Frankfurt am Main	78	273,109	57,800	1,319	1,528
Thyssengas GmbH, Duisburg	100	179,695	- <sup>2</sup>	110	-
VSE Aktiengesellschaft, Saarbrücken	69	133,217	14,318	244	325

1 Full time equivalent.

2 Profit- and loss-pooling agreement.

3 Truncated fiscal year from June 7 to December 31, 2005.

<b>I. Affiliates</b>	<b>Investment in acc. with Sec. 16 of the German Stock Corporation Act %</b>	<b>Equity of the last fiscal year €'000</b>	<b>Net income / loss of the last fiscal year €'000</b>	<b>External revenue 2005 € million</b>	<b>Employees<sup>1</sup> 2005 average</b>
<b>RWE npower</b>					
RWE Npower Holdings plc, Swindon / UK <sup>2</sup>	100	758,905	-80,349	6,385	10,006
<b>RWE Thames Water</b>					
RWE Thames Water plc, Reading / UK <sup>2</sup>	100	2,241,930	173,635	2,268	8,762
American Water Works Company, Inc., Wilmington / Delaware / USA AWW-Group <sup>2</sup> with 60 subsidiaries in the USA and Canada	100	4,088,986	117,231	1,486	6,194
Pridesa Proyectos y Servicios, S. A. U., Madrid / Spain Pridesa-Group <sup>2</sup> with 9 subsidiaries in Spain	100	20,149	-440	134	846
<b>Other subsidiaries</b>					
RWE Finance B. V., Zwolle / Netherlands	100	10,093	2,170	-	-
RWE Systems Aktiengesellschaft, Dortmund	100	150,507	- <sup>3</sup>	1,908	1,506

1 Full time equivalent.

2 Data from the group financial statement.

3 Profit- and loss-pooling agreement.

<b>II. Entities accounted for using the equity method</b>	<b>Investment in acc. with Sec. 16 of the German Stock Corporation Act %</b>	<b>Equity of the last fiscal year €'000</b>	<b>Net income / loss of the last fiscal year €'000</b>
<b>RWE Power</b>			
TCP Petcoke Corporation, Dover / Delaware / USA <sup>1</sup>	50	9,902	11,155
Grosskraftwerk Mannheim Aktiengesellschaft, Mannheim	40	114,141	6,647
<b>RWE Energy</b>			
Cegedel S. A., Luxembourg / Luxembourg <sup>1</sup>	30	307,017	20,601
Déldunántúli Gázszolgáltató Rt., Pécs / Hungary	50	202,501	6,086
Dortmunder Energie- und Wasserversorgung GmbH, Dortmund	47	150,437	59,087
Fővárosi Gázművek Rt., Budapest / Hungary	33	142,690	18,152
Kärntner Energieholding Beteiligungs-GmbH, Klagenfurt, Austria <sup>1</sup>	49	242,641	42,099
Kommunale Energie- und Wasserversorgung Neunkirchen AG, Neunkirchen	29	72,344	9,706
Niederrheinische Versorgung und Verkehr AG, Mönchengladbach <sup>1</sup>	50	419,933	27,379
RheinEnergie AG, Cologne	20	564,045	161,693
Stadtwerke Duisburg AG, Duisburg	20	151,223	29,348
Stadtwerke Essen AG, Essen	29	115,186	25,026
TIGÁZ Tiszántúli Gázszolgáltató Rt., Hajdúszoboszló / Hungary	44	134,342	770
<b>RWE Thames Water</b>			
RWE-Veolia Berlinwasser Beteiligungs AG, Berlin	50	252,452	-61,751
<b>III. Other investments</b>			
<b>RWE Energy</b>			
Stadtwerke Chemnitz AG, Chemnitz	19	255,562	13,120
<b>Others</b>			
RAG Aktiengesellschaft, Essen <sup>1</sup>	30	4,231,900	-13,200

1 Data from the group financial statement.

## The RWE Group's value management

**Return-oriented control of the company.** Increasing shareholder value lies at the heart of our strategy. Additional value is created when the return on capital employed (ROCE) exceeds capital costs. ROCE reflects the pure operating return. It is calculated by dividing the operating result by capital employed.

We calculate our cost of capital as a weighted average cost of equity and debt. Equity capital costs cover the market's expectation of company-specific returns when investing in an RWE share over and above that of a risk-free investment. The cost of debt is linked to long-term financing conditions in the RWE Group and allows interest on debt to be classified as tax deductible (tax shield). We calculate the Group's cost of debt by applying a pre-tax cost rate of 5.75%. The cost of equity is derived on the basis of an interest rate of 5.0%, which is customary for a risk-free investment, plus risk charges specific to the Group and the Group's divisions. We do not derive the relationship between equity and debt from the amounts carried on the balance sheet, but assume a ratio of 40:60 instead. Until 2004 we applied a 30:70 ratio. This adjustment is based on the reduction of our net financial debt. In 2005, the RWE Group's cost of capital was thus 9.0% before tax.

Relative value added is the difference between ROCE and capital costs. Multiplying this figure by the capital employed results in the absolute value added, which we employ as a central management benchmark. The higher the value added, the more attractive a particular activity is for our portfolio. It is the most important criterion for evaluating capital expenditure. Value added—in addition to free cash flow—is also our yardstick for determining bonus payments for RWE Group executives.

<b>RWE Group—capital costs</b>	
Risk-free interest rate	5.0%
Market premium	5.0%
Beta factor	0.7
Cost of equity after tax	8.5%
Cost of debt before tax	5.75%
Tax rate for debt	29.3%
Tax shield	-1.65%
Cost of debt after tax	4.1%
Proportion of equity	40%
Proportion of debt	60%
<b>Capital costs after tax</b>	<b>5.8%</b>
Tax rate for blanket conversion	35%
<b>Capital costs before tax</b>	<b>9.0%</b>

<b>RWE Group—determining value added 2005<sup>1</sup></b>		
<b>Operating result</b>	€ million	<b>6,201</b>
Intangible assets / property, plant and equipment <sup>2, 3</sup>	€ million	52,372
+ Investments including loans	€ million	4,523
+ Inventories <sup>3</sup>	€ million	2,057
+ Trade accounts receivable	€ million	7,870
+ Other assets incl. prepaid expenses	€ million	10,759
- Non-interest-bearing provisions <sup>4</sup>	€ million	9,726
- Non-interest-bearing liabilities <sup>5</sup>	€ million	25,252
+ Adjustments to average capital employed <sup>6</sup>	€ million	-464
<b>Capital employed</b>	€ million	<b>42,139</b>
ROCE	%	14.7
Relative value added	%	5.7
Absolute value added	€ million	2,408

1 Balance sheet items each with average figures for December 31, 2004 and 2005.

2 RWE npower's figure was adjusted to account for deferred tax liabilities relating to the capitalized customer base.

3 Assets capitalized in accordance with IAS 16.15 are not taken into account since these assets do not employ capital. This relates to €268 million in non-current assets and €94 million in inventories.

4 Including tax provisions and other provisions; excluding non-current provisions of €1,142 million.

5 Including trade liabilities, income tax liabilities, other liabilities, deferred income and prepayments received. Also includes deferred tax liabilities of RWE Thames Water amounting to €2,947 million.

6 Including adjustments made to average capital employed due to first-time consolidations and deconsolidations during the fiscal year. This relates primarily to RWE Umwelt and "Assets / Liabilities held for sale." The impairment loss recognized for American Water was not netted against capital employed. Therefore, it did not have an impact on value added in 2005.

## Supervisory Board

### Dr. Thomas R. Fischer

Düsseldorf

Chairman

Chairman of the Board of Management of WestLB AG

- Audi AG
- AXA Konzern AG
- Hapag-Lloyd AG
- HSH Nordbank AG
- Amvescap plc
- DekaBank Deutsche Girozentrale
- Deutscher Sparkassen Verlag GmbH
- KfW – Kreditanstalt für Wiederaufbau

### Frank Bsirske

Berlin

Deputy Chairman

Chairman of ver.di Vereinte Dienstleistungsgewerkschaft

- Deutsche Lufthansa AG
- IBM Central Holding GmbH

### Dr. Paul Achleitner

Munich

Member of the Board of Management of Allianz AG

- Allianz Global Investors AG
- Allianz Immobilien GmbH (Chairman)
- Bayer AG

### Carl-Ludwig von Boehm-Bezing

Bad Soden

Former member of the Board of Management of Deutsche Bank AG

### Wilfried Donisch

Mülheim an der Ruhr

Chairman of the Works Council of SAG Netz- und Energietechnik GmbH

- RWE Energy AG
- RWE Solutions AG

### Dieter Faust

Eschweiler

– since August 1, 2005 –

Chairman of the Works Council, Plant Services / Materials Management PFB, PBS of RWE Power AG

### Simone Haupt

Hagen

– since April 11, 2005 –

Chairman of the General Works Council of RWE Systems AG

### Ralf Hiltenkamp\*

Arnsberg

– until April 10, 2005 –

Chairman of the General Works Council of RWE Umwelt Westfalen-Ruhr GmbH

### Heinz-Eberhard Hoß

Osnabrück

Former Chief Administrative Officer, Osnabrück Rural District

- Georgsmarienhütte GmbH
- Georgsmarienhütte Holding GmbH

### Berthold Huber

Oberursel-Oberstedten

Trade Union Secretary of IG Metall

- Audi AG
- Heidelberger Druckmaschinen AG
- Siemens AG

### Dr. Dietmar Kuhnt

Essen

Former CEO of RWE AG

- Allianz Versicherungs-AG
- Dresdner Bank AG
- GEA Group AG
- Hapag-Lloyd AG
- HOCHTIEF AG
- TUI AG
- Société Electrique de l'Our S. A.

### Dr. Gerhard Langemeyer

Dortmund

Mayor of the City of Dortmund

- Dortmunder Stadtwerke AG (Chairman)
- Harpen AG
- KEB Holding AG (Chairman)
- WestLB AG
- Klinikum Dortmund gGmbH (Chairman)
- Schüchtermann Schiller'sche Kliniken KG
- Sparkasse Dortmund (Chairman)

**Dagmar Mühlenfeld**

Mülheim an der Ruhr

– since January 4, 2005 –

Mayor of the City of Mülheim an der Ruhr

- Mülheimer Wohnungsbau e. G. (Chairman)
- Beteiligungsholding Mülheim an der Ruhr GmbH
- Flughafen Essen / Mülheim GmbH (Chairman)
- medl GmbH (Chairman)
- Mülheimer & Business GmbH (Chairman)
- Ruhrgebiet Tourismus Management GmbH

**Dr. Wolfgang Reiniger**

Essen

Mayor of the City of Essen

- EGZ Entwicklungsgesellschaft Zollverein mbH
- EMG Essen Marketing GmbH Gesellschaft für Stadtwerbung, Touristik und Zentrenmanagement (Chairman)
- Entwicklungsgesellschaft Universitätsviertel Essen mbH (Chairman)
- Essener Wirtschaftsförderungsgesellschaft mbH (Chairman)
- Margarethe Krupp-Stiftung für Wohnungsfürsorge (Chairman)
- Messe Essen GmbH (Chairman)
- Sparkasse Essen (Chairman)

**Günter Reppien**

Lingen

Chairman of the General Works Council of RWE Power AG

- RWE Power AG
- Stadtwerke Lingen GmbH

**Bernhard von Rothkirch**

Frechen

M.A. in mining engineering

**Dr. Manfred Schneider**

Leverkusen

Chairman of the Supervisory Board of Bayer AG

- Allianz AG
- DaimlerChrysler AG
- Linde AG (Chairman)
- Metro AG
- TUI AG

**Klaus-Dieter Südhofer**

Recklinghausen

Former Trade Union Secretary of IG Bergbau, Chemie, Energie

- RWE Dea AG

**Uwe Tigges**

Bochum

Chairman of the General Works Council of

RWE Westfalen-Weser-Ems AG

- RWE Westfalen-Weser-Ems AG

**Prof. Karel Van Miert**

Beersel

Professor, Nyenrode University

- Münchener Rückversicherungs-Gesellschaft AG
- Agfa-Gevaert N. V.
- Anglo American plc
- De Persgroup
- Koninklijke Philips Electronics N. V.
- SIBELCO N. V.
- SOLVAY S. A.
- Vivendi Universal S. A.

**Jürgen Wefers**

Goch

Chairman of the Works Council of

RWE Rhein-Ruhr AG, Wesel site

**Erwin Winkel\***

Niederzier

– until July 31, 2005 –

Chairman of the General Works Council of RWE Power AG

- RWE Power AG

- Member of other mandatory supervisory boards.
- Member of comparable domestic and foreign supervisory bodies of commercial enterprises.
- \* Information valid as of the date of retirement from the Supervisory Board.

## Supervisory Board Committees

### ***Executive Committee of the Supervisory Board***

Dr. Thomas R. Fischer (Chairman)  
Frank Bsirske  
Dr. Paul Achleitner  
Dieter Faust – since September 16, 2005 –  
Dr. Wolfgang Reiniger – since February 22, 2005 –  
Günter Reppien  
Dr. Manfred Schneider  
Uwe Tigges  
Erwin Winkel – until July 31, 2005 –

### ***Mediation Committee in accordance with Sec. 27, Par. 3 of the German Co-Determination Act (MitbestG)***

Dr. Thomas R. Fischer (Chairman)  
Frank Bsirske  
Dr. Manfred Schneider  
Uwe Tigges

### ***Executive Board Personnel Affairs Committee***

Dr. Thomas R. Fischer (Chairman)  
Frank Bsirske  
Dr. Paul Achleitner  
Heinz-Eberhard Holl  
Klaus-Dieter Südhofer

### ***Audit Committee***

Carl-Ludwig von Boehm-Bezing (Chairman)  
Ralf Hiltenkamp – until April 10, 2005 –  
Dr. Dietmar Kuhnt  
Dr. Gerhard Langemeyer  
Günter Reppien  
Bernhard von Rothkirch  
Uwe Tigges – since April 14, 2005 –

## Executive Board

### Harry Roels

Essen

CEO of RWE AG

- RWE Energy AG (Chairman)
- RWE Power AG (Chairman)
- RWE Npower Holdings plc (Chairman)
- RWE Thames Water plc (Chairman)
- RWE Trading GmbH (Chairman)

### Berthold A. Bonekamp

Grevenbroich

Executive Vice-President of RWE AG

- RAG AG
- RheinEnergie AG
- RWE Rhein-Ruhr AG (Chairman)
- RWE Westfalen-Weser-Ems AG (Chairman)
- STEAG AG
- RWE Energy Nederland N. V.
- RWE Npower Holdings plc
- STOEN S. A. (Chairman)
- VSE a. s.

### Alwin Fitting

Westhofen

– since August 1, 2005 –

Executive Vice-President of RWE AG

- Harpen AG
- RWE Energy AG

### Dr. Gert Maichel\*

Dortmund

– until February 22, 2005 –

Executive Vice-President of RWE AG

- Harpen AG (Chairman)
- RAG AG
- RWE Dea AG (Chairman)
- RWE Energy AG
- TÜV Rheinland Holding AG
- RWE Npower Holdings plc
- RWE Trading GmbH
- Société Electrique de l'Our S. A.

### Dr. Klaus Sturany

Dortmund

Executive Vice-President of RWE AG

- Commerzbank AG
- Hannover Rückversicherung AG
- Heidelberger Druckmaschinen AG
- RAG AG
- RWE Energy AG
- RWE Power AG
- RWE Systems AG (Chairman)
- Österreichische Industrieholding AG
- RWE Npower Holdings plc
- RWE Thames Water plc

### Jan Zilius

Cologne

Executive Vice-President of RWE AG

- Harpen AG (Chairman)
- RAG AG
- RWE Dea AG (Chairman)
- RWE Energy AG

- Member of other mandatory supervisory boards.
- Member of comparable domestic and foreign supervisory bodies of commercial enterprises.
- \* Information valid as of the date of retirement from the Executive Board.

## Economic Advisory Board

### **Prof. Dr. Dr. Theodor Baums**

Frankfurt am Main  
Member of the Executive Committee of Deutsche  
Schutzvereinigung für Wertpapierbesitz e. V.

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Chairman of the Supervisory Board of  
ThyssenKrupp AG

### **Jürgen Dormann**

Zurich  
Chairman of the Administrative Council of ABB

### **Dr. Michael Frenzel**

Hanover  
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### **Dr. Jürgen Großmann**

Hamburg  
Partner in Georgsmarienhütte Holding GmbH

### **Helmut Haumann**

Cologne  
President and CEO of RheinEnergie AG

### **Prof. Dr. Hubert Markl**

Konstanz  
Former President of Max-Planck-Gesellschaft

### **Wolfgang Mayrhuber**

Frankfurt am Main  
– since February 1, 2005 –  
CEO of Deutsche Lufthansa AG

### **Dr. Thomas Middelhoff**

Essen  
Chairman of the Management Board of  
KarstadtQuelle AG

### **Klaus-Peter Müller**

Frankfurt am Main  
Chairman of the Board of Managing Directors of  
Commerzbank AG

### **Dr. Udo Oeß**

Leverkusen  
Executive Vice-President of Bayer AG

### **Alfred Freiherr von Oppenheim**

Cologne  
– deceased on January 5, 2005 –

### **Dr. Heinrich von Pierer**

Munich  
Chairman of the Supervisory Board of Siemens AG

### **Dr. Bernd Pischetsrieder**

Wolfsburg  
Chairman of the Board of Management of  
Volkswagen AG

### **Prof. Dr. Dieter Schmitt**

Essen  
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### **Klaus Schneider**

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Chairman of Schutzgemeinschaft der  
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Ludwigshafen  
Chairman of the Supervisory Board of BASF AG

### **Dr. Alfons Friedrich Titzrath**

Cologne  
Former Chairman of the Supervisory Board of  
Dresdner Bank AG

### **Marilyn Ware**

Pennsylvania  
– until January 31, 2006 –  
CEO of Ware Family Office

### **Dr. Jürgen Weber**

Frankfurt am Main  
– until January 31, 2005 –  
Chairman of the Supervisory Board of  
Deutsche Lufthansa AG

### **Wilhelm Werhahn**

Neuss  
Personally liable partner in Wilh. Werhahn KG

## **Group Business Committee**

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CEO of RWE AG

### ***Berthold A. Bonekamp***

CEO of RWE Energy AG

Executive Vice-President of RWE AG

### ***Jan Zilius***

CEO of RWE Power AG

Executive Vice-President of RWE AG

### ***Dr. Klaus Sturany***

Executive Vice-President of RWE AG

### ***Alwin Fitting***

Executive Vice-President of RWE AG

### ***Peter Terium***

Chairman of the Board of Directors of RWE Trading GmbH

### ***Andrew Duff***

CEO of RWE Npower Holdings plc

### ***Dr. Georg Schöning***

CEO of RWE Dea AG

### ***Huib Morelisse***

Head of Corporate Development at RWE AG

## Glossary

**BAFA price.** Germany's Federal Office of Economics and Export Control (BAFA) uses reports made by hard coal buyers to determine the price paid in Germany for hard coal including all costs incurred from the German border to the buyer. The price of power plant hard coal is published by BAFA quarterly and annually in shipping tons and tons of hard coal units.

**Barrel.** International unit of measurement for trading petroleum, available in "imperial" and US variants. A US barrel corresponds to 158.987 litres.

**Combined heat and power generation.** Heat which is not used in conventional thermal power generation plants is captured and used as steam or hot water. This increases the fuel efficiency of a power plant.

**Commercial paper.** Tradable, unsecured bearer bond issued only for short-term debt financing. Commercial paper is a revolving credit facility, with terms typically ranging from one day to twelve months.

**Credit default swap (CDS).** Financial derivative for trading default risks associated with debt financing. The party seeking to hedge such risks generally pays an annual fee to the principal. In the event that the underlying credit is not repaid, the hedge-seeking party receives a contractually agreed sum from the principal.

**Debt issuance programme.** Contractual master and model documents for the issuance of bonds on the domestic and foreign market. It can be used as a flexible financing vehicle to issue long-term debt.

**EBITDA.** Earnings before interest, taxes, depreciation and amortization.

**Entry-exit system.** Enables the flexible trading of gas in gas grids. Quantities of gas can be booked independent of individual transactions more simply than before. Entry-exit systems are a prerequisite for liquid gas markets and thus enable trades without gas transmission.

**Equity accounting.** Method for accounting for entities whose assets and liabilities cannot entirely be included in the consolidated financial statements by fully consolidating the entity. In such cases, the carrying amount of the investment is recorded on the basis of the development of the share held in the entity's equity. This change is recorded in the income statement of the company which owns the share in the entity.

**European Energy Exchange (EEX).** The German energy exchange, headquartered in Leipzig.

**Forward trading.** Trading scheme that works like an exchange for conducting trades at a fixed point in time in the future. This means that the conclusion of the contract and its fulfilment (delivery and payment) do not occur at the same time.

**Hard coal unit (HCU).** Reference value for the assessment of the energy content of various energy carriers. One kilogram HCU corresponds to 29,308 kilojoules.

**Inflation-adjusted historic cost accounting.** Method for calculating grid fees.

Inflation-adjusted historic cost accounting depreciates assets at historic cost and applies a nominal interest rate when determining the return on capital. Also see “Regulatory current cost accounting.”

**LNG = liquefied natural gas.** In cases where it is difficult or unprofitable to transmit gas through pipelines from remote locations, the gas is liquefied to reduce the space it occupies. LNG is transported in special ships to consumer countries where it is then converted back into gas.

**Megawatt (MW).** Unit of measurement of electric output.

1 megawatt =  $10^3$  kilowatts, 1 gigawatt =  $10^6$  kilowatts, 1 terawatt =  $10^9$  kilowatts.

**Proprietary trading.** Buying and selling a commodity with the object of making a profit. In contrast to trading, e. g. electricity in order to facilitate the sale of a long position to the market in an orderly fashion.

**Rating.** Standardized method in international capital markets for assessing the risk exposure and creditworthiness of debt issuers. A Single A rating is given to borrowers of strong creditworthiness.

**Regulatory current cost accounting.** Method for calculating grid fees. This method takes into account imputed depreciation on the current cost of non-current assets and applies a real interest rate when determining the return on equity capital. Interest on debt is directly recorded as an expense (cf. “Inflation-adjusted historic cost accounting”).

**Single A rating.** See “Rating.”

**Spot market.** General term for markets where payment and delivery are effected immediately on conclusion of the transaction (cf. “Spot trading”).

**Spot trading.** Trades on international exchanges in return for immediate payment and delivery taking into account the settlement periods customary on exchanges (usually two days).

**Spread.** Difference between the buying and selling price. As regards bonds, the spread represents the difference in yield on bonds from different issuers.

**Stock appreciation right (SAR).** Rights to partake of the increase in a company’s value. SARs are paid as the difference between the company’s value at the beginning and the end of the term, generally once pre-determined hurdles have been reached or periods have elapsed. SARs grant the right to receive payment of the difference between the exercise price and the market price at the exercise date.

**Value-at-risk method.** Method for measuring the loss that might occur from a risk position, assuming a certain probability and that the position is held for a certain period of time.

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## Imprint

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<b>Five-year overview*</b> <b>RWE Group</b>		<b>2005</b>	2004	2003	2002	2001 TFY <sup>1</sup>
<b>External revenue</b>	€ million	41,819	42,137	43,875	46,633	33,301
<b>Income</b>						
EBITDA	€ million	8,324	8,400	8,476	7,241	3,637
Operating result	€ million	6,201	5,976	5,551	4,504	2,029
Income from continuing operations before tax <sup>2</sup>	€ million	3,828	3,935	2,123	2,722	1,143
Net income <sup>2</sup>	€ million	2,231	2,137	953	1,050	621
Earnings per share <sup>2</sup>	€	3.97	3.80	1.69	1.87	1.10
Return on equity	%	21.3	23.8	10.4	13.5	7.3
Return on revenue	%	14.9	15.1	10.2	10.7	6.4
<b>Value management<sup>3</sup></b>						
Return on Capital Employed (ROCE)	%	14.7	13.5	10.4	10.4	11.1
Value added	€ million	2,408	1,998	781	395	307
Capital employed	€ million	42,139	44,480	53,961	44,293	37,860
<b>Cash flow / capital expenditure / depreciation and amortization</b>						
Cash flows from operating activities	€ million	5,304	4,928	5,289	5,933	1,021
Free cash flow <sup>4</sup>	€ million	1,637	1,499	927	1,838	-1,274
Capital expenditure	€ million	4,143	3,737	9,762	16,985	3,706
Property, plant and equipment	€ million	3,667	3,429	4,362	4,095	2,295
Depreciation, amortization, impairment losses and asset disposals <sup>5</sup>	€ million	4,098	7,051	6,819	6,655	3,144
Free cash flow per share	€	2.91	2.67	1.65	3.27	-2.27
<b>Workforce</b>						
Workforce at end of fiscal year <sup>6</sup>		85,928	97,777	127,028	131,765	155,634
<b>Asset / capital structure<sup>7</sup></b>						
Non-current assets	€ million	70,344	65,406	66,731	69,170	57,581
Current assets	€ million	37,778	27,964	32,411	31,103	33,868
Balance sheet equity	€ million	13,117	11,193	9,065	8,924	11,129
Non-current liabilities	€ million	64,302	60,321	61,327	64,384	54,000
Current liabilities	€ million	30,703	21,856	28,750	26,965	26,320
Balance sheet total	€ million	108,122	93,370	99,142	100,273	91,449
Net financial debt	€ million	11,438	12,385	17,838	15,494	1,126
Capital-to-assets ratio	%	12.1	12.0	9.1	8.9	12.2

<b>Five-year overview*</b> <b>RWE Aktiengesellschaft</b>		<b>2005</b>	2004	2003	2002	2001 TFY <sup>1</sup>
<b>Dividend / dividend payment</b>						
Dividend payment	€ million	984 <sup>8</sup>	844	703	619	562
Dividend per share	€	1.75 <sup>8</sup>	1.50	1.25	1.10 <sup>9</sup>	1.00 <sup>10</sup>
<b>Market capitalization / rating</b>						
Market capitalization at end of fiscal year	€ billion	34.9	22.6	17.5	13.7	23.6
Long-term credit rating						
Moody's		A1	A1	A1	A1	Aa3
(outlook)		(stable)	(negative)	(negative)	(negative)	(negative)
Standard & Poor's		A+	A+	A+	A+	AA-
(outlook)		(negative)	(negative)	(negative)	(stable)	(negative)

\* Part of the Review of Operations.

1 Truncated fiscal year for the Group from July to December 2001.

2 As a result of the change in International Financial Reporting Standards, the figures for 2004 and 2005 do not include goodwill amortization.

3 Figures for 2004 to 2005 are based on a new method. Please refer to pages 186 et seqq. of RWE's 2004 annual report.

4 Cash flows from operating activities minus capital expenditure on property, plant and equipment.

5 In accordance with IAS 1, as of 2005 excluding financial assets.

6 Full time equivalent.

7 Balance sheet structure in accordance with IAS 1 as of December 31, 2004; 2001 to 2003: non-current assets = fixed assets including deferred taxes,

2001 to 2003: current assets = inventories, accounts receivable and other assets, marketable securities, cash and cash equivalents, prepaid expenses.

8 Proposed dividend for RWE AG's 2005 fiscal year, subject to approval by the April 13, 2006 Annual General Meeting.

9 Includes €0.10 bonus.

10 Dividend for RWE AG's 2001 fiscal year (January to December).

## ***Financial Calendar 2006 / 2007\****

- 04 / 13 / 2006** Annual General Meeting
- 04 / 18 / 2006** Ex-dividend date
- 05 / 15 / 2006** Interim report for the first quarter of 2006  
with analyst conference call
- 08 / 10 / 2006** Interim report for the first half of 2006
- Press conference
  - Analyst conference
- 11 / 09 / 2006** Interim report for the first three quarters of 2006  
with analyst conference call
- 02 / 23 / 2007** Annual report for fiscal 2006
- Press conference
  - Analyst conference
- 04 / 18 / 2007** Annual General Meeting
- 04 / 19 / 2007** Ex-dividend date
- 05 / 15 / 2007** Interim report for the first quarter of 2007  
with analyst conference call
- 08 / 09 / 2007** Interim report for the first half of 2007
- Press conference
  - Analyst conference
- 11 / 14 / 2007** Interim report for the first three quarters of 2007  
with analyst conference call

\* All events will be broadcast live on the Internet and can thus be followed by the public at large, investors and analysts simultaneously. We will keep the recordings on our website for at least three months.

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