

Financial Review

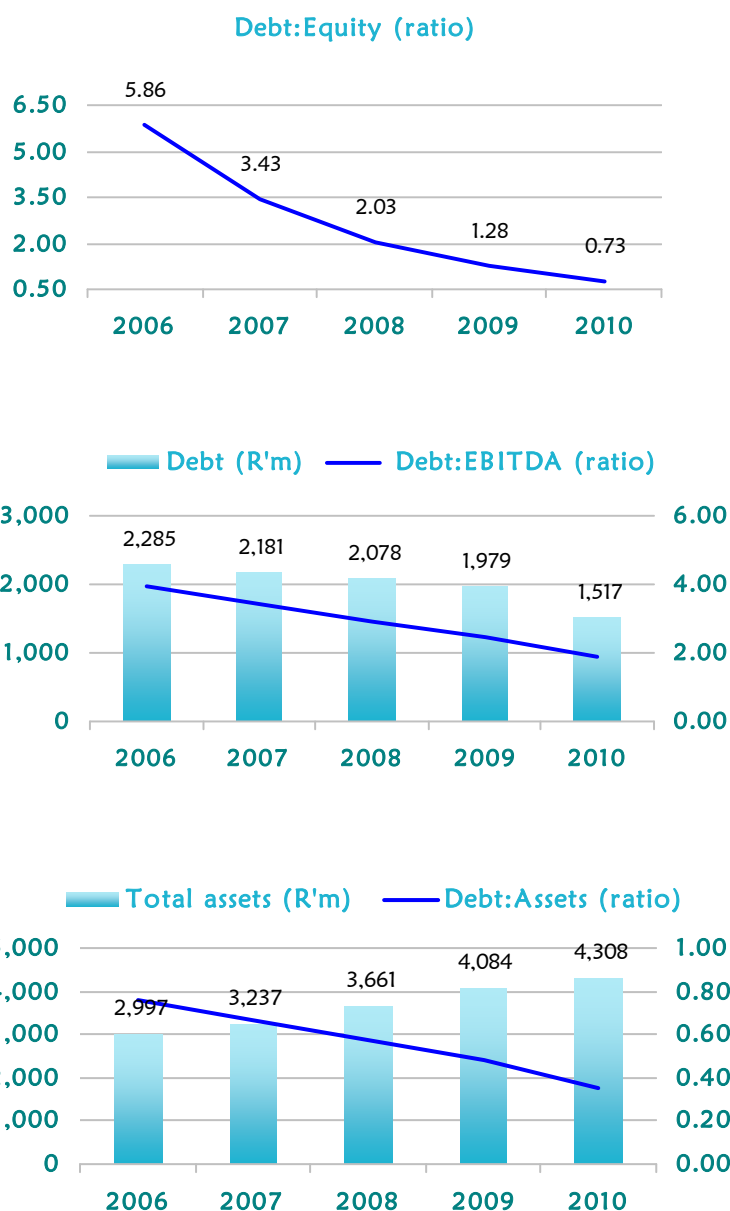
1. Introduction

The financial year under review was characterised by the global financial crisis and the economic downturn in the local economy. At Umgeni Water the focus during this period was to ensure adequate liquidity for the planned capital expenditure programme, while reducing gearing levels and managing the impact of higher costs versus reduced growth in sales volumes.

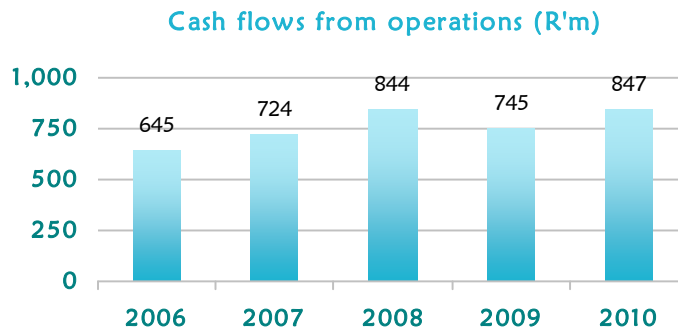
2. Financial performance

Umgeni Water measures its financial performance in terms of its achievement against certain financial indicators which are aligned to the organisation's strategic objectives and are indicated by the graphs that follow.

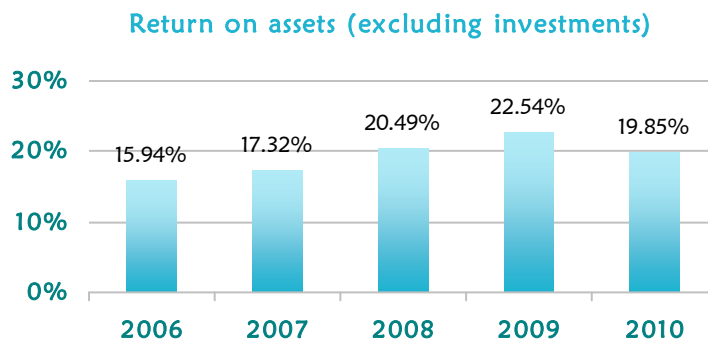
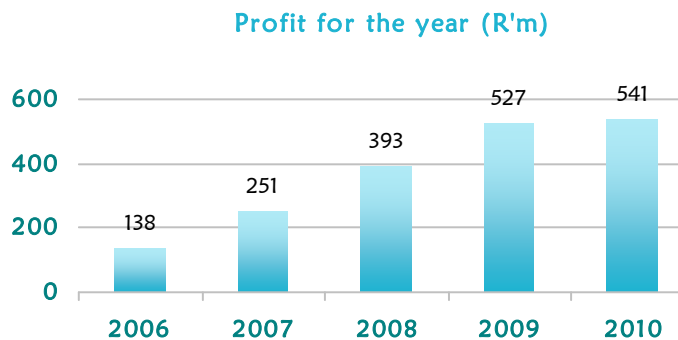
2.1. Lowering of gearing levels



2.2. Strength of operating cash flows



2.3. Positive operating performance



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3. Operating performance

3.1. Key indicators of the group's operating performance

	Group operating performance		
	2010	%	2009
	R'm	change	R'm
Revenue	1,633	9	1,493
Water	1,374	9	1,260
Wastewater	44	5	42
Section 30/Other activities	215	13	191
Cost of sales	(621)	14	(545)
Water	(417)	13	(370)
Wastewater	(27)	4	(26)
Section 30/Other activities	(177)	19	(149)
Gross profit	1,012	7	948
Other income	9	(72)	32
Other operating and administration costs	(403)	19	(338)
Profit from operations	618	(4)	642
Net finance costs	(80)	(31)	(116)
Share of profit from associate	3	200	1
Profit for the year	541	3	527

	Business segment operating profit		
	2010	%	2009
	R'm	change	R'm
Bulk	584	(3)	603
Wastewater	15	7	14
Section 30/Other activities	19	(24)	25
Operating profit	618	(4)	642

3.2. Analysis of year on year changes

The revenue growth in bulk water is due to the 6.5% tariff increase and a 2.4% volume increase. The growth in section 30 activities arises primarily from work undertaken by Umgeni Water as an implementing agent for water infrastructure projects on behalf of the Department of Water Affairs.

The increase in the direct costs of production continues to be driven primarily by above inflation increases in energy, maintenance, and staff costs. As a result the gross profit margins reduced from 64% to 62%.

The reduction in sundry income is mainly attributable to the prior year recovery, from the Department of Water Affairs, of above average dam maintenance costs.

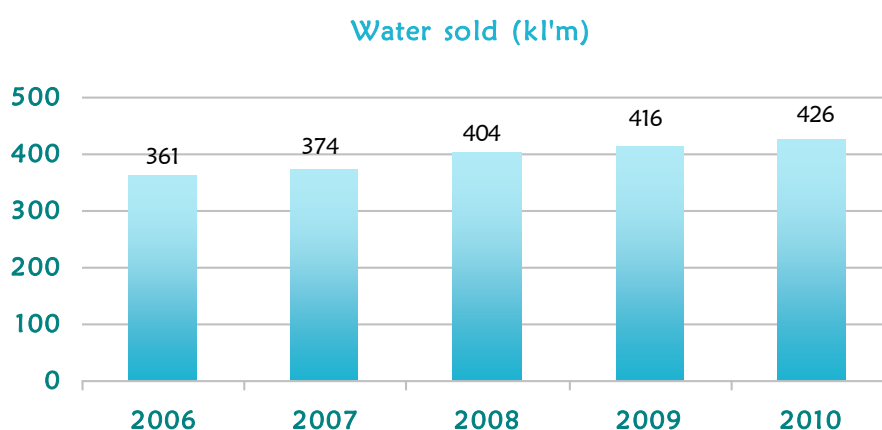
The significant increase in other operating and administration costs is as a result of the inclusion in the prior year of the reversal of a financial impairment and the profit on sale of property amounting to approximately R38m.

The 31% reduction in net finance costs is derived primarily from lower interest paid due to the reduction of debt and the increase in the amount of borrowing costs capitalised to work in progress.

In summary the increase in revenue combined with the reduction in net finance costs has enabled Umgeni Water to absorb the above inflation cost increases and still achieve R541m profit for the year which is 3% higher than the prior year.

3.3. Bulk water volume sales analysis

Total volume growth at 2.4% was negatively impacted on by the water demand management initiatives undertaken by Umgeni Water's major customer eThekweni Metropolitan Municipality which reflected a 0.9% growth in volume sales while the remaining areas achieved a 7.8% increase due to the expansion of services into such areas.



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Volume by customer and % change

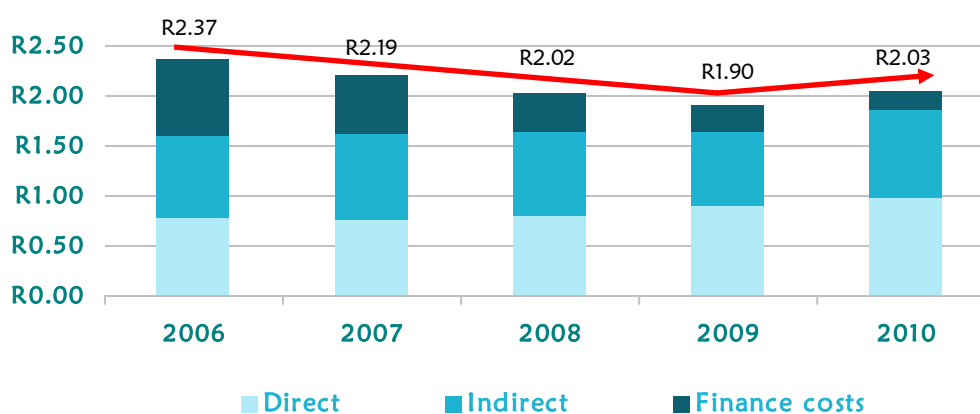
	2006		2007		2008		2009		2010	
	k'l'm	% change	k'l'm	% change	k'l'm	% change	k'l'm	% change	k'l'm	% change
	eThekwini	290	2.3	299	3.1	315	5.4	326	3.5	329
Msunduzi	51	2.9	52	2.0	58	11.5	56	(3.4)	58	3.6
uMgungundlovu	7	7.2	8	14.3	9	12.5	11	22.2	11	-
Siza	3	1.1	3	-	4	33.3	4	-	4	-
Ugu	4	(11.9)	5	25.0	6	20.0	6	-	8	33.3
iLembe	2	8.8	3	50.0	8	166.7	9	12.5	12	33.3
Sisonke	1	10.1	1	-	1	-	1	-	1	-
Other	3	(0.8)	3	-	3	-	3	-	3	-
Total	361	2.5	374	3.6	404	8.0	416	3.0	426	2.4

k'l'm: kilolitres million

3.4. Bulk water cost per kilolitre

The average cost of bulk water increased by 7%, from R1.90 to R2.03 per kilolitre. The main cost drivers are energy, maintenance, impairments and staff costs.

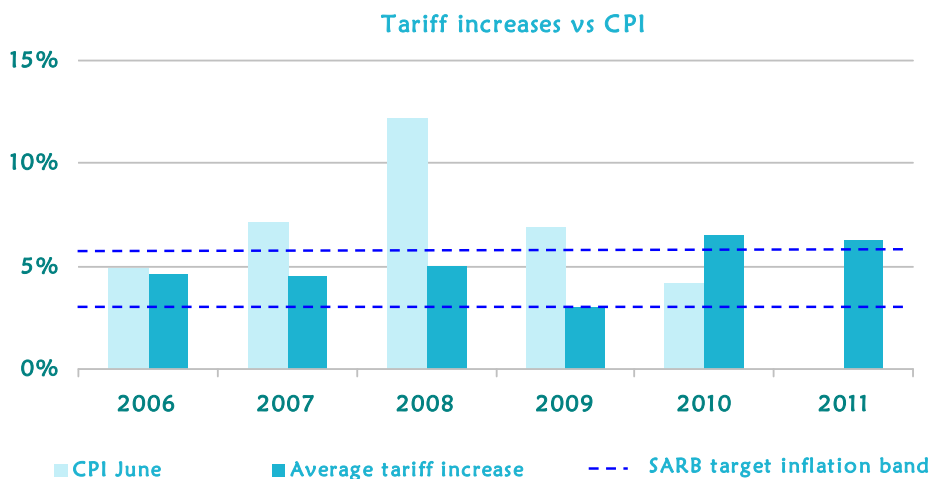
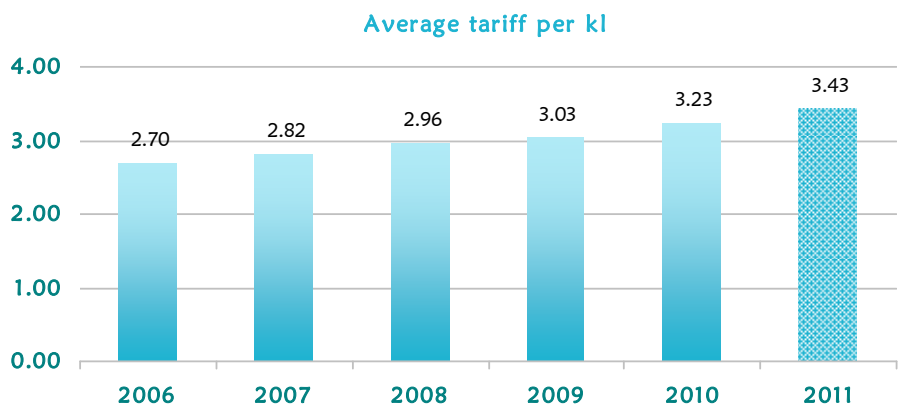
Cost per kl of bulk water



4. Bulk water tariff

Umgeni Water's tariff methodology is cash flow based and assumes tariff increases linked to CPI, thus ensuring that the tariff is constant in real terms while allowing for the repayment of debt and infrastructure funding requirements.

Over the last five years Umgeni Water's tariff increases have been well within the SARB targeted CPI band of 3%-6%. The tariff increase for the next financial year, effective 1 July 2010, has been approved at 6.2%.

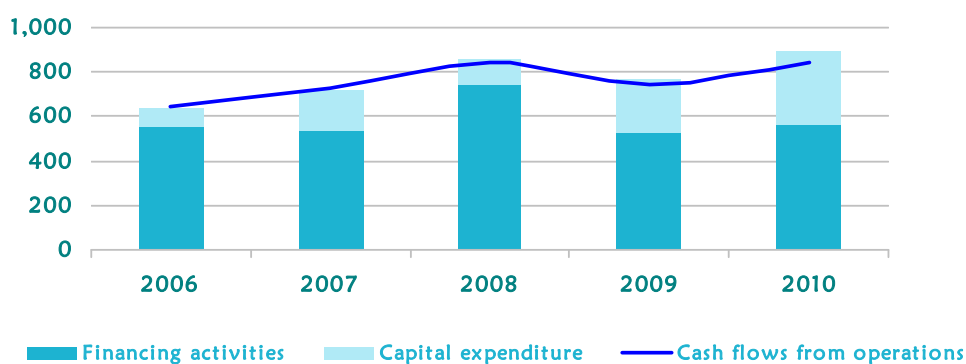


5. Cash flow analysis

In the last five years, Umgeni Water has generated cash in excess of R600m per annum from its operating activities. The cash resources have been used primarily to repay debt and to fund capital expenditure.

During the year under review Umgeni Water realised R847m cash from operations which represents an increase of R102m on the prior year. The increase is mostly attributable to working capital changes. The net cash from operating activities was utilised as follows: R310m in investing activities and R560m in financing activities. Cash used in financing activities consisted of R1,086m debt repayment, R600m from a new bond issue, R41m placed in financial investments and R32m net interest paid.

Utilisation of cash flows from operations (R'm)

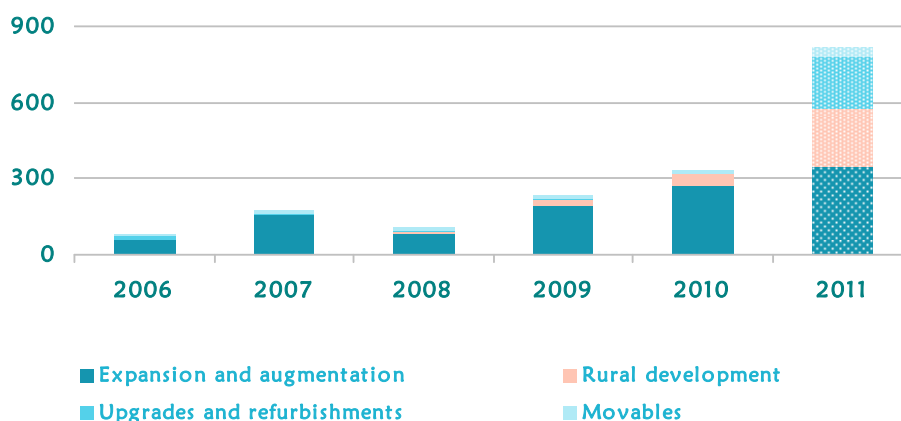


6. Capital projects

The Capital Expenditure Programme for the next five years has been reviewed in terms of the organisation's commitment to the elimination of potable water backlogs and is estimated at R3 billion. The funding requirements are discussed below under Debt Management.

During the year Umgeni Water's capital expenditure totalled R334m (2009: R237m) and work in progress including interest capitalised as at 30 June amounted to R341m (2009: R250m). A total of R244m (2009: R46m) projects were commissioned in the current year. Details of the projects can be found in note 8.2 of the annual financial statements.

Capital expenditure (R'm)



7. Debt management

Debt Management is a key focus area at Umgeni Water and is integral to the delivery of sustainable financial business solutions. The Board approved an optimal target gearing ratio of 0.70 which was achieved in the current year due primarily to the reduction in debt levels as indicated below.

	2010	2009
	R'm	R'm
Long-term debt	1,400	918
Short-term debt	117	1,061
Total Debt	1,517	1,979
Decrease in Funding	(462)	(100)

Umgeni Water strives to maintain an optimal level of 70% fixed to 30% floating interest rate which was successfully met as at 30 June 2010.

The gross weighted average cost of capital decreased to 9.50% (2009: 12.52%) due primarily to the repayment of the UG65 bond which had an effective interest rate of 15.50%.

7.1. Main funding changes

Redemption of the UG65 bond

On 01 June 2010, the UG65 bond was redeemed at its nominal value of R973m. There was sufficient liquidity to meet the repayment amount as a result of the matching assets in the bond redemption portfolio.

New bond issue UG21

The R600m UG21 fixed rate bond was issued in March 2010 under the newly established Domestic Medium Term Note (DMTN) programme. The bond, which pays a coupon of 10.70% semi-annually and has an 11 year maturity, will be used towards the funding of the organisation's capital expenditure requirements.

7.2. Funding requirements

Umgeni Water will continue to fund its requirements in the most cost-effective way while diversifying its sources of funding.

Umgeni Water's funding plans encompass:

- Issuing new bonds for long term funding requirements;
- Using commercial paper for short to medium-term needs;
- Utilising development funding; and
- Bank loans for short to medium-term needs.

Detailed cash flow forecasts have been prepared for the next five years, taking into account the group's R3 billion planned capital expenditure.

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Funding requirements	Short-term		Medium-term		Long-term
	2011	2012	2013	2014	2015
Financial year	R'm	R'm	R'm	R'm	R'm
Operational cash flows	682	658	700	774	821
Capex (escalated)	(816)	(712)	(509)	(497)	(494)
Net operating cash flow (shortfall) after Capex	(134)	(54)	191	277	327
Refinance - capital	(113)	(119)	(121)	(108)	(112)
Refinance - finance costs	(84)	(88)	(88)	(75)	(54)
Annual funding requirements	(331)	(261)	(18)	94	161
Cumulative incremental funding requirement	(331)	(592)	(610)	(516)	(355)

The funding requirements in the short to medium-term will be covered primarily from the existing financial investments and a proposed loan from a Developmental Funding Institution. Details of the various sources of funding available to Umgeni Water can be found in note 28 of the annual financial statements.

7.3. Borrowing limits

The borrowing limits for the period 2009 to 2011 have been approved by National Treasury with the concurrence of the Minister of Water and Environmental Affairs. The borrowing limit is applicable to the value of gross borrowings, collateral and guarantees exposure and may not exceed the approved unconditional limit.

	Unconditional	Conditional	Total borrowing limit
	R'm	R'm	R'm
2009	2,300	500	2,800
2010	2,800	-	2,800
2011	1,800	1,000	2,800

Utilisation of the borrowing limit as at 30 June 2010 was as follows:

	R'm
Actual gross borrowings:	1,517
Collateral and guarantees	1
Borrowing limit:	2,800
Under utilisation:	1,282

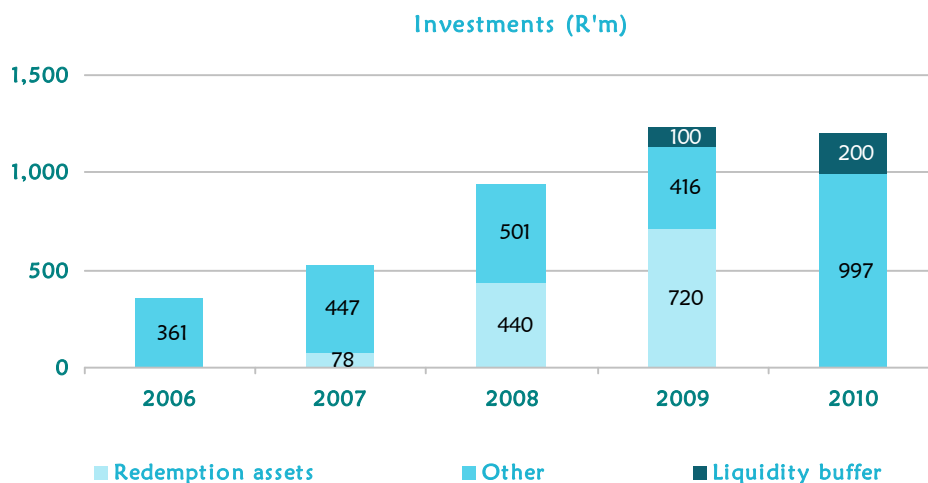
7.4. Credit rating

Umgeni Water's national credit ratings as issued by Fitch Ratings Agency are reflected at AA+ (long-term) and F1+ (short-term).

Umgeni Water's credit rating is underpinned by the strength of its operating cash flows. Risk management strategies in terms of protecting operating cash flows is via anticipating adverse market and business conditions, continuous monitoring and devising strategies to counteract the negative impact thereof.

8. Investments

The total financial investments in the current year reflect a net reduction of R39m to R1,197m. This is mainly attributable to the maturity of the UG65 redemption assets which was partly offset by the investment of the R600m proceeds from the UG21 bond.



9. Retirement benefit obligations

Defined benefit pension plan

The group's retirement benefit plan is in a net under funded position of R51m (2009: R79m) and a net liability of R12m has been reflected in the balance sheet in order to account for this position. Further details are disclosed in the notes to the annual financial statements.

Retirement medical aid

This scheme is currently unfunded and the group has recognised its full past service liability in the balance sheet at the actuarial valuation of R177m (2009: R153m). It is management's intention to transfer this liability off balance sheet and adequate provision has been made in the group's funding requirements for the transfer of the necessary funds.

10. Financial risks

As in most companies, Umgeni Water is faced with financial risks that need to be effectively managed in order to ensure that any negative impact on the group's financial performance and position is minimised.

The major risks and mitigating strategies are analysed in note 28 on financial risk management to the annual financial statements.

11. Accounting policies

The adoption of the new and revised standards and interpretations issued by the International Accounting Standards Board and the International Reporting Interpretations Committee effective for the current year, as noted in the accounting policies, have not led to any significant changes in the group's accounting policies.

12. Future prospects

The focus remains on a financially sustainable organisation through the management of debt within optimal debt levels and the implementation of cost reduction strategies and operational efficiencies to mitigate the impact of projected lower volume growth.