Financial position and resources

Corporate costs

International Power's headquarters is in London, where corporate and business functions are based to support our worldwide operations.

Corporate costs at £45 million are £14 million lower than 2005. This is mainly due to higher costs in 2005 arising from a number of non-recurring items, including a provision raised against certain CEGB legacy pension obligations and a high cost of employees' share options arising from the significant growth in the share price during 2005.

Interest

Net interest expense excluding exceptional items and specific IAS 39 mark to market movements at £248 million is £46 million higher than 2005. This is mainly due to the impact of additional debt relating to the acquisition of Coleto Creek, a full year impact of Saltend, which was acquired in July 2005, and first time interest expense at Tihama, where interest costs ceased to be capitalised as the assets became operational in 2006.

Tax

The tax charge excluding exceptional items and specific IAS 39 mark to market movements at £122 million is £54 million up on the 2005 charge. This is due to higher profitability slightly offset by a decrease in the effective tax rate from 31% in 2005 to 30% in 2006.

Tax on exceptional items and specific IAS 39 mark to market movements was a charge of £25 million (2005: £21 million).

Exceptional items and specific IAS 39 mark to market movements

Net exceptional gains before tax of £55 million were booked in 2006 (2005: gain of £120 million) comprising:

- £36 million – impairment reversal of Deeside power plant;
- £14 million – final TXU settlement receipt;
- £5 million – compensation for breach of contract in Turkey.

The specific IAS 39 mark to market movements reported in the year amount to a profit before tax of £44 million (2005: loss of £35 million).

Liquidity

Free cash flow for the year ended 31 December 2006 was £456 million, an increase of 60% compared to the previous year (2005: £285 million). This increase was driven by strong operational and financial performance across the Group, together with higher dividends from joint ventures and associates. This was partially offset by increased tax and interest payments (£86 million higher than 2005) and an increase in maintenance capital expenditure of £56 million.

Canunda, South Australia

Acquisitions of £842 million in 2006 mainly relate to Coleto Creek and the Levanto onshore wind farm portfolio, together with acquisitions of Indian Queens, Hidd, Opus Energy and BioX. A summary of the Group's cash flow is set out below:

	Year ended 31 December 2006 £m	Year ended 31 December 2005 £m
Profit for the year	**477**	330
Depreciation, amortisation and other movements [(i)]	**322**	183
Dividends from joint ventures and associates	**113**	92
Capital expenditure – maintenance	**(128)**	(72)
Movement in working capital	**(15)**	(21)
Net tax and interest paid	**(313)**	(227)
Free cash flow	**456**	285
Receipt from TXU Administrators – exceptional	**14**	58
Receipt of compensation for breach of contract – exceptional	**5**	–
Finance cost – exceptional	**–**	(5)
Debt financing costs capitalised on acquisition debt	**(14)**	(7)
Capital expenditure – growth	**(142)**	(188)
Returns from joint ventures and associates (net of investments)	**24**	48
Acquisitions	**(842)**	(571)
Disposals	**1**	211
Dividends paid	**(67)**	(37)
Proceeds from share issue	**15**	2
Net funding from minority interests	**3**	80
Foreign exchange and other	**213**	(181)
Increase in net debt	**(334)**	(305)
Opening net debt	**(2,979)**	(2,745)
Transitional adjustment on first time adoption of IAS 39	**–**	44
Net (debt)/funds on acquisition of subsidiaries	**(172)**	27
Closing net debt	**(3,485)**	(2,979)

(i) Depreciation, amortisation and other movements include income statement charges for interest, tax, depreciation, the share of profit of joint ventures and associates, the exceptional profit on the TXU settlement, and the exceptional profit on compensation for breach of contract.

Summary balance sheet

A summarised, reclassified Group balance sheet is set out below:

	As at 31 December 2006 £m	As at 31 December 2005 £m
Property, plant and equipment and intangibles	**4,840**	4,590
Investments	**1,290**	1,409
Long-term receivables and others	**1,278**	593
	7,408	6,592
Net current assets/(liabilities) (excluding net debt items)	**69**	(327)
Non-current liabilities (excluding net debt items)	**(1,252)**	(911)
Net debt	**(3,485)**	(2,979)
Net assets	**2,740**	2,375
Gearing	**127%**	125%
Debt capitalisation	**56%**	56%
Net debt – joint ventures and associates	**(1,524)**	(1,625)

The increase in property, plant and equipment and intangibles of £250 million principally reflects the acquisition of Coleto Creek and capital expenditure on growth projects, including Levanto. This was offset by depreciation and amortisation charges and the impact of currency retranslation of £246 million, principally on our Australian and US dollar assets.

Long-term receivables and others increased by £685 million due to the acquisition of Levanto (£278 million), which is accounted for as a number of finance leases, and the transfer of £344 million from property, plant and equipment to finance lease receivables at Tihama and Levanto, as further capacity became operational during the year.

Non-current liabilities have increased by £341 million mainly due to the recognition of a provision for £156 million at Coleto Creek in respect of out of the money contracts on acquisition and an increase in deferred tax liabilities of £139 million.

Net debt has increased during 2006 as a result of the acquisitions of Coleto Creek and Levanto and further capital expenditure at Tihama, partially offset by strong cash flow generation.

- Net assets increased to £2,740 million
- Net debt increased to £3,485 million
- Debt capitalisation remains at 56%

Net debt and capital structure

Group net debt

at 31 December comprised:

	2006 £m	2005 £m
Cash and cash equivalents	**980**	620
Assets held for trading	**42**	52
Convertible bonds	**(237)**	(125)
Other bonds	**(678)**	(445)
Secured bank loans and preferred equity	**(3,592)**	(3,081)
Net debt	**(3,485)**	(2,979)

The above net debt of £3,485 million excludes the Group's share of joint ventures' and associates' net debt of £1,524 million (2005: £1,625 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 and two convertible bonds. The revolving credit facility of US$640 million (£327 million) expires in October 2009 but can be extended by a further year subject to bank approval. The convertible bond of US$252 million (£129 million) matures in August 2023 but with bond holders having the right to 'put' the bond back to the Group in August 2010, 2013, 2018 and 2023. A new convertible bond of €230 million (£155 million) was issued in July 2006 with a maturity date of July 2013 but with bondholders having the right to convert the bond into our shares at anytime. 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, Loy Yang B repaid the existing amortising facility of A$ 617 million (£249 million) and replaced it with an interest only facility (with full capital repayment in 2012) of the same size, and Rugeley, UK was refinanced with a non-recourse facility of £485 million, of which £145 million will be used for the installation of FGD equipment. In addition, the Group raised non-recourse facilities of US$935 million (£477 million) to support the acquisition and operation of Coleto Creek, Texas.

Corporate and Group debt

On 31 December 2006 we had aggregated debt financing of £4,507 million denominated principally in US dollars, Australian dollars, sterling, euro, Czech koruna and Thai baht. Of this amount only £389 million is recourse at corporate level, the remaining £4,118 million being secured by fixed or floating charges over the assets of certain subsidiaries.

Aggregated debt financing of £240 million is due for repayment in 2007, with the majority of the remaining debt balance due after 2011.

During 2006 Standard & Poor's, Fitch and Moody's reviewed the credit rating at corporate level. Standard & Poor's maintained the rating of BB- but upgraded the outlook to positive. Fitch maintained its rating of BB with stable outlook and Moody's maintained its rating of B2 with stable outlook.

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 policy

The Group's policy is to fix interest rates for a significant portion of the debt (71% as at 31 December 2006) using forward rate or interest rate swap agreements. Turbogás interest costs are a pass through in the PPA tariff and therefore not an exposure to the Group. Adjusting for this item would increase fixed rate debt to 77%. The Group is broadly neutral to changes in interest rates as variable rate debt is similar in size to variable rate cash and cash equivalents. Significant interest rate management programmes and instruments require specific approval of the Board. The weighted average interest of the fixed rate debt was 7% in 2006. Where project finance is utilised, our policy is to align the maturity of the debt with the contractual terms of the customer offtake agreement.

KAPCO, Pakistan

Accounting policies

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.

Critical accounting policies and estimates

We prepare our consolidated financial statements in compliance with International Financial Reporting Standards (IFRSs) as adopted by the EU. 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 revenue 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 IFRS 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 in note 1 to the consolidated financial statements. The table below identifies some of the areas where significant judgements are required, normally due to the uncertainties involved in the application of certain accounting policies.

Income recognition

The majority of our income is derived from owning and operating power plants worldwide. In merchant markets the Group enters into various types of hedging or forward contracts for the buying and selling of commodities related to this activity: principally sales of electricity and the purchase of fuel for its own power plants. These contracts typically fall within the definition of derivative financial instruments and as such are required to be fair valued. Accounting for these contracts as cash flow hedges allows, to the extent the hedge is effective, the changes in value of the derivatives to be deferred in equity. In order to achieve cash flow hedge accounting it is necessary for the Group to determine, on an on-going basis, whether a forecast transaction is both highly probable and whether the hedge is effective. This requires both subjective and objective measures of determination (see also Fair values of energy derivatives).

When our power plants sell their output under long-term power purchase agreements it is usual for the power plant owning company to receive payment (known as a 'capacity payment') for the provision of electrical capacity whether or not the offtaker requests electrical output. In these situations, where there is a long-term contract to purchase electricity output and electrical capacity, it is necessary for the Group to evaluate the contractual arrangements and determine whether they constitute a form of lease or a service contract. Where the arrangements are determined to be or to contain a form of lease an evaluation is then required of where the substantial risks and rewards of ownership reside in order to determine the form of lease it represents. For those arrangements determined to be finance leases, it is necessary to calculate the proportion of total capacity payments which should be treated as finance income, capital repayment and as a fee for service provision and for operating leases the split between rental payments and fees for service provision.

The Group receives amounts from contractors in respect of late commissioning and under performance of new power plants. Receipts which relate to compensation for lost revenue are treated as income 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.

Fair values of energy derivatives

The Group has presented its financial statements in accordance with the requirements of IAS 32 (Financial Instruments: Presentation and Disclosure) and IAS 39 (Financial Instruments: Recognition and Measurement). In accordance with IAS 39, the Group records its derivative contracts on balance sheet at fair value (unless they qualify for the 'own use' exemption). Changes in the value of its derivative contracts in each period are recorded in earnings unless strict hedge accounting criteria are met which allow the movement in fair value to be recorded within equity. The Group estimates the fair value of its energy derivative contracts by reference to forward price curves. A forward price curve represents the Group's view as to the prices at which customers would currently contract for delivery or settlement of commodities, such as power or gas, at future dates. Generally the forward price curve is derived from published price quotations in an active market, over the short-term horizon period, and from valuation techniques over the more distant horizon period. The assumptions used during the application of valuation techniques will directly impact the shape of the forward price curve. The forward price curves are only estimates of future prices and thus possess inherent uncertainty and subjectivity.

Accounting policy	Critical accounting judgements and key sources of uncertainty derive from the determination of the:
Income recognition	– correct revenue recognition policy based on the contractual arrangements in place and the allocation of the risks and rewards of ownership of the plant – appropriate accounting treatment of receipts from contractors
Fair values of energy derivatives	– forward price curve for commodities where there is an inactive market
Recoverable amount of property, plant and equipment	– indications of impairment and the measurement of fair value using projected cash flows, together with risk adjusted discount rates, or other more appropriate methods of valuation
Fair values on acquisition	– useful economic life and residual value of certain assets – fair values of assets and liabilities acquired and hence how much of the purchase price is attributed to goodwill arising on acquisition of a business

Recoverable amount of property, plant and equipment

The original cost of greenfield developed power plants and other assets includes relevant borrowings and development costs:

- Interest on borrowings relating to major capital projects with long periods of development is capitalised during construction and then amortised over the useful life of the asset.
- Project development costs (including appropriate direct internal costs) are capitalised when it is virtually certain that the project will proceed to completion and income will be realised.

Depreciation of plant is charged so as to write down the value of the asset to its residual value over its estimated useful life:

- Gas plant is 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.
- Wind farms, coal and hydro plants are considered on an individual basis.

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

Fair values on acquisition

The Group is required to bring assets and liabilities acquired in business combinations on to the Group balance sheet at their fair value. Power plant and equipment usually have long operating lives, and are often bought with associated long-term contracts such as PPAs. Hence determination of the fair values of these long-life assets and contracts can require a significant amount of judgement.

Consolidation policy – amount of 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 financial statements. At entities which are not subsidiaries 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 investments available for sale. These investments available for sale are carried at market value where market prices are available. Where quoted market prices in an active market are not available, and where fair value cannot be reliably measured, unquoted equity instruments are measured at cost.

Where the Group owns between 20% and 50% of the equity of an entity and is in a position to exercise significant influence over the entity's operating and financial policies, we treat the entity as an associate or jointly controlled entity. Equally, where the Group holds a substantial interest (but less than 20%) in an entity and has the power to exert significant influence over its operations, we treat it as an associate or jointly controlled entity.

Exceptional items

The Directors consider that items of income or expense which are material by virtue of their nature and amount should be disclosed separately if the financial statements are to fairly present the financial position and financial performance of the Group. The Directors label these items collectively as 'exceptional items'.

Determining which transactions are to be considered exceptional in nature is often a subjective matter. However, circumstances that the Directors believe would give rise to exceptional items for separate disclosure would include:

- disposals of investments;
- discontinued operations;
- impairments and impairment reversals.

All exceptional items are included on the appropriate income statement line to which they relate. In addition, for clarity, separate disclosure is made of all such items in one column on the face of the income statement.

Taxation

The level of current and deferred tax recognised is dependent on subjective judgement as to the outcome of decisions to be made by the tax authorities in the various tax jurisdictions in which International Power operates.

It is necessary to consider the extent to which deferred tax assets should be recognised based on an assessment of the extent to which they are regarded as recoverable.

Accounting policy	Critical accounting judgements and key sources of uncertainty derive from the determination of the:
Consolidation policy – amount of influence	– extent of influence the Group is in a position to exercise over the operations, strategic direction and financial policies of entities in which it holds an equity stake
Items of income and expense which require separate disclosure – 'exceptional items'	– items of income or expense which are material by virtue of their nature and amount which require separate disclosure. The Directors consider these items most appropriately disclosed as 'exceptional'
Taxation	– appropriate provisions for taxation taking into account anticipated decisions of the tax authorities – assessment of the ability to utilise tax benefits through future earnings