Chief Executive Officer's statement

Dear Shareholder,

2006 was a strong year, with very good operational and financial performance reflected in a significant increase in our share price. The key commercial drivers were the continued recovery of the US and UK merchant markets, together with contributions from selected acquisitions and greenfield growth projects. However, none of this would have been possible without the continued enthusiasm, commitment and drive from our dedicated teams of professionals across the entire Group, and I thank every individual for this.

This performance needs to be viewed in the wider context of our industry. Power generation, and the energy sector as a whole, is right at the centre of a number of key international debates, including security of supply, high and volatile fuel prices, the environmental impact of emissions, and carbon dioxide in particular, technology advances, and government energy policies. It is critically important that we actively keep all these key themes under continual review to ensure we understand their impact and therefore best position International Power in all of the markets in which we operate.

Clear strategy to create value

Our results are based on a clear strategy to create value from power generation and very closely related activities, such as desalination and district heating. A key strength comes from our international portfolio approach, which provides a breadth of geography, market structure, fuel, and technology. This portfolio approach not only provides excellent risk mitigation, but also outstanding access to growth opportunities across all of our markets. Growth continues to be an important part of our business model, and our combination of in-depth regional market knowledge with a rigorous capital allocation process is designed to ensure only the best projects are selected. We will continue to focus on both carefully researched liberalised merchant markets, where we take full price risk for the power that we generate, and regulated markets where we have long-term offtake arrangements for our power with contractually agreed pricing.

Our overarching criterion, irrespective of the market structure in which we operate, is that our investments make money for our shareholders over the long-term. To deliver strong performance over the long-term, we must have strong values that all International Power employees ascribe to and live by. It is our values and behaviour that drive our performance, and it is worth a short reminder of our five core values, listed below.

These values, running through the heart of our core competencies – greenfield development, acquisitions, financing, asset and project management, trading, and plant operations – will continue to be our foundation.

A successful year – strong operational and financial performance

In terms of performance in 2006, it was a very good year across the portfolio with all regions contributing well, but with especially strong performances in the UK and in the US. Environmental upgrades and initiatives are a common theme across our portfolio, and you will see reference to a number of these in this review.

North America In the US, our two key merchant markets of Texas and New England continued their recovery. Oversupply continues to be reduced through consistent demand growth, enabling our plants in both Texas and New England to run at higher load factors and at higher margins than in 2005. In July 2006, we acquired Coleto Creek, a 632 MW coal fired plant in Texas, and this asset has been quickly and successfully integrated into our US portfolio. Coleto Creek provides good fuel diversity, and its access to low cost, low sulphur Powder River Basin coal from Wyoming represents a long-term cost advantage. We are now investing to improve the environmental performance of Coleto Creek by upgrading its dust emission control equipment. Coleto Creek also comes with expansion potential at site, and we are keeping this growth opportunity under close review. In New England, December 2006 saw the introduction of an enhanced Forward Capacity Market – this is a very welcome development, as it rewards capacity for being available.

Europe In Europe, the main driver for the increase in profits was the UK. As in the US, the reserve margin – the difference between installed capacity and peak demand – continues to reduce. This, when coupled with a high oil and gas price that generally sets the price of power in the UK, resulted in a much improved year for Rugeley, our 1,050 MW coal fired plant. We are investing some £145 million in environmental improvements at Rugeley to reduce sulphur and other emissions, providing this plant with a long-term role within UK generation. Price volatility, and the continual need for power at very short notice to ensure security of supply, combined to make 2006 a very good year for First Hydro, the largest fast-response pumped storage peaking unit in

Our core values:

- **Financial discipline** – we assess opportunities and risks carefully, we won't overpay for assets, and we look after shareholders' investment
- **Integrity** – honesty, openness, and fairness underpin all our business dealings, internally and externally
- **Respect** – for the individual, for opinions, for nationalities, genders, religions and ethnic backgrounds
- **Safety** – safe behaviour and attitude in everything we do – all day, every day
- **Team culture** – success in a complex business means bringing people of many different disciplines together into co-ordinated teams

the UK. For gas fired generation, the high price of gas generally meant that margins remained depressed – however, this was not the case for Saltend, our 1,200 MW gas fired plant, as this plant benefited from an attractively priced gas contract in 2006.

The balance of our European portfolio is largely contracted, and delivered an excellent performance, characterised by high plant availability. As in the UK, we are also installing improved emission control equipment at Pego, our Portuguese coal fired plant. We were also very pleased to announce two acquisitions during the year – Indian Queens, a 140 MW peaking plant in the UK, and Levanto, a 436 MW portfolio of wind farms in operation or under construction in Germany and France. Levanto represents our first significant move into renewables in Europe, and we plan to use this as a platform for further growth in renewables, using the acquired expertise and the inherent development opportunities.

Middle East Our performance in the Middle East in 2006 reflects additional capacity coming on line, our four plants in Saudi Arabia progressively reached full commercial operation during the year, in Qatar, our power and desalination plant commenced partial commercial operation and we also acquired the Hidd power and desalination plant in Bahrain in early 2006. By the end of 2006, we had 2,033 MW (net) of power plant, and 75 MIGD (net) of desalination plant in operation in the Middle East, with a further 355 MW (net) and 42 MIGD (net) due to come into operation from existing projects. Our existing plants continue to perform well under their long-term contracts, and we continue to target this region as a source of long-term growth through leveraging our operational and development skills, alongside our excellent market relationships.

Australia In Australia, our headline profit is down, due to lower achieved prices which were anticipated in this merchant market. Our forward contracting policy has significantly insulated the business from weaker market prices over the last few years, but 2006 margins reflect more recent, and hence lower, prices. However, the market background is now more encouraging, with forward prices showing an improvement. As we are largely contracted for 2007, we should see most of the benefit from this improvement from 2008 onwards. We are also investigating means of reducing carbon dioxide emissions from brown coal generation at our Hazelwood plant in Victoria, working with both federal and state governments, and with selected technology specialists. This is a medium to long-term project, and we are pleased to be at the forefront of addressing such an important issue for Australian power generation.

Asia In Asia, all of our assets operate under long-term offtake contracts, and all have performed well, with high availability the main driver. Profit is a little down year-on-year, primarily because the tax free status of one of our assets in Pakistan (KAPCO) has time expired, as originally planned. We continue to target growth opportunities in Asia, including both greenfield and acquisition opportunities, and accordingly we have strengthened our development resources in the region.

Focus on growth opportunities

Our strong operational performance has been matched by a very significant improvement in free cash flow. This ensures that our balance sheet remains robust, with gearing and debt capitalisation at levels very similar to last year, despite the acquisitions made during 2006. Our corporate liquidity also remains good, providing us with great flexibility to pursue growth opportunities, alongside our commitment to progressively increase our dividend pay-out ratio.

The foundation of our business is stronger, and we are focused on growth opportunities through greenfield development and acquisitions across our core regions. Recovering power markets are resulting in generally higher asset prices, but we will use our key strengths of regional market knowledge and financial discipline to ensure that we do not overpay, and that long-term shareholder value remains at the very top of our agenda.

Philip Cox
Chief Executive Officer