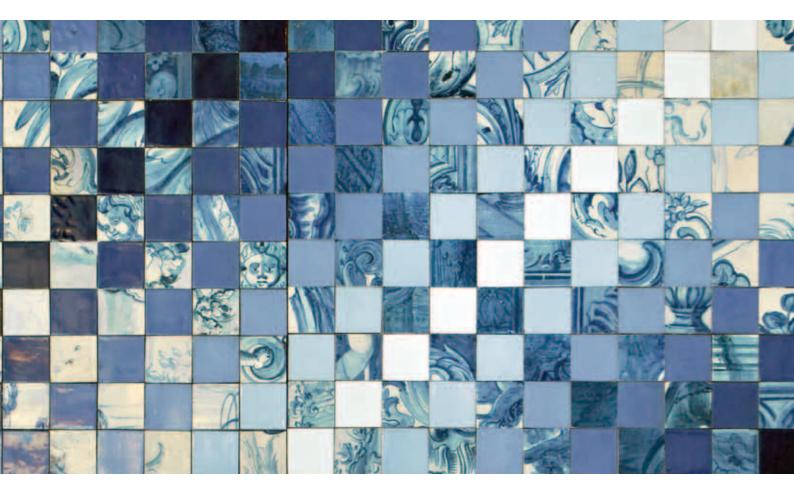






# Empresa Portuguesa das Águas Livres S.A. Abridged Annual Report and Accounts 2005





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# **Profile**

EPAL - Empresa Portuguesa das Águas Livres, S.A. (EPAL) is a public limited company wholly owned by Águas de Portugal, S.G.P.S., S.A., the holding company of the Águas de Portugal group consisting of 67 companies, which supplies water and provides waste water treatment services to seven million people in Portugal.

EPAL's function is to supply water for human consumption and offer a quality service to the community, protecting the environment and promoting public health.

The company's articles of association were approved by government decree (Decreto-Lei n° 230/91, 21st June), subsequently modified at the general meetings of 14 September 1999 and 27 February 2002.

EPAL covers a geographical area of 26 districts located north of the River Tagus, listed in Appendix I. In addition to the exclusive distribution in the city of Lisbon, EPAL also supplies Águas do Oeste, serving five districts to the north of Lisbon, as well as twenty districts to the west and north of the capital, on a bulk basis.

Company name: EPAL – Empresa Portuguesa das Águas Livres, S.A.

€150,000,000 wholly owned by Águas de Portugal, SGPS, S.A. Share capital:

Head office: Avenida da Liberdade, 24 – 1250-144 Lisboa

# Governing bodies

### General Meeting Committee

Chairman: AMEGA - Associação de Municípios para Estudos e Gestão da Água, represented by

Carlos Alberto Dias Teixeira

Vice-Chairman: Cristina Rebelo Pereira

Secretary: Alexandra Varandas

### Board of Directors (as from 9 June, 2005)

Chairman: João Manuel Lopes Fidalgo

Director: Jorge Luís Ferrão de Mascarenhas Loureiro

Director: José Alfredo Manita Vaz Director: António Bento Franco

Director: Rui Manuel de Carvalho Godinho

### Chartered Accountant (Fiscal Único)

António Dias Nabais

Joaquim Manuel da Silva Neves, deputy

### **Environmental Impact Board**

Chairman: Maria Helena Veríssimo Colaço Alegre

Member: Maria Paula Batista Antunes Member: Manuel Duarte Pinheiro

### **Board of Directors**



Rui Godinho Director

Jorge Loureiro Director

João Fidalgo Director

Director

José Manita Vaz António Bento Franco Director

# Principal indicators

<u> </u>			
	2003	2004	2005
SHARE CAPITAL (10 <sup>3</sup> EUR)	150,000	150,000	150,000
SHAREHOLDERS EQUITY (103 EUR)	334,548	343,093	345,906
NET ASSETS (10 <sup>3</sup> EUR)	650,580	675,369	687,786
INVESTMENT EXPENDITURE (10 <sup>3</sup> EUR)	39,950	59,520	57,372
TURNOVER (10 <sup>3</sup> EUR)	134,063	139,556	137,385
EBITDA (10 <sup>3</sup> EUR)	61,825	69002	65,684
EBIT (10 <sup>3</sup> EUR)	34,604	42,041	38,495
PROFIT BEFORE TAX (10 <sup>3</sup> EUR)	29,529	36,665	33,295
PROFIT AFTER TAX (10 <sup>3</sup> EUR)	20,436	26,024	23,788
CASH-FLOW (10 <sup>3</sup> EUR)	54,851	60,689	56,344
NUMBER OF STAFF AT 31 DECEMBER	850	806	811
NUMBER OF CLIENTS	336,564	339,111	341,924
NUMBER OF DISTRICTS SUPPLIED	26	26	26
NUMBER OF INHABITANTS IN THE SUPPLY AREA <sup>a)</sup>	2,556,955 a)	2,577,629 a)	2,594,033 a)
TOTAL AREA SUPPLIED (Km³)	5,443	5,406	5,406
WATER VOLUME SUPPLIED (m³)	221,650,618	222,720,242	218,850,664
DAILY ABSTRACTION CAPACITY (m³)	1,047,000	1,047,000	1,047,000
DAILY PRODUCTION CAPACITY (m³)	1,017,000	1,047,000	1,047,000

a) Estimate of resident population, December 2002, 2003 and 2004, National Bureau of Statistics



# Management report

# Chairman's report



Dear stakeholder.

I am pleased to present for the first time this abridged English version of our Annual Report and Accounts.

Portugal experienced

in 2005 one of the most severe and prolonged droughts since weather statistics began to be recorded in Portugal. I am proud to report that in this adverse environment, EPAL was equal to the challenge in ensuring the uninterrupted supply of high-quality water to its clients in the quantity demanded. This was made possible by the efficient management of the resources available, focusing on the company's immediate financial objectives and long-term economic, environmental and social goals.

For the first time in the history of EPAL, the quantity of water sold declined during the year. This was a result of the community's response to the challenge posed by the extremely dry conditions and a testament to our clients' perception of water as a valuable resource that warrants efficient use.

Investment expenditure during the year was significant with 45.7 million euros being spent on increa-

sing the size and improving the quality of extraction, transport and distribution networks. In a move designed to promote efficiency and sustainability of the company's operations, both the Master Plan and the Network Distribution Plan were revised resulting in the selection of improved technical options.

2005 was a milestone in the company's efforts to achieve ever-lower leakage levels. Indeed, a Monitoring and Control Task Force was set up in order to reduce water loss and raise analysis standards to international best practice levels within four years.

Important and far-reaching customer relation initiatives were undertaken during the year, which resulted in closer communications with the company's clients. This was made possible by the application of upgraded customer interface systems coupled with better staff training.

Finally, higher productivity levels arising from enhanced efficiency and exacting management mitigated the impact of lower water consumption.

I believe the actions taken on several fronts in 2005 have laid the foundations for sound growth in the coming years, being in the best interests of stakeholders and the environment alike.

João Manuel Lopes Fidalgo Chairman of the Board

# Production, Transportation and Distribution

### Production

Water production by EPAL consists of two stages: abstraction and treatment.

### Abstraction

Considering that water is a scarce resource, internal policy dictates that abstraction should be restricted to the quantities absolutely required to satisfy consumer demand.

In 2005, the following sources were used:

Surface water — Castelo do Bode reservoir on the River Zêzere and Valada on the River Tagus; Spring water — Olhos d'Água located at the source of the River Alviela;

Groundwater – Valada I and 3, Lezírias, Ota and Alenguer.

The volume of water abstracted totalled 255,443,634m<sup>3</sup>, distributed as follows:

### **Treatment**

The Asseiceira and Vale da Pedra treatment stations and chlorination units along the production and transportation system ensured a total volume of 255,289,130m<sup>3</sup> of treated water.

During the year, the chlorination unit at Olhos d'Água came into operation, thereby complementing the existing ultraviolet treatment system.

As a result of upgraded technology at both water treatment stations involving sediment drying and reuse of filter-rinsing water, the volume of process water was substantially reduced from 679,543m<sup>3</sup> in 2004 to a record 148,424m<sup>3</sup> in 2005.

### **Transportation**

The duplication of the Castelo do Bode trunk main at Meia Via and Brogueira, 7,440 and 3,590 metres long, respectively, were completed and entered operation during the year. In addition, a 4,000-metre stretch, out of a total of 8,650 metres, of the

Sources	Volume of water abstracted (m <sup>3</sup> )	Total %
Surface water	220,322,452	86.25
Spring water	6,360,817	2.50
Groundwater	28,760,365	11.25
Total	255,443,634	100.00

Although the volume of water abstracted was 5% lower than in 2004, the total volume of water supplied decreased by only 2.5%, which underlines the significant improvements achieved in water processing and leakage control.

ascending trunk main was concluded in the year. Both investments are part of a plan to expand capacity in the Castelo do Bode sub-system from 500,000m<sup>3</sup> to 625,000m<sup>3</sup> per day.

On the Alviela aqueduct, repair work proceeded on several sections.

The number of repaired leaks on the trunk main network was 154. Although this was higher than in 2004, the volume of water loss was significantly reduced to around four million cubic metres.

### Distribution

The total volume of water supplied in 2005 was 217,620,000 m3, a reduction of 2.5% from 2004. Despite the severe drought conditions, no consumption restrictions were imposed, which was mainly due to the judicious management of available resources.

The volume of water supplied by the Production and Transportation Business Unit (APT) was 156,864,000 m3 while the Distribution Business Unit (ADS) supplied 60,756,000 m3 to customers in the City of Lisbon.

The plan for the renewal of Lisbon's distribution network proceeded unabated in 2005, with the replacement of 85,340 metres of water mains. This was the largest length of replaced stretches since the plan was implemented in 2002.

The number of leaks in mains and in the distribution network declined to 2,738 in 2005, a 16.7% improvement in comparison to 2004. The largest number was in service connections, which had 2,046 leaks, while mains with a diameter less than 400mm incurred 598 leaks and mains with a diameter equal to or larger than 400mm had 94 such events.

Expansion work was also carried out in the network with the construction of 8,973 metres of new mains.

The fight against water losses and leakage — both apparent and real losses — was identified as a key objective for the development of the company. In September, the board of directors created a Monitoring and Control Task Force (GMC), given the responsibility of monitoring, evaluating and reducing the amount of unbilled water throughout the company.

The goal of the GMCTask Force is to ensure that within four years monitoring and control of network performance will be fully implemented in both network divisions, namely the Production and Transportation system as well as the Distribution network.

Following presentation of a progress report in the last quarter of the year, the GMC Task Force prepared an action plan for the monitoring and control of water losses to be implemented during the 2006-2009 period. In addition, District Metering Areas (DMAs) are to be established throughout the entire network along with expansion of a pilot project involving the installation of a new integrated telemetry system.

In 2005, water losses totalled 37,823,284 m3 or 14.8% of produced water, which represented an improvement of 17% in comparison with the preceding year. Year-on-year changes of water losses in cubic metres are illustrated in the following table:

2004	2005	2005/2004
15,282,926	10,892,005	-28.73%
30,416,019	26,931,279	-11.46%
45,698,945	37,823,284	-17.23%
	15,282,926 30,416,019	15,282,926 10,892,005 30,416,019 26,931,279



As a result of the measures taken since 2002, the annual volume of water losses in the distribution network also declined steadily – from 25.0% in 2002 to 23.5% in 2005.

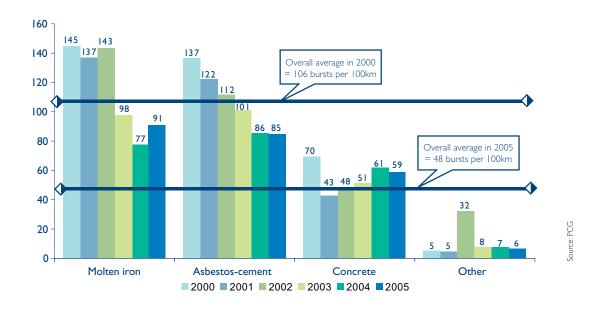
The beneficial impact of investments in the renewal of Lisbon's network is illustrated by the following graphs.

# Number of monthly burst repairs in mains Number of monthly burst repairs in mains

### Number of monthly burst repairs in trunk mains



### Number of burst per 100 km



# Water quality

Water quality is monitored by EPAL's central laboratory and at the Asseiceira and Vale da Pedra units.

The central laboratory's activities ensure two types of control: legal control - as laid down in the Water Quality Monitoring Programme (PMQA) and annually approved by the national water and waste regulator (IRAR) — and operating control. The Asseiceira and Vale da Pedra laboratories have developed their activities in compliance with their respective annual operating control plans. Both the PMQA and the operating plans attained their objectives in 2005.

Under the PMQA, 7,663 water samples were collected in 222 fixed locations identified as a representative sample of the EPAL network and includ-

ing abstraction sites, mains, distribution points, the Águas do Oeste regional utility and the City of Lisbon distribution network. In addition, samples were taken at 870 water sampling points in homes of residential customers.

Under the City of Lisboa distribution network's operating controls, an additional 1,912 samples were collected in order to test parameters and warning levels in response to infiltrations and water quality complaints, washing and disinfection of reservoirs and mains, interruptions at Castelo do Bode production sub-system and pre-cleaning of residential taps.

The total number of analyses was distributed as follows:

PMQA	Analyses
Subterranean Extractions	9,840
Surface Water Extractions	5,621
Trunk Mains	25,712
Supplies to other water companies	53,865
Direct Trunk Main system customers	458
City of Lisbon Distribution network (operating controls)	65,265
City of Lisbon Distribution network (legal controls)	23,485
Sub-Total	184.246
Other Progams	
Production interruptions at Castelo do Bode	258
Pre-cleaning of residential taps	1,185
Treatment of PIVP	4,233
Water quality complaints	8,40
Outthers (infiltrations, etc.)	4,617
Sub-Total	18.694
Total	202.940

### Water quality at source

In combination with high temperatures, the severe drought in 2005 had a significant impact on water quality at the company's abstraction sites.

### River Zêzere - Castelo do Bode reservoir

In 2005, temperatures at the reservoir showed above-average levels for all of the three A1, A2 and A3 classes in 3.5% of analyses, which led to Castelo do Bode water being classed as less than A3.

The recorded values were primarily related to the abstraction tower's surface sample points. Of the two underwater sample points that were used throughout the year, only one determination was found for all classes' temperature parameter. In addition, higher temperature observations are not considered to be of great concern, as they do not imply water contamination. They are however, a natural consequence of the abnormally warm weather conditions in the country.

For the total and faecal coliform parameters, abnormal levels were found in 10% of the samples collected at the surface locations mostly during November and December. This period experienced fairly intensive rainfall in 2005 resulting in poorer water quality.

Situations of reduced water quality at the source are not a cause of concern because they can be resolved by the treatment system at Asseiceira. In 2005 the system proved to be crucial in safeguarding abstraction areas from quality deterioration as required by law.

### Valada Tejo – River Tagus

Quality tests for the water extracted at Valada do Ribatejo by the River Tagus showed above-average levels for all classes of water for the temperature parameter. This led to water extracted at Valada being classed as A3.

The incidence of abnormal levels for total coliforms was erratic and was resolved by the Vale da Pedra treatment station. This is confirmed by the tests conducted at the station exit, where no levels were recorded, which would have not been within the quality standards directed by government decree (Decreto-Lei n° 243/2001).

### Olhos de Água spring on the River Alviela

The water abstracted at Olhos de Água proved to be hard and mineral-rich with no above-average values recorded for Class I in accordance with the law (Appendix to Decreto-Lei n° 236/98, art. 16, n°3).

### Underground abstractions

Water abstracted from underground limestone aquifers at Ota and Alenquer was mineral-rich with a low chloride and sulphate content and no abnormal values in accordance with the above decree.

The water abstracted on the River Tagus floodplains (Lezírias) from underground streams dating back to the Miocene was mineral-rich, and averagely hard with a medium chloride and sulphate content. The temperature, copper and barium parameters showed above-average levels for Class I, according to the above law.

# Quality of treated water at the treatment stations

In order to monitor treatment procedures at treatment stations, the Asseiceira laboratory conducted 24,848 analyses covering 59 parameters, with only one occurrence of non-compliance.

The Vale da Pedra laboratory conducted 72,167 analyses covering 46 parameters, with two non-compliances.



In this context, it should be emphasised that finding a non-compliance initiates a strict procedure of analysis and treatment for the purpose of ascertaining its causes.

### Quality of supplied water

The higher incidence of non-compliances in 2005 in comparison to 2004 was evidence of the poorer water quality for human consumption supplied by the company to the city of Lisbon and distributing entities.

law (Decreto-Lei n.° 243/2001, of 5 September and Portaria n° 1216/2003, of 16 October) was published monthly by EPAL, on the company website and quarterly in the national press.

The number of analyses in the City of Lisbon distribution network undertaken within legal and operating water quality control systems was 88,750. In relation to the evidence obtained, it was concluded that, except for a few rare instances, the quality of the water complied with the standards required under Portuguese law, with only 0.11% of analyses being found to be non-compliant.

	Higher than F Number	PV 2004 %	Higher than Number	PV 2005 %	
Consumer taps in the City of Lisbon	47	0.19	58	0.25	
City of Lisbon distribution network	36	0.05	45	0.07	
Wholesale distribution	41	0.08	54	0.10	

In 2005, statistical data from compliance tests conducted on water collected from (I) sampled taps of consumers supplied by the city of Lisbon's distribution network, (2) fixed sampling sites on Lisbon's distribution network and (3) sites for delivery to distributing entities – as provided in the

A comparable conclusion was drawn from the 53,865 analyses undertaken on the water supplied to bulk supply clients, where the incidence of noncompliances was 0.10%.

# Customer relations

The company devoted considerable resources to upgrading client relationships throughout the year.

### Satisfaction levels

Satisfaction surveys with wholesale clients showed that the municipalities supplied by the company were satisfied with both the delivered product and the level of service provided by EPAL. Water quality, considered to be the most important item by most clients, was highly rated, with 59% of clients surveyed stating it was 'of good quality' and 35% 'of very good quality'. The level of service was rated at 4.3 on a scale of 1 to 5 and 53% of the clients said the relationship with EPAL was 'good' while 29% said it was 'very good'.

In parallel with improved service to retail clients, it was deemed necessary to revise the rating criteria applied since 2002. A number of residential customer panels and company interviews were conducted with a view to identifying which service quality criteria were currently the most relevant to customer requirements. These review panels were undertaken in December and the results, to be presented during the first half of 2006, will provide the basis for the reformulation of future customer satisfaction surveys.

The sixteen complaints filed by wholesale clients were addressed by the company in a manner that was considered to be 'fully satisfactory' in 75% of the cases.

In the retail sector, the number of complaints by City of Lisbon customers – received mostly (91.7%) through the Customer Service telephone line – rose to 22,382, up 7.8% from 2004. Out of the complaints addressed, 90.2% were resolved within 15 days, an improvement on the 89.3% recorded in 2004.

Written complaints, however, were answered in 15 days in 82% of the cases, which was virtually unchanged from 2004. Out of the total number of resolved complaints, 72.5% were accepted while 27.5% were declined.

Like in previous years, most complaints were related to interruption of water supply.

### Customer service

Demand for customer service facilities made available by the company over the last two years is shown in the following table:

Type of service	2004	2005	Change
General Purpose counter	100,402	81,238	-19,164
Payment counter	117,361	90,551	-26,810
Citizen's Advice Bureau	81,302	62,304	-18,998
Assistance by Telephone	190,307	207,464	17,157
Assistance by Mail	8,562	11,020	2,458
Assistance by Internet	2,168	4,672	2,504
Total	500,102	457,249	-42,853



The substantial reduction in the number of customers served over the counter was primarily due to the company's initiatives to promote the use of more convenient means such as entering into contracts over the Internet or by telephone, paying bills by direct debit and using the company website for information requests.

In 2005, 24,818 locations were checked for possible illegal consumption. Out of these, 5,802 led to action such as closure or removal of illegal bypasses or meters.

### Bulk municipal and multi-municipal clients

Joint efforts between EPAL and municipal clients ensured that supply interruptions resulting from

the duplication of Castelo de Bode trunk main were resolved effectively. As these difficulties were overcome, the existing functional and technical relationships between EPAL and its clients were further consolidated.

The company reached an agreement with the region of Mafra for the purpose of building a new trunk main for the supply of water to the growing municipality, located north of Lisbon.

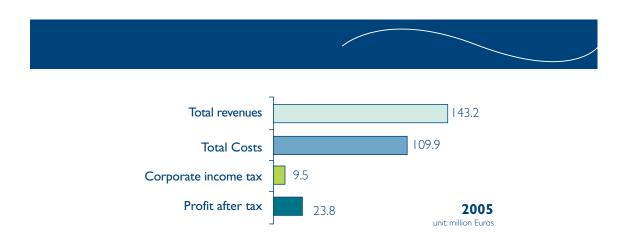
### Retail clients

The structure and change, between 2004 and 2005, of the number of contracts with retail clients in the city of Lisbon was the following:

Client category	2003	2004	2005	% of Total	Change between 2004 and 2005
Residential	282,879	285,623	288,749	84.49%	1.09%
Trade and industry	45,918	45,548	45,384	13.27%	-0.44%
Public institutions	2,453	2,547	2,624	0.77%	3.02%
State Bodies	2,972	2,974	2,902	0.85%	-2.42%
City of Lisbon (for its own use)	2,059	2,132	2,141	0.63%	0.42%
Total	336,281	338,824	341,764	100%	0.87%

# Financial performance

The company performed well in 2005, earning €23.8 million after tax on total revenues of €143.2 million. It also achieved ROE of 6.88% and ROA of 3.46%.



### Revenues

The following table shows the main revenue categories over the 2003-2005 period as well as the change between 2004 and 2005:

Revenue category	2003	2004	2005	Tho Change 2005 Amount	ousand euro / 2004 %
Operating revenue	136,197	142,266	139,673	(2,593)	(1.8)
Financial income	293	450	220	(230)	(51.1)
Non-recurrent income	3,274	5,624	3,281	(2,343)	(41.7)
TOTAL	139,764	148,340	143,174	(5,166)	(3.5)

The 3.5% decrease in total revenues was due to a 1.8% decline in water sales and a sharp reduction in non-recurrent income, which had a combined effect of nearly €5 million. Although non-

-recurrent income for 2005 was in line with 2003, it was significantly lower than in 2004, when a €2.1 million reversal of provisions impacted the item significantly.

The following table shows a breakdown of operating revenue:

				Tho	usand eur
Revenue category	2003	2004	2005	Change 05	/04
				Amount	%
Water sales	131,146	136,464	134,034	(2,430)	(1.8
Services	2,917	3,092	3,351	259	8.4
Aditional revenues	1,864	2,411	1,982	(429)	(17.8
Work for the company	208	95	179	84	88.4
Other	62	204	127	(77)	(37.7
Operating Revenue	136,197	142,266	139,673	(2,593)	(1.8

The decline in water sales from €136.5 million in 2004 to €134.0 million derived from a volume decrease of 2.3% from 222.8 to 217.6 million cubic metres, primarily due to water saving campaigns during a year of severe drought. In addition, the sales decrease was even more pronounced when compared to 2004, a year with an abnormally high volume of water sales.

At €3.4 million, the provision of services, mainly pipe work installations for customers, showed

good growth and had a larger contribution to overall revenues. Additional revenues of €2 million were mainly sourced from international contracts.

### Costs

Totals costs of €109.9 million – wich were €1.8 million lower than in 2004 – are broken down as follows:

Cost category	2003	2004	2005	Tho  Change 05	usand euro
				Amount	%
Operating costs	104,750	105,726	104,300	(1,426)	(1.3)
Financial costs	5,075	5,376	5,200	(176)	(3.3)
Non-recurrent costs	410	573	379	(194)	(33.9)
Total	110,235	111,675	109,879	(1,796)	(1.6)

Operating costs are detailed in the following table:

			Th	ousand euro
2003	2004	2005	Change	05/04
			Value	%
2,825	2,774	3,103	329	11.9
36,096	34,514	34,715	201	0.6
639	804	875	71	8.8
32,317	32,076	32,395	319	1.0
586	14	23	9	64.3
28,216	27,292	27,591	299	1.1
4,071	8,252	5,598	(2,654)	(32.2)
104,750	105,726	104,300	(1,426)	(1.3)
	2,825 36,096 639 32,317 586 28,216 4,071	2,825 2,774 36,096 34,514 639 804 32,317 32,076 586 14 28,216 27,292 4,071 8,252	2,825     2,774     3,103       36,096     34,514     34,715       639     804     875       32,317     32,076     32,395       586     14     23       28,216     27,292     27,591       4,071     8,252     5,598	2003         2004         2005         Change Value           2,825         2,774         3,103         329           36,096         34,514         34,715         201           639         804         875         71           32,317         32,076         32,395         319           586         14         23         9           28,216         27,292         27,591         299           4,071         8,252         5,598         (2,654)

Cost of goods sold rose by 11.9% to €3.1 million despite lower sales. This was the result of reduced water levels at Castelo do Bode and River Tagus in the dry summer months, which increased water treatment costs.

Current costs, which represented one third of operating costs, were in line with 2004, despite energy costs rising by 5.8% on the back of both higher unitary prices and higher energy use in water collection from lower levels at the Castelo de Bode reservoir, as a result of drought conditions.

Payroll costs, representing almost a third of operating costs, rose by 1% compared to 2004. Although remunerations including social security contributions incurred the heaviest costs, namely €23.1 million, pension plans also incurred a substantial cost of €7.1 million. The reduction in the number of staff partially offset a 3% overall salary increase and limited the increase in remunerations to 1.1%.

While depreciation increased 1.1%, reflecting sustained investment levels, provisions declined by

32.2% to €5.6 million as litigation reduced.

Financial costs declined by 3.3% to €5.2 million, which was mainly due to the reduction in investment losses on equity holdings to €257 thousand, down from €434 thousand in 2004. Interest paid to the European Investment Bank (EIB) in respect of borrowings was virtually unchanged at €4.7 million despite a €32.2 million increase in indebtdness. This was largely the result of a decrease in the average interest rate following renegotiated terms on two fixed-rate loans.

At a 1:1 debt-to-equity ratio, the improved cost of debt had a significant impact on the overall cost of capital. However, two factors warrant caution, firstly, the exposure to interest rate risk and secondly, the new borrowing requirements to fund future investments and debt service. Most loans are still in their period of grace.

In the second half of the year, the company's commercial paper programme was renegotiated leading to materially improved terms.



### Profitability

The following table sets the company's profitability in a three-year perspective:

2003 2004		2005	Thousand euro Change 05/04		
			Amount	%	
31,447	36,540	35,373	(1,167)	(3.2)	
(4,782)	(4,926)	(4,979)	(53)	1.1	
26,665	31,614	30,394	(1,220)	(3.9)	
2,864	5,051	2,901	(2,150)	(42.6)	
29,529	36,665	33,295	(3,370)	(9.2)	
9,093	10,641	9,507	(1,134)	(10.7)	
20,436	26,024	23,788	(2,236)	(8.6)	
	31,447 (4,782) 26,665 2,864 29,529 9,093	31,447 36,540 (4,782) (4,926) 26,665 31,614 2,864 5,051 29,529 36,665 9,093 10,641	31,447 36,540 35,373 (4,782) (4,926) (4,979) 26,665 31,614 30,394 2,864 5,051 2,901 29,529 36,665 33,295 9,093 10,641 9,507	2003     2004     2005     Change 05 Amount       31,447     36,540     35,373     (1,167)       (4,782)     (4,926)     (4,979)     (53)       26,665     31,614     30,394     (1,220)       2,864     5,051     2,901     (2,150)       29,529     36,665     33,295     (3,370)       9,093     10,641     9,507     (1,134)	

The return on assets, equity and sales for the 2003-2005 period is shown in the following table:

2003	2004	2005
3.14%	3.85%	3.46%
6.11%	7.59%	6.88%
15.24%	18.65%	17.31%

### Cash flow

At  $\ensuremath{\in} 56.3$  million, cash flow was on the trend line but still 7.2% down compared to 2004, which was, by all considerations, an exceptional year.

### Assets

At the year-end, the company had net assets of €687.8 million of which fixed assets represented €630.3 million, a 5.2% increase on 2004, driven by new investments of €57.3 million. Current assets declined by €19.6 million as available cash was used to reduce short-term liabilities. Overall, the company's net cash position suffered no material change.

Assets	2003	2004	2005	Tho Change 05 Amount	usand eur 5/04 %
Fixed Assets	566,022	599,396	630,308	30,912	5.2
Current Assets	66,638	56,602	37,006	(19,596)	(34.6)
Accruals and deferrals	17,919	19,371	20,472	1,101	5.7
Total assets	650,579	675,369	687,786	12,417	1.8

### Medium- and long-term debt

Borrowings with a longer maturity than one year rose in 2005 by €31.6 million to €175.2 million. Of this, €145.3 million was scheduled to mature within five years. The increase was primarily due to two new drawdowns for a combined amount of €37 million under the BEI EPAL III loan agreement.

### Equity

Shareholders' funds grew by €2.8 million which, set against the net profit generated in 2004 reflected a high payout ratio.

### Pension fund

At 31 December, the value of EPAL's pension fund was €41.4 million, 12.8% up on 2004.

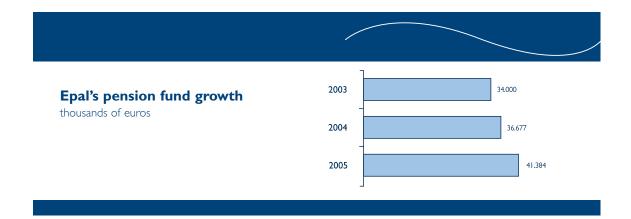
Payouts during the year were virtually unchanged at €1.7 million, while new contributions from the company totalled €3.6 million, a 55% increase over 2004. According to the generally accepted rules (Instituto de Seguros de Portugal's Norma 21/96-R), obligations were fully funded at the end of the year. Returns reached 8.1%, a significant improvement on the preceding year's 6.4%.

### Equity holdings

Equity stakes were unchanged over the year and are detailed below:

### Prolagos, SA

EPAL's stake in Prolagos is the company's most significant holding. EPAL operates the concession held by Prolagos for the supply of water and treatment of wastewater in a number of Brazilian municipali-



Affiliate	Share Capital	EPAL's hold Amount	ling %	Currency
Prolagos, SA (Brazil)	119,658,998	8,974,425	7,5	R\$
Clube de Golfe das Amoreiras, SA	350,000	350,000	100,0	EUR
Shore, Lda	420,000	31,500	7,5	EUR
Ambelis, SA	1,000,000	9,976	1,0	EUR

ties. The 92.5% of Prolagos that EPAL does not own is held, directly or indirectly, through EBAL – Águas do Brasil, SA, by Águas de Portugal, SGPS. The holding in Prolagos was valued at year-end at €4.8 million.

### Clube de Golfe das Amoreiras, SA

EPAL is the sole owner of this company, which was created for the purpose of providing an outdoor use for the land around Amoreiras reservoir. The project never came into operation, however, due to the lack of planning consent from the City of Lisbon council. Ensuing litigation with the contracted operator has not been resolved.

# Investments

In 2005, the company spent €57.3 million on new investments, a level of expenditure that was in line with 2004. The expansion of production and transportation capacity at Castelo do Bode and the renewal of Lisbon's distribution network attracted 48% and 32% of the total, respectively.

### Production and transportation

At Castelo do Bode, a second pumping station was completed with a capacity for raising I25,000m<sup>3</sup> a day with a daily storage capacity of 250,000m<sup>3</sup>. At the same time, five direct current transformers were replaced in the existing station with alternating current systems.

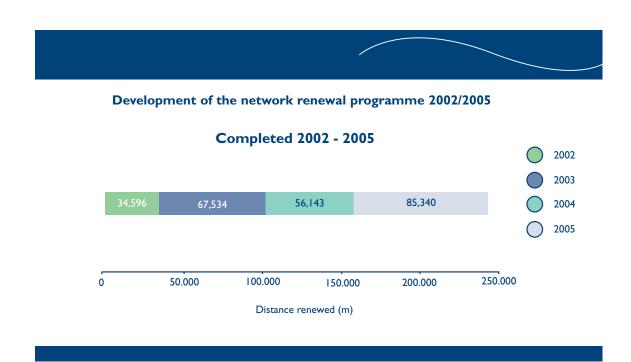
At Asseiceira, work proceeded towards the completion, by 2007, of expansion works designed to take the treatment station's capacity from 500,000m³ to 625,000m³ a day , introducing new technology in the process.

The following projects were also underway:

- Expansion of the storage capacity for treated water at Asseiceira through the construction of a new reservoir with two reserves of 20,000m<sup>3</sup> each;
- Duplication of the trunk main between the new pumping station and Asseiceira's treatment station in order to create a transport capacity of 1,000,000m<sup>3</sup> per day;
- Duplication of two stretches on the Castelo do Bode trunk main which will raise transportation capacity from 500,000m<sup>3</sup> to 625,000m<sup>3</sup> per day;
- Repair of the Alcanhões Alcoentre section of the Alviela aqueduct.

### Distribution

As can be seen in the table below, 2005 was a record year in terms of the kilometres of mains





replaced under the network renewal project that started in 2002 in the City of Lisbon.

The investment during 2005 was €19.4 million out of a total of €42.3 million since the project started in 2002.

Expansion of the network resulted in the addition of 9 new kilometres.

### New technology

Automation with remote operation and supervision was the main focus of the company's efforts towards improving process management. Another area that prompted management action was the

integration of sites and sub-systems with a view to minimising duplications and maximising back-up capabilities. A package of disaster-recovery measures including an upgrade of the company's telecommunications infrastructure was implemented with the objective of restricting damage in case of systems failure or any other adverse event.

Another far-reaching initiative is Interaqua, a project that aims to allow the Wholesale unit to map its network digitally using a geographical information system (GIS). The project will also ease the flow between the company's various departments and also between the company and external entities resulting in savings in manpower and financial resources.

# Social and environmental activities

### Environment

In 2005 the company completed its first three-year cycle of environmental certification, with the renewal audit coinciding with the audit for the transition to NP EN ISO 14001:2004.

The level of success in achieving performance targets for the reporting period can be seen in the table below:

Out of the 51 projects spread over nine annual objectives outlined in the Environmental Management Programme (PGA), 19 have been completed whilst a further 29 are currently being evaluated or are being prepared for tender. Completion is scheduled for 2006.

The integrated waste management projects were particularly effective, with the amount of waste

Indicators	Goals	Outcome
Total water losses as a percentage of abstracted water	15.9%	14.8
Network renewal	70 km	85 km
Number of DMAs for monitoring the network	74	74
Percentage of leaks in mains of less than 400 mm repaired in less than 24 hours	85%	89%
Leaks in mains repaired in less than 24 hours	75%	75%
Losses in production and transportation network	< 15.4 million m <sup>3</sup> /year	10.9 million m <sup>3</sup> /year
Losses in distribution network	< 27.5 million m <sup>3</sup> /year	26.9 million m <sup>3</sup> /year
Non-compliances in respect of legal control of consumer connections	0.4% analyses	0.25% analyses
INon-compliances in respect of legal control of deliveries of bulk water	0.15% analyses	0.10% analyses
Non-compliances in respect of the City of Lisbon operating control	0.09% analyses	0.07% analyses
Non-compliances in respect of operating control outside Lisbon ETAs and transportation)	0.15% analyses	0.06% analyses
Number of production tests of pumping aggregates	20 analyses	6
Number of measures to solve noise pollution at Verdelha and Amadora premises	2	2
Mud reduction at Asseiceira	6 000 metric tons	6 016 metric tons
Mud reduction at Vale da Pedra	3 500 metric tons	2 500 metric tons
Cut in leasing costs for containers and waste transportation	10%	22.5%
Arrangement for the collection of copying toner	1	1
Waste reduction	70 metric tons	217 metric tons
Waste recycling	20.5%	37.8%
Remedies to deficient management or maintenance	2	ı



being reduced by more than 50% during the year, excluding mud at treatment stations. In addition, 37.8% of the 203 metric tonnes of waste produced were recycled during the year.

Together with the quality programme for retail clients, the PGA will be integrated in the company's quality management system which started in March and will be certified according to NP EN ISO 9001:2000.

### Customer care

The use of modern technology enabled the company to create a closer relationship with its customer base thereby attaining good results in terms of satisfaction. Employees in this area actively participated in the implementation of these new systems the results of which were rapidly appreciated.

### Community

Particular attention was given to preserving EPAL's landmark properties and promoting the public use of

the national monuments entrusted to the company.

The various locations of the Water Museum welcomed 50,255 visitors, hosting 27 painting, two sculpture, three photography and six composite exhibitions. In addition, a large number of meetings and conferences were also held in the museum's premises.

### Resource conservation

As a result of increased awareness of the severe drought conditions experienced in the country in 2005, EPAL sponsored campaigns supporting a more efficient use of water on behalf of Águas de Portugal and the Department for the Environment as well as in-house campaigns.

### Sustainability

To illustrate the company's resolve to contribute to global sustainable development and to highlight its performance, EPAL will publish its first sustainability report in 2006.

# Outlook for 2006

Quality issues will dominate the agenda as the integration of management systems is further improved.

Firstly, updated strategic planning systems will allow the company to better evaluate its operating environment and to identify risks and opportunities in a more efficient manner.

Secondly, the programme for leakage control, which was presented in January by the Monitoring and Control Task Force is scheduled to start obtaining significant achievements in leak reduction in 2006, through a detailed action plan, with the aim to achieve international best practice levels.

Thirdly, greater efforts will be made in to achieve a better level of customer service whilst, at the same time, outlining the company's vision on water management and environment preservation.

In order to sustain profitable operations, new revenue sources and cost-cutting opportunities will be reviewed. This is considered a priority as water sales are expected to stagnate or even decline in the coming years.

The forthcoming challenges and added responsibilities are expected to further motivate an enthusiastic workforce.



# Proposed distribution of net income

In accordance with Article 21 of the company's articles of association, the board of directors proposes that net income for the year of €23,787,526.20 shall be distributed as follows:

■ €2,378,752.62 for the legal reserve;

- €17,840,644.65 for the payment of dividends to shareholders;
- €976,407,00976,407.00 for the employees profit-sharing scheme;;
- €2,591,721.93 for retained earnings.

# Acknowledgements

An expression of gratitude is in order for all those who participated in EPAL's activities during 2005:

- The company staff for their efforts and professionalism.
- The governing bodies, in particular the board members who departed during the year, the chartered accountant, members of the Environmental Impact Board and members of the general assembly committee.
- -The company's suppliers, contractors and service providers for the responsive cooperation provided during the year.

- The sole shareholder, Águas de Portugal SGPS, SA, for the attention and support given to the development of the company.
- Bankers and insurers for their trust.
- The Department for the Environment, Department for the Economy as well as other government bodies as Instituto Regulador da Água e Resíduos, Direcção-Geral da Empresa, Instituto da Água, Comissão de Coordenação e Desenvolvimento Regional de Lisboa e Vale do Tejo.
- EPAL's clients for their aspirations and expectations, trust and relationship with the company.

Best wishes to you all,

João Manuel Lopes Fidalgo Chairman of the Board of Directors

Jorge Luís Ferrão de Mascarenhas Loureiro Board member

> António Bento Franco Board member

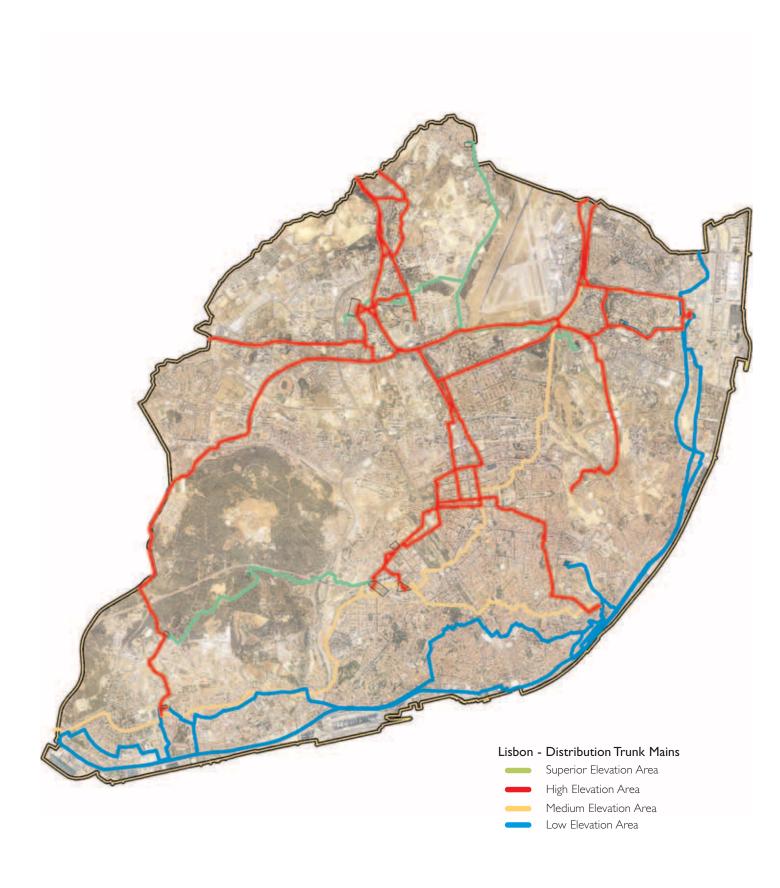
Rui Manuel de Carvalho Godinho

Board member

Appendix I - Bulk Supply Area

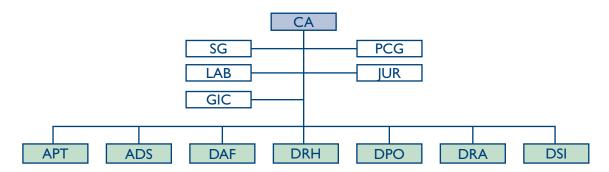


# Appendix II - City of Lisbon Distribution Area



### Apendix III - Organisation chart

The following chart illustrates the current management organisation:



CA - Board of directors

APT - Production and Transportation Business Area

ADS - Distribution Business Area

DAF - Finance and Administration Department

DRH - Human Resources Department

DPO - Project and Construction Department

DRA – Department for Renewal and Expansion of

the Lisbon network

DSI - Information Systems Department

SG - Company Secretary

PCG - Office of Planning and Control

LAB - Central Laboratory

JUR - Legal Department

GIC - Communications and Public Relations

Department

In addition, the Water Museum (Museu da Água) and the Monitoring and Control Task Force report

to the board of directors. The officers on the first reporting level are the following:

Advisor to the board - Nicolau Lopes

APT - Conceição Almeida

ADS – Luís Branco

DAF - Hélder Oliveira

DRH - Ana de Almeida Pile

DPO – Francisco Serranito

DRA – José Figueira

DSI – Luís Reis

SG – José Manuel Zenha

PCG – Anita Ferreira

LAB – Maria João Benoliel

JUR – Luís Durão

GIC – José Manuel Zenha

MDA – Margarida Ruas

GMC - Andrew Donnelly

### Apendix IV - Invoiced water

In 2005, the volume of water invoiced by EPAL was 218,788,583m<sup>3</sup>, 1.83% down on 2004. In amount, the total invoiced was €134,491,057.89.

Out of the 157,756,158m<sup>3</sup> utilised by the bulk segment, 156,490,150m<sup>3</sup> went to municipal and multimunicipal (utility) clients and 1,266,008m<sup>3</sup> to direct clients within the municipality regions. The volume sold through the bulk unit business declined in 2005 by 0.71%, or 1,131,000m<sup>3</sup>, compared to 2004. In amount, invoicing was €66,806,925.89, 1.16% down on 2004.

Water sales to the Distribution area totalled €67,684,132, a 0.7% decrease compared to 2004. The volume sold by this area was 61,032,425m<sup>3</sup>.

# Shares of Bulk and Distribution markets, %



Water sales by municipal/multi-municipal client and category of direct clients are illustrated in the table below:

Client/Client category	<b>Volumes</b> (m <sup>3</sup> )	Amount (EUR)		
Municipalities				
Sintra	33,455.010	14,411.820		
Loures/Odivelas	30,259.025	13,036.210		
Oeiras/Amadora	29,240.299	12,594.892		
Cascais	22,087.250	9,517.875		
Vila Franca de Xira	13,083.864	5,637.486		
Mafra	3,503.090	1,649,320		
Tomar	1,440.820	620,746		
Entroncamento	1,327.100	571,934		
Ourém	1,306.710	564,179		
Torres Novas	1,260.130	543,162		
Alcanena	967,002	299,514		
Porto de Mós	707,470	304,798		
Vila Nova da Barquinha	657,310	283,145		
Constância	395,620	170,450		
Leiria	323,350	139,445		
Santarém	270,748	69,952		
Cartaxo	229,378	84,582		
Batalha	205.760	94.319		
Multi-Municipal utility				
Águas do Oeste	15,770.708	4,973.335		
Direct clients				
Residential	29,92.293	26,284.002		
Trade and Industry	13,713.036	22,525.529		
Public interest bodies	2,283.967	2,616.515		
State bodies	6,807.543	9,241.430		
City of Lisbon	8,306.587	7,016.656		
Other	1,265.514	1,239.761		
Total	218,788.583	134,491.058		

## Glossary

#### Abstraction

The process of taking water from a river, a reservoir or a borehole.

#### Aqueduct

A structure for carrying water across a valley or low ground.

#### Aquifer

Underground water source - water-bearing rock and soil strata.

#### Chlorination

The application of chlorine to water for the purpose of disinfection.

#### Coliform bacteria

A group of bacteria found in the intestine and faeces of most animals. Coliforms can sometimes be found in untreated water. The treatment process removes them and disinfection prevents their reappearance in the distribution system. In water receiving discharges, faecal coliform bacteria are used to indicate the presence of sewage.

#### Communication main

That part of the pipe which conveys water from the main to the customer's house and which is in the road or footpath.

#### Cost of capital

The minimum return that providers of capital (lenders or shareholders) require in order to encourage them to supply capital to a business, given its risks. Estimates of the cost of capital form the basis for the rates of return allowed in price analyses.

#### Depreciation

The accounting measure of the consumption or wearing-out of an asset over its useful life. Depreciation is a key component of price limits.

#### Disinfection

The destruction of pathogens by physical or chemical means.

#### Drought

A prolonged period of dry weather; said to exist if, for at least 15 days, on each day, rainfall has been less than 0.25mm.

#### Groundwater

Water occurring in permeable underground strata, such as chalk and sandstone.

#### Hardness

Characteristic of waters containing dissolved calcium and magnesium salts that makes lathering difficult.

#### Impounding reservoir

The traditional form of upland reservoir produced by damming watercourses.

#### Mains

Pipes carrying treated water.

A device for measuring the quantity and flow rate of water.

#### Service reservoir

Reservoir for storing treated water.

#### Storage reservoir

Reservoir for storing untreated water.

#### Streptococci

Bacterial indicator of faecal contamination of water.

#### Supply/demand balance

The extent to which the demand for water and the water resources available are in balance, taking variability of supply and demand into account.

## Supply pipe

That portion of pipe which conveys water from the main to the customer's house and which is on the customer's property.

## Ultraviolet (UV) treatment

Treatment of drinking water or effluent with UV rays to neutralise bacteria.

## Water treatment

The process of converting raw untreated water to a public water supply safe for human consumption; can involve, variously, screening, initial disinfection, clarification, filtration, pH correction and final disinfection.

#### Water Treatment Works (WTW)

Works which treat raw water to produce potable water for public supply.





# Financial statements

## Balance Sheet at 31 December 2005

			Thousand
	Notes	2005	200
Assets		687,786	675,3
ixed assets		629,571	599,3
Intangibles	10	21	
Land and natural resources	3a), 10	49,248	49,2
Buildings and other construction	3a), 10	29,665	30,3
Equipment	3a), 10, 14	482,800	463,0
Work in progress	3a), 10	62,801	51,1
Equity holdings	3a), 10, 16	275	
Long term securities and placements	3a), 10, 16, 32	109	I
Other	3a), 10	4,652	5,3
Current assets		37,743	56,6
Stocks	3c), 41	1,248	1,1
Debtors	3d), 21, 23, 48, 49	30,363	30,8
Short term investments	3e), 53	3,400	21,0
Banked Cash and in hand	53	2,732	3,6
Accruals and deferrals	3f), 3h), 6, 50	20,472	19,3
Equity shareholders' funds		345,906	343,0
Share capital	36, 37, 40	150,000	150,0
Adjustments on equity holdings	40	(4)	
Revaluation surplus	3j), 39, 40	118,165	101,3
Legal reserves	40	23,213	20,6
Other reserves	40	22,171	22,1
Retained earnings	40	8,573	22,9
Profit Net for the year	40	23,788	26,0
Liabilities		341,880	332,2
Provisions for liabilities	3k), 34	18,729	13,2
Medium and long-term debt	29, 51	175,208	143,6
Creditors		63,149	86,7
Bank loans	29,51	5,397	29,7
Suppliers		42,178	42,1
Government	48	3,443	2,6
Other	52	12,131	12,1
Accruals and deferrals	3f)g)h)i), 6, 50	84,794	88,7

## Income Statement (for the year ended 31 December 2005)

					Thousand e
	Notes		2005	200	14
		'000 EUR	%	'000 EUR	Ç
ales	44	137,385	100.0%	139,555	100.09
Production costs	54	34,538	25.1%	32,457	23.39
GROSS INCOME		102,847	74.9%	107,098	76.7
Other operating income	54	2,732	2.0%	5,559	4.09
Distribution costs	54	29,225	21.3%	29,901	21.49
Administrative costs	54	28,724	20.9%	28,278	20.39
Other operating costs	54	9,185	6.7%	12,568	9.09
OPERATING INCOME		38,445	28.0%	41,910	30.09
Net interest		4,901	3.6%	4,855	3.59
Profit or Loss on affiliated investments	10, 45	27	0.0%	44	0.03
Profit or Loss on other investments	10, 34, 36	257	0.2%	434	0.39
PROFIT BEFORE TAX		33,260	24.2%	36,577	26.2
Income tax	6, 54	9,473	6.9%	10,553	7.69
NET PROFIT FOR THE YEAR		23,787	17.3%	26,024	18.6
ARNINGS PER SHARE		0.79 euros		0.87 euros	
		0.1.7.04.00		0.0. 000	

## Cash Flow statement (for the year ended 31 December 2005)

		Thousand euro
Notes	2005	2004
NET CASH INFLOW FROM OPERATING ACTIVITIES	57,788	48,632
Net cash inflow from operations	92,829	97,023
Receipts from clients	163,113	166,829
Payments to suppliers	(35,612)	(38,181)
Payments to the staff	(34,672)	(31,624)
Net cash outflow for other items	(34,854)	(48,378)
Payment of income tax	(10,578)	(16,039)
Other operating payments	(24,276)	(32,339)
Net cash outflow for non-recurrent items	(187)	(13)
Receipts	169	333
Payments	(356)	(346)
NET CASH OUTFLOW FOR CAPITAL EXPENDITURE		
AND FINANCIAL INVESTMENTS	(59,042)	(42,573)
Receipts	257	514
Financial investments	6	19
Tangible fixed assets	31	149
Interest and similar income	220	346
Payments	(59,299)	(43,087)
Financial investments	(272)	(434)
Tangible fixed assets	(59,027)	(42,653)
NET CASH OUTFLOW FOR FINANCING	(17,239)	(20,333)
New loans raised	103,000	30,000
Loans repaid	(95,775)	(29,077)
Interest and similar costs	(4,946)	(4,908)
Payment of equity dividends	(19,518)	(16,348)
DECREASE IN CASH IN THE YEAR	(18,493)	(14,274)
Cash and cash equivalents at the start of the year	24.625	38,899
Cash and cash equivalents at the end of the year	6,132	24,625
Cash and cash equivalents at the end of the year	5,132	2 1,023

## Notes to the financial statements

#### I. Prices

The pricing structure applicable to the sale of water by EPAL is set by government decree (Decreto-Lei n° 230/91 of 21 June 1991), that provides for agreement to be reached between the company and the state, represented by Direcção Geral da Empresa. The price structure for 2005 is contained in the Agreement signed on 20 June 2005 and effective from 1 July 2005.

## 2. Basis of preparation

The financial statements have been prepared in accordance with the historical cost convention, modified by any subsequent revaluations, assuming the continuity of operations and based on the company's accounting records kept in compliance with Portuguese GAAP.

## 3. Accounting policies

#### a) Tangible fixed assets

Tangible fixed assets are recorded at cost or restated value in accordance to applicable legal rules. Depreciation follows the straight-line method and is based on each item's estimated economic life. Annual depreciation percentages used by the company correspond to the top rates accepted for tax purposes and are the following for the various asset categories:

Asset Category	Depreciation percentage range		
Buildings	2 % - 10 %		
Production equipment	2 % - 25 %		
Transportation equipment	6.2 % - 25 %		
Tools	10 % - 25 %		
Office equipment	10 % - 25 %		
Containers	14.28 %		
Other	6.66 % - 12.5 %		

#### b) Financial investments

Investments in affiliated companies are valued according to the equity method, which means that holdings are initially recorded at cost and annually adjusted to reflect (i) the share of the affiliate's net profit/loss on the company's net profit and (ii) the change in the affiliate's own equity on the company's "Adjustments on equity holdings" item. In addition, dividends received from affiliates are deducted from investment values.

Other investments are recorded at cost, adjusted by any deductions reflecting estimated losses on disposal.

## c) Stocks

Items recorded under 'stock' are valued at average acquisition cost. Whenever market value is lower than the accounting value, adjustments for the difference are recorded.

#### d) Debts

Debts owed to the company are recorded at nominal value, except for debts whose receipt has been deferred for a longer period than one year. In this latter case, the debt is recorded at the discounted value of future cash flows.

Adjustments to debt items are measured through an evaluation of the probability of collecting accounts receivable, taking into account the existence, if any, of collateral.

#### e) Traded securities

Traded securities are valued at the lower of acquisition and market value.

#### f) Matching principle

Income and expense are recorded in accordance with the matching principle, which means that both are recognised as they are generated, irrespective of the time for receipt or payment. Differences between receipts and payments and the generated income and expense are recorded as accruals and deferrals.

#### g) Government grants for investment spending

Government grants received for funding the acquisition or construction of tangible fixed assets are recorded, at the date of the approval of the grant, under "Deferred revenues" (Note 50). As the subsidised item is annually depreciated and in the same proportion, the income related to the grant is recognised in the year's profit and loss.

#### h) Income tax

The company recognises deferred tax arising from temporary differences between accounting and taxable profit, in accordance with IAS 12, translated into Portuguese GAAP by Directriz Contabilística n°28. This means that deferred tax is recognised under accruals and deferrals using the tax rate expected to be in force when the difference is reversed.

Therefore, income tax impacting net profit for the year includes (i) current and (ii) deferred tax.

While current tax is the estimate of tax payable in the year, deferred tax reflects the implications of (1) revenue and cost items for the year with tax effects in other years, (2) tax losses carried forward, (3) changes in tax rates, (4) changes in Portuguese tax law, (5) the reappraisal of deferred tax asset items and (6) any reversal of deferred tax that has been previously recognised in the income statement.

Deferred-tax assets are not recognised unless it can be reasonably expected that they will be absorbed by taxable profits and offset by the reversal of deferred-tax liabilities at the date of reversal.

Deferred tax arising from application of the equity method is not recorded unless the difference is likely to be reversed in the foreseeable future.

The company does not offset deferred-tax liabilities against deferred-tax assets nor does it record temporary differences arising from transactions that did not initially impact either the accounting or tax profit.

#### i) Pension benefits

The company has a benefit scheme for its employees designed to complement state-sponsored retirement pensions, on account of seniority or disablement. In addition, it bears the costs that originate from early retirement. Qualified independent professionals have assessed the obligations incurred under the benefit scheme and the attendant costs have been recognised in compliance with IAS 19.

#### j) Revaluation surplus

Amounts entered into Revaluation surplus correspond to net increases in fixed assets resulting from revaluations in accordance with the legislation in force.

#### k) Provisions

Provisions are made when at balance date there are obligations, either known or probable, that derive from past events and for which (i) it is probable that liquidation will entail the outflow of resources and (ii) it is possible to obtain a reliable estimate of the anticipated outflow.

When the outflow of resources is possible, yet not probable, or a reliable estimate of the outflow is not possible to obtain, the company will not make any provision. However, such obligations are stated in the notes as contingent liabilities.

#### I) Sales

Revenues from the sale of water are recorded in accordance with Portuguese GAAP (Directriz Contabilística n° 26).

At the end of the accounting year, the amount recorded for water sales corresponds to actual consumption in the period as provided by meter readings or, when not possible, through estimated value calculated in a reliable manner.

During the year, revenues from the sale of water are recognised when they are invoiced. At the end of the year, in accordance with the matching principle, consumption that has not been read and invoiced is estimated and recognised as revenue against Accrued revenues (Note 50).

## m) Interest expense

Interest on amounts borrowed to fund the acquisition or construction of fixed assets is recorded as cost in the accounting year during which it is incurred.

#### 4. Income tax

The company is liable to pay state income tax (IRC – Imposto sobre o Rendimento das Pessoas Colectivas) at the rate of 25%, to which local tax of up to 2.5% (10% of state tax or derrama) may be added.

According to Portuguese law, tax authorities may audit filed returns for a period of four years. The company's returns for the years up to and including 2002 have been audited, which leaves the returns from 2003 through 2005 open to audit. EPAL's board of Directors considers that any restatements of these returns that may be imposed by the tax authorities will not have a material impact on the financial statements for the year ended 31 December 2005.

## 5. Number of staff

	2004	2005
Governing bodies	4	4
Permanent staff	803	804
Temporary staff	8	2
Total	815	810
Monthly average	818	843

## 6. Legislation applicable to the revaluation of tangible fixed assets

- Decreto-Lei n.º 430/78 as amended by Decreto-Lei n.º 24/82 of 30 January 1982
- Decreto-Lei n.º 219/82 of 2 June 1982
- Decreto-Lei n.° 399-G/84 of 28 December 1984
- Decreto-Lei n.º 118-B/86 of 27 May 1986
- Decreto-Lei n.º 111/88 of 2 April 1988
- Decreto-Lei n.° 49/91 of 25 January 1991
- Decreto-Lei n.º 264/92 of 24 November 1992
- Decreto-Lei n.° 31/98 of 11 February 1998

## 7. Revaluations

Tangible fixed assets are shown in the table below at historical cost and after revaluation and accumulated depreciation:

	Historical cost a)	Revaluation a) b) (Note 39)	Valuation at 31 Dec/05
Asset Category			
Land and natural resources	12.575.508,18	33.102.725,56	45.678.233,74
Buildings	9.236.620,57	5.867.459,61	15.104.080,18
Production equipment	117.417.948,09	89.706.209,56	207.124.157,65
Other	10.603,23	1.804,91	12.408,14
	139.240.680,07	128.678.199,64	267.918.879,71
a) Net of depreciation b) Encompassing all revaluation	ions over the years		

## 8. Equity holdings

Company	Location	Net Profit	Equity	% held	Nominal value	Adjustments	Net value
Clube de Golf das Amoreiras	Portugal	(26,835.33)	265,024.58	100.0	265,024.58	-	265,024.58
Prolagos	Brazil	(3,412,745.11)	16,551,966.94	7.5	4,789,530.99	4,789,530.9	-
Shore	Portugal			7.5	31,500.01	31,500.01	-
Ambelis	Portugal			1.0	9,975.96	-	9,975.96
TOTAL					5,096,031.54	4,821,031.00	275,000.54

EPAL's own financial statements are consolidated into the accounts of AdP - Águas de Portugal, SGPS, S.A., the sole shareholder.

## 9. Long-term borrowings

At 31 December 2005, debt falling due in more than five years consisted entirely of loans, amounting to €145,344,536.01, from the European Investment Bank (EIB).

## 10. Off-balance sheet obligations

#### a) Retirement benefits

The company's obligations under its retirement benefits plan amounted to €95,475,448.00, up 6.4% on 2004.

EPAL's retirement benefits plan comprises early retirement situations and complements to government retirement pensions.

Obligations arising from the company's pension plan are covered by the assets of Fundo de Pensões EPAL, created in November 1990. Obligations arising from early retirement are covered by a specific provision recognised as an accrued expense in the company's financial statements.

In compliance with IAS 19, EPAL reduced the discount rate used for the calculation of obligations from 5.20% to 4.75% in 2005.

The table below shows the change in the fund's assets:

	2005	2004
Value at the start of the period	36.676.983,00	34.000.254,00
Effective return	2.866.892,27	2.076.729,00
Contribution by Epal	3.559.716,75	2.295.933,80
Paid benefits	(1.719.716,75)	(1.695.933,80)
Value at the end of the period	41.383.875,27	36.676.983,00

The company's provision amounted to €18,484,000 at 31 December 2005 and was recorded under cost accruals.

EPAL's overall retirement benefits position is summarised below:

euros

Item	2005	2004
Obligations	95,475,448.00	89,752,258.00
Fund assets	41,383,875.27	36,676.983.00
Specific provision	18,484,000.00	19,158.000.00
Deferred actuarial losses	35,607,572.73	33,917,275.00
Prior Service Cost *	11,887,000.00	13,443,000.00
Losses under 10% corridor	9,547,544.80	8,975,225.80
Losses in excess of corridor *	14,173.027.93	11,499,049.20

<sup>\*</sup>To be amortised over the future average service time of the active population, according to international accounting standards.

## b) Contracted investments

euros

Item	Contracted amount	Invoiced in 2005	To be invoiced in coming years
Construction	72,875,716.55	43,922,640.29	28,953,076.26
Equipment	21,001,381.25	7,241,753.57	13,759,627.68
Electrical installations	1,278,892.17	793,310.97	485,581.20
Inspection	775,503,23	649,631.41	125,871.82
Land	323,526.66	303,238.06	20,288.60
Studies and projects	1,931,998.72	981,920.32	950,078.40
Various investments	1,903,701.49	1,430,709.34	472,992.15
Quality management	62,344.00	62,344.00	-
Quality guarantee	277,004.11	273,126.11	3,878.00
Telemanagement	704,901.89	616,836.54	88,065.35
Meters	292,322.75	250,181.75	42,141.00
Non-fixed assets	913,693.97	846,783.74	66,910.23
Total	102,340,986.79	57,372,476.10	44,968,510.69

## c) Leasing of vehicles and computer hardware

Financial commitments in respect of leasing contracts for vehicles and computer hardware amounted to  $\in 3,178,324.44$  and  $\in 1,499,567.88$ , respectively.

## 11. Issued guarantees

Beneficiary	2005	2004
European Investment Bank	28,270,431.58	27,857,499.96
Municipalities	12,275,078,84	6,065,338.89
Courts of Justice	6,308,616.98	3,042,903.90
Other	542.56	3,527.25
Total	46,854,669.96	36,969,270.00

#### 12. Provisions

euros

Starting balance	Additions	Reductions	Ending Balance
6,814,428.14	373,131.92	(34,669.23)	7,152,890.83
316,836.17	-	(40,971.15)	275,865.02
6,075,745.78	5,225,000.00	-	11,300,745.78
13,207,010.09	5,598,131.92	(75,640.38)	18,729,501.63
	6,814,428.14 316,836.17 6,075,745.78	6,814,428.14 373,131.92 316,836.17 - 6,075,745.78 5,225,000.00	6,814,428.14 373,131.92 (34,669.23) 316,836.17 - (40,971.15) 6,075,745.78 5,225,000.00 -

The company has conducted a thorough review of commitments, obligations, either probable or contingent, pending lawsuits, unresolved tax differences and claims and other contentious issues. On the basis of this review and upon analysis of the risks involved, the company considers that the amount of €18,729,501.63 reserved at 31 December 2005 is adequate to cover the identified risks.

## 13. Share capital

At 31 December 2005, the company had a share capital of €150 million, fully subscribed and paid up, supported by 30 million shares of 5 euros each.

## 14. Distribution of net profit for the year

According to a resolution approved by the company's AGM on 30 March 2005, the net profit of €26,024,376.30 for the 2004 accounting year was distributed as follows:

	euros
Net Profit retained	5,049,904.31
For legal reserves	2,602,437.63
For retained earnings	<u>2,447,466.68</u>
	<u>5,049,904.31</u>
Net profit distributed	
To shareholders	19,518,282.22
To staff	1,456,189.77
	20,974,471.99
Net profit for 2004	26,024,376.30

## 15. Changes in equity items

Although Portuguese law mandates that a minimum of 5% of net profit for the year should be added to legal reserves until they total at least 20% of the company's share capital, EPAL's Articles of Association require the allocation to reserves to be 10%. Legal reserves may not be distributed unless the company is liquidated but can be used (i) for the absorption of losses when all the other reserves have been used or (ii) for scrip issues.

Changes in equity items were the following in the year:

euros

	Starting balance	Net profit distribution	Additions	Transfers (Note 39)	Adjustments (Note 39)	Ending Balance
Share Capital	150,000,000.00	-	-	-	-	150,000,000,00
Adjustments on equity holdings	(4,063.81)	-	-	-	-	(4,063.81)
Revaluation surplus	101,339,875.63	-	-	(4,605,257.72)	21,430,279.58	118,164,897.49
Legal Reserves	20,611,045.26	2,602,437.63	-	-	-	23,213,482.89
Free reserves	22,171,377.45	-	-	-	-	22,171,377.45
Retained earnings	22,950,492.79	2,447,466.68	-	4,605,257.72	(21,430,279.58)	8,572,937.61
Profit Net for the year	26,024,376.30	(26,024,376.30)	23,787,526.20	-	-	23,787,526,20
SHAREHOLDER'S EQUITY	343,093,103.62	(20,974,471.99)	23,787,526.20	-	-	345,906,157.83

## 16. Remuneration of the governing bodies

euros

	2005	2004
Board of directors	547,628.32	517,564.98
Chartered accountant	17,911.88	17,911.88
Total	565,540.20	535,476.86

## 17. Breakdown of turnover

euros

	2005	2004
Water sales	134,033,956.55	136,463,854.87
Services rendered	3,351,335.61	3,091,780.71
Total	137,385,292.16	139,555,635.58

Turnover was entirely realised in the domestic market and was exclusively related to the supply of water. Services rendered consisted primarily of meter and mains installations for  $\leq$ 2,156,030.49 and supply projects for  $\leq$ 511,694.15.

## 18. Net financial income

	2005	2004
Interest expense	4,760,100.61	4,763,595.58
Losses on equity holdings (Note 10)	26,835.33	44,457.54
Adjustments on financial investments (Note 10)	257,374.22	433,672.51
Unfavourable exchange differences	129.61	51.77
Other financial costs and losses	155,315.69	134,466.48
FINANCIAL COSTS AND LOSSES	5,199,755.46	5,376,243.88
Interest income	200,776.43	348,510.22
Favourable exchange differences	28.22	51.51
Discounts obtained for cash payments	1,849.07	101,545.61
Reversals and other financial income and gains	17,610.46	-
FINANCIAL INCOME AND GAINS	220,264.18	450,107.34
NET FINANCIAL INCOME	(4,979,491.28)	(4,926,136.54)

Interest expenses relate almost exclusively to the EIB loans and commercial paper programme, totalling €4,699,024.71 and €56,991.68, respectively. The Other financial costs and losses item consists of guarantee commissions and other banking services.

Interest income is primarily related to interest on the occasional investment of surplus cash and bank deposits, in the amounts of €99,324.60 and €96,787.74, respectively.

## 19. Net non-recurrent income

euros

2005	2004
3,021,933.48	3,021,933.48
34,669.23	1,945,517.70
223,878.46	656,616.71
3,280,481.17	5,624,067.89
285,640.32	315,484.83
93,418.70	257,408.23
379,059.02	572,893.06
2,901,422.15	5,051,174.83
	3,021,933.48 34,669.23 223,878.46 3,280,481.17 285,640.32 93,418.70 379,059.02

## 20. Accruals and deferrals

On the asset side:

eu	ros
----	-----

	2005	2004
Water and services to be invoiced	9,415,158.58	9,872,260.05
Other	138,073.88	144,145,73
TOTAL ACCRUED REVENUES	9,553,232.46	10,016,405.78
	2005	2004
	2005	2004
Insurance premiums paid	767,599.06	707,260.79
Other	499,185.05	347,733.83
Other	177,100.00	,

## On the liabilities side:

euros

	2005	2004
Retirement benefits to be paid	18,484,000.00	19,158,000.00
Vacation benefits to be paid	3,469,946.97	3,546,246.10
Other	3,067,306.75	2,683,315.98
TOTAL ACCRUED COSTS	25,021,253.72	25,387,562.08
	2005	2004
	2005	2004
Government grants for investment spending	49,201,320.87	52,223,254.35
Other	1,707.18	<u> </u>
	40.202.020.05	52.223.254.35
TOTAL DEFERRED REVENUES	49,203,028.05	32,223,234.33

## 21. Debt to credit institutions

	2005	2004
Maturities over one year	175,208,184.68	143,604,884.50
EIB		29,775,009.68
Maturities up to one year		
EIB	5,396,699.83	4,775,009.68
Commercial paper	-	25,000,000.00
TOTAL OWED	180,604,884.51	173,379,894.18

2005
103,000,000.00
37,000,000.00
66,000,000.00
95,775,009.67
4,775,009.67
91,000,000.00
7,224,990.33

## 22. Income statement

Selected items of the income statement are explained as follows:

## a) Production costs

This item consists of operating costs minus the annual depreciation of the share of investment grants corresponding to the fixed assets allocated to the Production Business Unit.

## b) Distribution costs

This item relates to the operating costs of the Distribution Business Unit.

## c) Administrative costs

This item consists mainly of the operating costs incurred by all support units.

## d) Net interest

This item includes interest on bank loans as well as commissions for the guarantees required for the EIB loans.

## Audit Report

**PriceWaterhouseCoopers** 

To the shareholders of EPAL – Empresa Portuguesa das Águas Livres, S.A.

#### Audit Report

#### Introduction

I. We have examined the financial statements of EPAL – Empresa Portuguesa das Águas Livres, S.A., which consist of (i) the balance sheet at 31 December 2005 evidencing a total of €687,785,942.56, equity of €345,906,157.83 and a net profit of €23,787,526.20), (ii) the income statements and (iii) the cash flow statement for the 2005 accounting year, as well as the appendices.

#### Responsibilities

- 2. The board of directors' responsibility is to prepare such financial statements that will, in a true and appropriate manner, present the financial position of the company, the financial result and cash flows of its operations, as well as adopt adequate accounting principles and maintain an appropriate internal control system.
- 3. Our responsibility is to express an independent and professional opinion, based on our examination of the aforementioned statements.

#### Scope

- 4. Our examination has been conducted in accordance with the Technical Standards and the Auditing Guidelines of the Institute of Chartered Accountants, which require the examination to be planned and executed in such a manner that an acceptable confidence degree can be obtained that the financial statements do not contain materially relevant distortions. To that end, the examination has involved (i) checking, through the use of sampling techniques, the basis for the amounts and disclosures contained in the financial statements and evaluating the estimates used for their preparation, based on judgements and criteria defined by the board of directors, (ii) considering whether the adopted accounting principles and their disclosure are adequate in view of the circumstances, (iii) checking applicability of the continuity principle and (iv) judging on the overall adequacy of the financial statements' presentation.
- 5. Our examination has also encompassed the verification that the financial information contained in the management report is consistent with the financial statements.
- 6. We believe that our examination provides an acceptable basis for our opinion.

## Opinion

In our opinion, the aforementioned financial statements present in a true and appropriate manner, in all materially relevant respects, the financial position of EPAL - Empresa Portuguesa das Águas Livres, S.A. at 31 December 2005 as well as the result of its operations and the cash flows in the 2005 accounting year, in compliance with the generally accepted accounting principles in Portugal.

Lisbon, 10 March 2006

PriceWaterhouseCoopers & Associados, S.R.O.C., Lda. Represented by: José Manuel Oliveira Vitorino, R.O.C.

Condensação e adaptação para inglês SINÓPTICA — Comunicação empresarial, Lda.

EPAL, Empresa Portuguesa das Águas Livres, S.A.

GIC - Gabinete de Imagem e Comunicação

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