Operating and financial review

ABOUT INTERNATIONAL POWER WE ARE AN INTERNATIONAL WHOLESALE POWER GENERATOR AND DEVELOPER WITH INTERESTS IN 12 COUNTRIES COVERING FOUR CONTINENTS. FOR REPORTING PURPOSES WE ORGANISE OUR BUSINESS INTO FIVE SEGMENTS: NORTH AMERICA, EUROPE, MIDDLE EAST, AUSTRALIA AND REST OF THE WORLD.

Our business

International Power owns, controls or operates more than 16,000 MW of generating capacity worldwide. Formed in October 2000 by the demerger of National Power, International Power is currently listed on the London and New York Stock Exchanges. Since demerger, we have increased our international presence by building new generating assets in the US, Oman and the UAE and through the acquisition of plants in Australia, the UAE and the UK.

We generate electricity from gas, oil, coal and renewable energy sources. We also maximise value through complementary activities. These include mining coal and transporting gas by pipeline in Australia, desalinating water in the Middle East and providing steam for district heating systems in Europe. Some of the power we generate is sold to customers through competitive merchant markets. The remainder is sold to single customers under long-term power purchase agreements.

Environmental care is an integral part of all our operations. New initiatives range from developing our first wind farm in Australia to increasing our capability to burn more environmentally friendly fuels in our UK coal-fired power station.

The corporate social responsibility section (see pages 36 to 42) sets out how we manage environmental impacts and our relationship with the communities in which we operate.

Our strategy

We aim to create value in wholesale power generation through operating our existing asset portfolio efficiently, trading output competitively and growing the business in our core regions of North America, Europe, the Middle East and Australia. We aim to maintain a balanced portfolio of assets in terms of fuel diversity, dispatch type, geographical spread and participation in both merchant markets and long-term contracts.

We have the people, the resources and the determination to deliver for the benefit of all our shareholders and stakeholders.

Our core skills

We operate in a capital-intensive industry where financing expertise optimises the funding structure for all our assets and investments. Growth comes from a mixture of development projects and acquisitions. We have a co-ordinated corporate and regional approach to the sourcing, selection and evaluation of acquisition opportunities. Robust technical, commercial and financial criteria ensure our capital is used wisely.

Long-term success depends on the quality of the development opportunities we secure. We have been particularly successful in the Middle East, where long-term off-take agreements significantly balance risk in developing and building new capital-intensive plant. Our development, construction management and commercial skills are essential for ensuring satisfied customers and sound financial returns.

Our business requires maximum plant availability, particularly at times of peak demand, and our experienced operations and engineering personnel help us deliver at these times of significant value. There is close integration between operations and trading teams in all our core regions to ensure speed and flexibility of response to market conditions. Our fuel procurement teams are responsible for co-ordinating our gas, coal and oil supply with the demands of our power generation profile.

Financial highlights

Profit and loss account

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Excluding exceptional items		
Turnover – gross	**1,273**	1,129
Profit before interest and tax	**285**	388
Interest	**(111)**	(132)
Tax	**(54)**	(77)
Minority interests	**(7)**	(6)
	113	173
Earnings per share	**10.2p**	15.5p
Including exceptional items		
(Loss)/profit before interest and tax	**(57)**	327
(Loss)/earnings per share	**(19.7)p**	10.1p

Balance sheet

	As at 31 December 2003 £m	As at 31 December 2002 £m
Net assets	**1,562**	1,769
Net debt	**692**	812
Gearing	**44%**	46%
Debt capitalisation	**31%**	31%

- Earnings per share (before exceptional items) of 10.2p, in line with guidance
- Profit before interest and tax (before exceptional items) of £285 million (2002: £388 million)
- Operating cash flow of £285 million (2002: £391 million)
- Book value of US merchant plants written down by £404 million to £600 million (as an exceptional item)
- Balance sheet strength maintained – gearing 44%; debt capitalisation 31%
- Interest cover (before exceptional items) of 2.6x (2002: 2.9x)
- US$252 million convertible bond issued; US$450 million three-year revolver signed

Left: Umm Al Nar, UAE

Regional highlights

Segment results – excluding exceptional items

	Year ended 31 December 2003	Year ended 31 December 2002
	£m	£m
Turnover		
North America	**414**	315
Europe	**474**	440
Middle East	**33**	–
Australia	**224**	226
Rest of the World	**128**	148
Gross turnover	**1,273**	1,129
Less: turnover of joint ventures	**(136)**	(122)
Less: turnover of associates	**(285)**	(290)
Group turnover	**852**	717
Profit before interest and tax		
North America	**2**	99
Europe	**103**	100
Middle East	**23**	9
Australia	**101**	101
Rest of the World	**84**	108
Segmental operating profit	**313**	417
Corporate costs	**(28)**	(29)
Operating profit (excluding exceptional items)	**285**	388
Exceptional items	**(342)**	(61)
(Loss)/profit before interest and tax	**(57)**	327

- Added 1,600 MW (net) of new capacity (in operation and under construction) to portfolio
- Acquired 20% ownership of Umm Al Nar power and water desalination plant in Abu Dhabi
- De-mothballed 250 MW unit at Deeside, UK in Q4 2003
- Awarded contract by Saudi Aramco for four cogeneration plants in Saudi Arabia
- Completed 687km SEA Gas pipeline in Australia
- Secured first wind farm project in Australia (46 MW) with 10-year power purchase agreement

The regional performance is discussed in more detail on pages 8 to 12. Corporate costs and exceptional items are discussed on page 13.

Regional performance

North America

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Turnover	**414**	315
PBIT (pre-exceptional items)	**2**	99
Exceptional items	**(404)**	–
PBIT	**(402)**	99

Weak wholesale prices impacted our financial performance in North America during 2003. Gross turnover in North America increased to £414 million from £315 million in 2002, as all plants were operational during 2003. However, 2003 profit before interest and tax decreased to £2 million from £99 million in 2002, due to a combination of low spark spreads and declining compensation payments from Alstom.

In light of recent trading conditions and future price forecasts in the ERCOT (Texas) and NEPOOL (New England) markets, we reviewed the balance sheet book values of the US merchant plants (Hays, Midlothian, Blackstone, Bellingham and Milford). This review resulted in an impairment of these assets by an aggregate amount of £404 million. The revised net book value of these assets totals £600 million.

Given uncertainty in the ability of these merchant assets to meet all future costs including interest payments, our US subsidiary, ANP Funding 1, has proactively approached its US bank group to renegotiate the terms of its non-recourse project finance in order to provide an appropriate long-term financing structure. Discussions with the bank group will examine a wide range of options. As we are also in discussion with the US bank group regarding certain claimed technical events of default, this non-recourse debt is disclosed as current debt in our accounts.

Due to uneconomic prices, we mothballed our modern 1,100 MW combined cycle gas turbine (CCGT) Hays power station in Texas in January 2004, for an indefinite period.

	Fuel / Type	Gross capacity power MW	Net capacity[2] power MW	Gross capacity heat (MWth)	Net capacity[2] heat (MWth)
Assets in operation					
Hartwell, Georgia	Gas (OCGT)	310	155	–	–
Oyster Creek, Texas	Gas (Cogen/CCGT)	425	213	100	50
Hays, Texas[1][3]	Gas (CCGT)	1,100	1,100	–	–
Midlothian I and II, Texas[1]	Gas (CCGT)	1,650	1,650	–	–
Blackstone, Massachusetts[1]	Gas (CCGT)	570	570	–	–
Milford, Massachusetts	Gas (CCGT)	160	160	–	–
Bellingham, Massachusetts[1]	Gas (CCGT)	570	570	–	–
North America total in operation		**4,785**	**4,418**	**100**	**50**

(1) Capacity shown for these assets is the nameplate capacity.
(2) Net capacity is the Group share of gross capacity.
(3) The generation capacity at Hays was mothballed in January 2004.

Left: Blackstone, US

International Power operates within the wholesale generation market, with the skills and resources to play an active role in all phases of the power generation chain.

Europe

	Year ended 31 December 2003	Year ended 31 December 2002
	£m	£m
Turnover	**474**	440
PBIT (pre-exceptional items)	**103**	100
Exceptional items	**7**	(103)
PBIT	**110**	(3)

All our European assets delivered a strong operational performance last year. Turnover increased by 8% to £474 million, principally supported by the performance of the contracted assets in this region. Our long-term contracted assets in Portugal and Turkey delivered excellent financial performance, and coupled with a record profit performance from EOP in the Czech Republic, offset the weak market conditions in the UK and helped the region generate profit before interest and tax of £103 million (2002: £100 million).

Overall profitability in the UK was lower than last year due to the termination of the tolling agreement at Rugeley (with TXU Europe) in November 2002 and weak wholesale prices during much of 2003. Following the termination of the tolling contract, the existing £160 million non-recourse debt facility for Rugeley was renegotiated and reduced to £90 million in August 2003. We continue to discuss appropriate compensation with TXU Europe's administrators, but at present we are unable to forecast the timing of a resolution.

In the UK, in order to provide additional support for our contracted capacity during the winter period, we returned the 250 MW mothballed unit at the Deeside plant to service in October 2003.

Although UK wholesale prices showed some improvement in the second half of 2003, significant increases in gas and coal prices quickly eroded this benefit. Despite these tough market conditions, we see potential opportunities to add value by consolidating our position in the UK and we will continue to review market developments carefully.

In January 2004, the UK government announced draft carbon dioxide emission allocations and commenced industry consultation to finalise the position by the end of September this year. The draft allocations for Rugeley and Deeside were broadly in line with our expectations. Carbon dioxide allocations are an important factor in deciding whether the fitting of flue gas desulphurisation (FGD) at Rugeley is economic. This decision will be made in June 2004 when we decide on our plans for Rugeley under the Large Combustion Plant Directive (LCPD).

EOP and Pego are well placed to meet their requirements under the LCPD. FGD is already fitted at EOP, and plans are underway to build FGD at Pego during 2006.

The Portuguese government has commenced discussions with incumbent generators to make changes to existing long-term Power Purchase Agreements (PPAs). These discussions are targeted to enable the Portuguese market to integrate with the new liberalised Iberian wholesale power market that is due to commence operation in 2006. These discussions are at an early stage and are likely to continue into the second half of 2004. We believe that the government intends to preserve the value in these contracts and therefore we expect to be kept economically whole through this process.

In February 2004, we disposed of our stake in Elcogas, Spain. This investment had been fully provided against, and the release of a guarantee will result in an exceptional gain in Q1 2004.

To reflect our current management structure we now report the results of our Middle East business as a separate region rather than with the European business results, as reported last year.

	Fuel / Type	Gross capacity power MW	Net capacity[1] power MW	Gross capacity heat (MWth)	Net capacity[1] heat (MWth)
Assets in operation					
EOP, Czech Republic[2]	Coal/Gas	585	580	1,945	1,925
Deeside, UK	Gas (CCGT)	500	500	–	–
Rugeley, UK	Coal (50 MW of OCGT)	1,050	1,050	–	–
Tejo Energia (Pego), Portugal	Coal	600	270	–	–
Uni-Mar (Marmara), Turkey	Gas (CCGT)	480	160	–	–
Europe total in operation		**3,215**	**2,560**	**1,945**	**1,925**

(1) Net capacity is the Group share of gross capacity.
(2) Gross capacity amount shown for EOP represents the actual net interest owned directly or indirectly by EOP.

Middle East

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Turnover	**33**	–
PBIT (pre-exceptional items)	**23**	9
Exceptional items	**–**	–
PBIT	**23**	9

Turnover rose to £33 million (2002: £nil) and operating profit increased to £23 million (2002: £9 million) as a result of the acquisition of Umm Al Nar and the commencement of operations at Al Kamil.

In April, together with our partners TEPCO and Mitsui, we acquired a 20% interest in Umm Al Nar, a large power and water desalination plant. The acquisition is backed by a 23-year Power and Water Purchase Agreement (PWPA) with the Abu Dhabi Water and Electricity Company. In July, a US$1.77 billion non-recourse funding package was secured to fund the acquisition and the associated plant expansion project. Since acquisition, the plant has delivered robust financial and operational performance.

In December, together with our partner Saudi Oger, we signed an agreement with Saudi Aramco to develop, own and operate four cogeneration plants in Saudi Arabia. These facilities will have a total capacity of 1,074 MW and be capable of producing 4.5 million lbs/hr of steam. They are expected to commence operation on a phased basis between March and December 2006. On completion the plants will supply power and steam to Saudi Aramco under 20-year Energy Conversion Agreements. International Power owns 60% of the project company, with Saudi Oger holding the remaining 40%.

In February 2004, the financing for the Saudi Aramco cogeneration projects was completed. The financing comprises a non-recourse US$510 million facility that has a 17-year term. International Power's total equity commitment to the projects amounts to US$78 million.

The construction of the Shuweihat S1 power and water plant in Abu Dhabi is progressing and the plant is expected to commence operation in Q4 2004. The first two of five gas turbines and the first of six multi-stage flash desalination units have been successfully commissioned.

	Fuel / Type	Gross capacity power MW	Net capacity[1] power MW	Gross capacity heat (MWth) desal (MIGD) steam (million lbs/hr)	Net capacity[1] heat (MWth) desal (MIGD) steam (million lbs/hr)
Assets in operation					
Al Kamil, Oman	Gas (OCGT)	285	285	–	–
Arabian Power Company (Umm Al Nar), UAE	Gas (CCGT)/desalination	870	174	162 MIGD	32 MIGD
Middle East total in operation		**1,155**	**459**	**162 MIGD**	**32 MIGD**
Assets under construction					
Arabian Power Company (Umm Al Nar expansion), UAE	Gas (CCGT)/desalination	1,550	310	25 MIGD	5 MIGD
Shuweihat S1, UAE	Gas (CCGT)/desalination	1,500	300	100 MIGD	20 MIGD
Saudi Aramco Cogen Projects, Saudia Arabia	Gas (Cogen)	1,074	644	4.5m lbs/hr	2.7m lbs/hr
Middle East total under construction		**4,124**	**1,254**		

(1) *Net capacity is the Group share of gross capacity.*

Australia

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Turnover	**224**	226
PBIT (pre-exceptional items)	**101**	101
Exceptional items	**–**	–
PBIT	**101**	101

Reflecting the strength of our contracted position in Australia, turnover at £224 million (2002: £226 million), and operating profit at £101 million (2002: £101 million) were both flat when compared to 2002, despite relatively lower market prices in 2003. We continue to retain a strong forward contracted position through 2004.

Work is underway to further develop the open cast coal mine at Hazelwood. This project will extend the life of the mine and will provide coal reserves to support generation at Hazelwood until the end of 2009. The Hazelwood turbine upgrade programme is progressing well and is expected to increase the plant's peak capacity from 1,610 MW to 1,740 MW by 2007.

Construction of the 687km SEA Gas pipeline was completed on 1 January 2004 on schedule and on budget. The pipeline will be used to transport gas from the Minerva gas field in Victoria by Q4 2004.

We are pleased to report that we have secured our first wind power project at Canunda in South Australia. Construction of this 46 MW plant is expected to start in Q2 of this year, with a view to commencing commercial operation in Q2 2005. Power from this plant will be sold under a 10-year long-term contract to AGL, Australia's largest energy retailer. With the addition of Canunda, our Australian portfolio is now well balanced with good fuel diversity, ranging from fossil fired (brown coal and efficient gas-fired) through to wind power.

Above: Wind farm, Australia

Assets in operation	**Fuel / Type**	**Gross capacity power MW**	**Net capacity[1] power MW**
Hazelwood, Victoria	Coal	1,610	1,480
Synergen, South Australia	Various (OCGT)	360	360
Pelican Point, South Australia	Gas (CCGT)	485	485
SEA Gas pipeline, South Australia[2]		n/a	n/a
Australia total in operation		**2,455**	**2,325**

(1) Net capacity is the Group share of gross capacity.
(2) 687km gas pipeline from Victoria to South Australia.

With interests in over 30 power stations around the world, we own one of the most geographically diverse asset portfolios, generating enough power to light up 20 million homes.

Rest of the World

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Turnover	**128**	148
PBIT (pre-exceptional items)	**84**	108
Exceptional items	**55**	42
PBIT	**139**	150

Our plants in the Rest of the World have delivered steady performance over the past year, with turnover of £128 million (2002: £148 million) and profit before interest and tax at £84 million (2002: £108 million).

Both of our investments in Pakistan (HUBCO and KAPCO) continue to perform well. We have sold a 5% shareholding in HUBCO in line with our policy of selectively monetising investments at the appropriate time generating cash of £21 million. Our equity interest in HUBCO now totals 20.7%. We have booked an exceptional gains of £52 million, reflecting the profit on this sale and the reversal of a previous impairment provision.

Malakoff made two acquisitions in Malaysia in 2003. It acquired 100% of Prai Power, a 350 MW CCGT plant and 90% of the equity interest in Tanjung Bin, a 2,100 MW coal-fired plant. Both acquisitions are backed by long-term PPAs with Tenaga Nasional Berhad, Malaysia's leading utility.

Our 110 MW plant in Thailand sells the majority of its power under a long-term contract to the Electricity Generating Authority of Thailand with the remainder of its output being sold to local industrial customers. In 2003, the plant benefited from increased retail sales to its industrial customers due to the acceleration of economic growth in Thailand, which looks set to continue.

In 2003 we concluded our divestments in China, realising an exceptional gain of £3 million.

	Fuel / Type	Gross capacity power MW	Net capacity(1) power MW	Gross capacity heat (MWth)	Net capacity(1) heat (MWth)
Assets in operation					
Malakoff, Malaysia(2)	Gas (OC/CCGT)	1,895	355	–	–
Thai National Power (Pluak Daeng), Thailand	Gas (Cogen)	110	110	20	20
HUBCO, Pakistan	Oil	1,290	270	–	–
KAPCO, Pakistan	Gas/Oil (CCGT)	1,600	575	–	–
Rest of the World total in operation		**4,895**	**1,310**	**20**	**20**
Assets under construction					
Malakoff, Malaysia(2)	Coal	1,890	355		
Rest of the World under construction		**1,890**	**355**		

(1) Net capacity is the Group share of gross capacity.
(2) Gross capacity amount shown for Malakoff represents the actual net interest owned directly or indirectly by Malakoff.

Above: Lumut power plant, Malakoff, Malaysia

Outlook

Our clear immediate priority is the successful restructuring of the US business and we are focused on finding a solution that provides value for our shareholders. Alongside our drive to deliver value from our existing asset base, we continue to review a range of growth opportunities in our core markets.

Our earnings per share guidance for 2004 remains 7p to 9p.

Corporate

Corporate costs

The Group operates from corporate offices in London and Swindon, where corporate and business functions are based to support our worldwide operations. Continued cost control resulted in the cost of providing these services being reduced to £28 million (2002: £29 million).

In addition, the Group operates regional business support offices in the US, Australia, the Czech Republic, Italy, Japan and the UAE.

These offices vary in size dependent on the scale of operations in the region, and apart from the US and Australia, are primarily focused on business development.

Exceptional items

During the year, the Group recorded two operating exceptional items:

- impairment of US plant by £404 million;
- reversal of past impairment of our HUBCO investment by £35 million.

The carrying values of our US plant were reviewed following the sharp decline in both current and forward electricity prices in the ERCOT and NEPOOL markets in the US. This resulted in impairment of our US merchant plants (Hays, Midlothian, Blackstone, Bellingham and Milford).

The revised US book values were determined by applying a risk adjusted discount rate of 9.7% to the post-tax cash flows expected from the plants over their remaining useful lives.

Additionally during the year, the Group recorded the following three non-operating exceptional items:

- profit on disposal of a 5% holding in HUBCO of £17 million;
- profit on disposal of a Czech fixed asset investment of £7 million;
- proceeds and a gain relating to China exit of £3 million.

Net interest

Net interest payable for the year ended 31 December 2003 was £111 million (excluding exceptional items). Corporate and subsidiary operations accounted for interest payable of £79 million comprising gross interest of £123 million on bonds, bank loans and overdrafts offset by £23 million interest receivable, foreign exchange gains of £19 million and by capitalised interest of £2 million. Associates and joint ventures incurred net interest payable of £32 million. Consolidated interest cover was 2.6 times (excluding exceptional items).

Additionally during 2003, the Group recorded an exceptional interest charge of £16 million in relation to the write-off of unamortised facility costs in the US and the UK.

Tax

The tax charge for the year (pre-exceptional items) amounted to £54 million compared to £77 million in the previous year. The tax charge represents an effective tax rate of 31%, compared to 30% in the prior period.

Additionally during 2003, the Group recorded an exceptional tax credit of £26 million relating to a net write back of deferred tax following the impairment of the US plant.

Above: Pego, Tejo Energia Portugal

We are actively seeking viable renewable energy opportunities for future development.

Financial position and resources

Liquidity

A summarised, reclassified presentation of the Group cash flow is set out below:

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Operating (loss)/profit	**(279)**	105
Impairment of plant	**404**	103
	125	208
Depreciation and amortisation	**109**	112
Dividends from joint ventures and associates	**68**	84
Dividends received from fixed asset investments – ordinary	**33**	31
Movement in working capital and provisions	**(50)**	(44)
Operating cash flow	**285**	391
Capital expenditure – maintenance	**(64)**	(48)
Tax and interest paid	**(96)**	(108)
Exceptional items:		
Dividends received from fixed asset investments	**–**	42
Refinancing charges	**(4)**	(25)
Free cash flow	**121**	252
Capital expenditure – growth	**(57)**	(98)
Capital expenditure – other financial investment	**(9)**	–
Compensation for long-term performance shortfalls	**56**	–
Acquisitions and disposals (2003 - exceptional)	**35**	(144)
Share buyback	**(13)**	–
Foreign exchange, hedging and other	**(13)**	75
Decrease in net debt	**120**	85
Opening net debt	**(812)**	(897)
Closing net debt	**(692)**	(812)

Operating cash flow for the year ended 31 December 2003 decreased by 27% to £285 million as compared to £391 million for the year ended 31 December 2002. The principal reasons include lower operating profit performance from the US and the UK and a reduction in dividend receipts from joint ventures and associates. Capital expenditure to maintain the operating capacity of our power stations has increased compared with the previous year, reflecting the completion of our new build capacity in Massachusetts and Texas in 2002. Capital expenditure to increase our operating capacity amounted to £57 million as compared to £98 million in the previous year, reflecting spend on the build of our US and Al Kamil plants. During the year ended 31 December 2003, the Group received £56 million from contractors in relation to compensation for plants not achieving the long-term performance levels specified in the original contracts.

Net interest of £79 million (2002: £88 million) was paid in the year reflecting a small reduction in average debt levels over the course of the year, together with a slightly lower average cost of debt. Additionally, debt issue costs totalling £3 million are also included within the interest line. Net tax payments in the year were £14 million (2002: £20 million). Acquisitions and disposals principally comprise of cash receipts from the sale of a 5% holding in HUBCO and from the sale of our investment in VCE (Czech Republic).

Balance sheet

A summarised, re-classified presentation of the Group balance sheet is set out below:

	Year ended 31 December 2003 £m	Year ended 31 December 2002 £m
Fixed assets		
Intangibles and tangibles	**2,049**	2,474
Investments	**538**	507
Total fixed assets	**2,587**	2,981
Net current liabilities (excluding short-term debt)	**(90)**	(138)
Provisions and creditors due after more than one year	**(243)**	(262)
Net debt	**(692)**	(812)
Net assets	**1,562**	1,769
Gearing	**44%**	46%
Debt capitalisation	**31%**	31%

Net assets at 31 December 2003 decreased by £207 million to £1,562 million, as compared with £1,769 million at the end of the previous year. The significant impacts on net assets in the year were a reduction in fixed assets of £404 million following the US impairment, an increase of £35 million in investments following the reversal of the HUBCO impairment and a reduction in tax creditors of £27 million following a net deferred tax write back following the US impairment.

Net debt at 31 December 2003 of £692 million is down from £812 million at 31 December 2002. This reflects the strong operating cash flow of the business and the positive impact of translation of net debt balances denominated in foreign currencies, offset by the write-off of unamortised facility fees in the US. Net debt at 31 December 2003 is shown net of facility fees of £15 million, which have been capitalised and offset against the debt in accordance with accounting standard FRS 4.

In addition, net assets were also impacted by a net gain of £15 million arising on the retranslation of our net investment in foreign entities offset by a reduction of £13 million as a result of the share buyback programme.

Net debt and capital structure

Group net debt at 31 December comprised:

	2003 £m	2002 £m
Cash and liquid resources	**743**	842
Euro dollar bonds	–	(37)
Convertible bond	**(200)**	(231)
Loans (non-recourse)	**(1,235)**	(1,386)
	(692)	(812)

The above net debt of £692 million excludes the Group's share of joint ventures' and associates' net debt of £712 million (2002: £503 million). These obligations are generally secured by the assets of the respective joint venture or associate borrower and are not guaranteed by International Power plc or any other Group company. In view of the significance of this amount, it has been disclosed separately.

The Group has sufficient credit facilities in place to fund and support adequately its existing operations and to finance the purchase of new assets. These facilities comprise a revolving credit facility for US$450 million (expiry October 2006), the portion of the existing convertible bond for US$103 million not 'put' by bond holders (maturing November 2005), and a new convertible bond for US$252 million (maturing August 2023 but with bondholders having the right to 'put' the bond back to the Group in August 2010, 2013, 2018 and 2023). In addition, the Group has uncommitted bilateral credit lines from various banks at its disposal at the corporate level.

Secured non-recourse finance

The Group's financial strategy is to finance its assets by means of limited or non-recourse project financings at the asset or intermediate holding company level, wherever that is practical. As part of this strategy, we refinanced EOP in the Czech Republic, increasing the facility to Czk 3,000 million and extending the maturity to 2007.

The non-recourse debt at Rugeley of £160 million, which was in technical default at the beginning of the year, was successfully renegotiated in August 2003 and the debt maturity reinstated to 2008 for a reduced amount of £90 million. In May 2003 at American National Power (ANP), our US bank group waived all claimed technical defaults on our US non-recourse financing and therefore this debt was redesignated to its original maturity at 30 June 2003. However, in the fourth quarter our US banks claimed further technical defaults on this financing. Therefore as these issues were not formally resolved at 31 December 2003, the debt at ANP has been reported as current non-recourse debt in our accounts.

In line with all non-recourse finance, any support to the ANP facility would be entirely discretionary, and would not have a material impact on the Group's liquidity or investment capability.

During 2003 both Standard & Poors and Moody's reviewed the credit rating of our wholly owned subsidiary ANP and this resulted in a downgrade to below investment grade. This in itself is not an act of default on the ANP facility, although it does increase the interest margin of the outstanding debt.

Corporate and Group debt

Apart from the ANP facility, which is reclassified as current, there are no major debt maturities at Corporate or Group level in 2004. Significant new capital expenditure on growth projects will be financed from existing cash resources, drawing down on bank lines or issuing new fixed rate debt, depending on market conditions at the time.

On 31 December 2003, we had aggregated debt financing of £1,435 million denominated principally in US dollars, Australian dollars, sterling, Czech koruna and Thai baht. Of this amount £531 million is due for repayment in 2004, with the majority of the remaining balance due after 2008. This short-term debt includes the ANP facility already discussed in this section.

Left: Blackstone, US

Treasury and counterparty risk policy

Treasury policy seeks to ensure that adequate financial resources are available for the development of the Group's business whilst managing its currency, interest rate and counterparty credit risks. The Group's treasury policy is not to engage in speculative transactions. Group treasury acts within clearly defined guidelines that are approved by the Board. The major areas of treasury activity are set out below.

Currency translation exposure

In common with other international companies, the results of the Group's foreign operations are translated into sterling at the average exchange rates for the period concerned. The balance sheets of foreign operations are translated into sterling at the closing exchange rates. This translation has no impact on the cash flow of the Group. In order to hedge the net assets of foreign operations, borrowings are generally in the same currency as the underlying investment. The Group aims to hedge a reasonable proportion of its non-sterling assets in this way.

It is our policy not to hedge currency translation through foreign exchange contracts or currency swaps.

Average and year end sterling rates for major currencies which are significant to the Group were:

	Average		At 31 December	
	2003	2002	**2003**	2002
US dollar	**1.64**	1.50	**1.79**	1.61
Australian dollar	**2.53**	2.78	**2.38**	2.86
Czech koruna	**46.20**	49.16	**45.97**	48.42

Currency transaction exposure

This arises where a business unit makes actual sales and purchases in a currency other than its functional currency. Transaction exposure also arises on the remittance from overseas of dividends or surplus funds. The Group's policy is to match transaction exposure where possible, and hedge remaining transactions as soon as they are committed, by using foreign currency contracts and similar instruments.

Short-term deposits

Surplus funds are placed for short periods in investments that carry low credit risk and are readily realisable in major currencies.

Interest rate risk

The Group's policy is to fix interest rates for a significant portion of the debt (82% as at 31 December 2003) using forward rate or interest rate swap agreements. Significant interest rate management programmes and instruments require specific approval of the Board. The weighted average interest of the fixed rate debt was 7%. Where project finance is utilised, our policy is to align the maturity of the debt with the contractual terms of the customer off-take agreement.

Counterparty credit risk

The Group's policy is to manage its credit exposure to trading and financial counterparties within clearly defined limits. Energy trading activities are strictly monitored and controlled through delegated authorities and procedures, which include specific criteria for the management of counterparty credit exposures in each of our key regions. Counterparty exposure via customer off-take agreements is monitored and managed by the local asset team with assistance from Group treasury where appropriate. In addition, Group treasury manages the Group-wide counterparty credit exposure on a consolidated basis, with the active and close involvement of the Global Risk Manager. Financial counterparty credit exposure is limited to relationship banks and commercial paper with companies which have strong investment grade credit ratings.

Our focus on fiscal discipline together with our solid financial position is a key strength.

Critical accounting policies and estimates

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the UK. As such, we are required to make certain estimates, judgements and assumptions that we believe are reasonable based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements; the reported amounts of revenues and expenses during the periods presented and the related disclosure of contingent assets and liabilities.

On an ongoing basis, we evaluate our estimates using historical experience, consultation with experts and other methods considered reasonable in the particular circumstances to ensure full compliance with UK GAAP and best practice. Actual results may differ significantly from our estimates, the effect of which is recognised in the period in which the facts that give rise to the revision become known.

Our Group accounting policies are detailed on pages 67 and 68. The table below identifies the areas where significant judgements are required, normally due to the uncertainties involved in the application of certain accounting policies.

Of the accounting policies identified in the table a discussion follows on the policies we believe to be the most critical in considering the impact of estimates and judgements on the Group's financial position and results of operations.

Fixed asset valuation

Tangible fixed assets

The original cost of greenfield-developed assets includes relevant borrowing and development costs:

- Interest on borrowings relating to major capital projects with long periods of development is capitalised during construction and written-off as part of the total cost over the useful life of the asset.
- Project development costs (including appropriate direct internal costs) are capitalised from the point that it is virtually certain that the project will proceed to completion.

Accounting policy	Judgements/uncertainties affecting application
Fixed asset valuation	Determination of trigger events indicating impairment and measurement of fair value using projected cash flows, together with risk adjusted discount rates, or other more appropriate methods of valuation.
Consolidation policy – trade investments, associates, joint ventures and subsidiaries	Determination of the extent of influence the Group has over the operations and strategic direction of entities in which it holds an equity stake.
Liquidated damages	Determination of the appropriate accounting treatment of receipts from contractors.
Exceptional items	Determination of the transactions or events which require separate disclosure as exceptional items.
Tax provisions	Determination of appropriate provisions for taxation, taking into account anticipated decisions of tax authorities. Assessment of the ability to utilise tax benefits through future earnings.

Depreciation of plants is charged so as to write down the assets to their residual value over their estimated useful lives.

- Gas turbines and related equipment are depreciated over 30 years to a 10% residual value, unless the circumstances of the project or life of specific components indicate a shorter period or a lower residual value.
- Coal plant is considered on an individual basis.

Tangible fixed assets and fixed asset investments

Management regularly considers whether there are any indications of impairment to carry values of fixed assets or investments (e.g. the impact of current adverse market conditions). Impairment reviews are generally based on risk adjusted discounted cash flow projections that inevitably require estimates of discount rates and future market prices over the remaining lives of the assets.

Consolidation policy – significant influence

The determination of the level of influence the Group has over a business is often a mix of contractually defined and subjective factors that can be critical to the appropriate accounting treatment of entities in the consolidated accounts.

We achieve influence through Board representation and by obtaining rights of veto over significant actions. We generally treat investments where the Group holds less than 20% of the equity as trade investments. Trade investments are carried in the balance sheet at cost less amounts written off. Income is recorded as earned only on the receipt of dividends from the investment.

Above: Hazelwood, Australia

Above: Deeside, UK

The continuing global trends of deregulation and privatisation offer us multiple opportunities to grow.

Where the Group owns between 20% and 50% of the equity and has significant influence over the entity's operating and financial policies, we generally treat the entity as an associated undertaking or joint venture. Equally, where the Group holds a substantial interest (but less than 20%) in an entity and is able to exert significant influence over its operations, we treat it as an associated undertaking or joint venture. Conversely, although we generally treat a holding of more than 20% of the equity as an associated undertaking or joint venture, where the Group is unable to exert significant influence over the operations of the entity, we treat it as a trade investment.

Associated undertakings and joint ventures are accounted for using the equity method of accounting, which involves including the Group's share of operating profit, interest and tax on the respective lines of the profit and loss account, and the Group's share of net assets within the fixed asset investments caption in the balance sheet. In addition, we provide voluntary disclosure of the amount of net debt held by these entities, although in accordance with UK GAAP, this net debt is not included in the consolidated balance sheet.

The Group generally consolidates entities in which it holds in excess of 50% of the equity and where it exerts control over the strategic direction of the entity. However, if the Group were to hold in excess of 50% of the equity but was unable to exert dominant influence over the strategic direction or operations of the entity, we would account for the entity as an associated undertaking or joint venture.

Liquidated damages

The Group receives amounts from contractors in respect of the late commissioning and under performance of new power plants. The receipts that relate to compensation for lost revenue are treated as revenue when the compensation is due and payable by the contractor. Those receipts that relate to compensation for plants not achieving long-term performance levels specified in the original contracts are recorded as a reduction in the cost of the assets.

Below: Al Kamil, Oman

We continue to be very active in reviewing growth opportunities, both in our existing merchant markets and in markets that provide long-term contracts.

Exceptional items

An item is considered exceptional if it derives from ordinary activities and is considered of such significance that separate disclosure is needed if the financial statements are to give a true and fair view. All exceptional items, other than those listed below are included under the statutory line-item to which they relate. In addition, separate disclosure on the face of the profit and loss account is required for the following items:

- profits or losses on the sale or termination of an operation;
- costs of a fundamental re-organisation or restructuring having a material effect on the nature and focus of the Company's operations;
- profits or losses on the disposal of fixed assets.

Determining which transactions are to be considered exceptional in nature is often a subjective matter.

Preparing for the conversion to International Financial Reporting Standards (IFRS)

For reporting periods beginning on or after 1 January 2005, the consolidated accounts of the Group must comply with IFRS.

The Group has developed a conversion plan to assess the potential impact of IFRS and to determine a clear path forward that is cost effective, minimises disruption to the business and ensures ongoing communication of the impact of IFRS on our performance targets. We have reviewed and assessed the impact of accounting literature expected to be effective on the date of transition to IFRS and will continue to monitor and assess the impact of any further pronouncements issued by the International Accounting Standards Board (IASB).

The principal areas expected to be impacted by the transition to IFRS are as follows:

- presentation of primary financial statements;
- recognition of derivatives and financial instruments;
- accounting for goodwill on acquisitions;
- accounting for employee benefits (pensions and share-based payments);
- accounting for joint ventures, associates and trade investments.

Above: HUBCO, Pakistan