Our approach to risk and risk management

International Power's principal activities are the development, acquisition and operation of power generation plants together with closely related activities, such as desalination and district heating. These principal activities are supported by a number of local, regional and corporate offices which carry out activities such as trading and treasury operations. All of these activities have inherent risks.

Our general approach to risk management and risk governance is set out below. This is followed by a description of the principal risks faced by the business.

Risk management framework

Our risk management philosophy is designed to deal with the diverse nature of our asset base. International Power owns, or has equity stakes in, over 40 plants and businesses located in 20 countries on four continents. Our portfolio contains all major technologies and fuel types with the exception of nuclear power. In terms of age, our plants range from those which entered service in the 1950s through to those still under construction. Overall, the majority of the portfolio entered service less than 15 years ago. Politically and economically the portfolio is similarly diverse, having a presence in developed and developing countries, with a variety of cultural, political and legal systems.

To reflect the profile of our business we have developed a system that contains both bottom up and top down elements to identify and manage risks.

Corporate level	Policy, delegations and exposure limits are set at the corporate level, with the Board of Directors taking ultimate responsibility. Acceptable business practices and health, safety and environmental standards are set centrally.
Regional business	Market and trading risks are managed regionally within the framework set at corporate level. Political risks are also managed regionally with support from the corporate centre.
Business units	Risk assessments and action plans are mainly business unit based. Health, safety and environment compliance activities are also managed at asset level, albeit within a central policy framework. Business managers are accountable for managing the risks within their areas of responsibility. This principle also applies to managers of corporate functions.

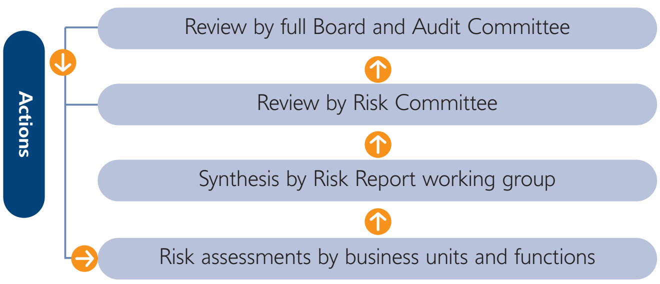
Hub, Pakistan

There is a continuous process for identifying, evaluating and managing the key risks faced by the Group. Activities are co-ordinated by the Risk Committee, which is chaired by the Chief Financial Officer (CFO) and comprises Executive Directors, other regional directors and senior managers. The Risk Committee has responsibility, on behalf of the Board, for ensuring:

- the adequacy of systems for identifying and assessing significant risks;
- that appropriate control systems and other mitigating actions are in place;
- that residual exposures are consistent with the Company's strategy and objectives.

During the business planning process, each business unit and functional group identifies and assesses the key risks associated with achievement of its principal objectives and assesses their impact. These assessments are conducted by all material entities. During the year, significant changes in the risk profile are highlighted through the business performance reporting process.

The centrepiece of our risk management activities is an annual, Group-wide, risk review. This is based on the outcome of the business planning exercise, updated as necessary to take account of 'post business plan' events. The assessments are synthesised into a Risk Report that identifies all the principal risks and which is reviewed by the Risk Committee. Where risks are considered to exceed the Company's risk appetite, the Risk Committee directs which actions are to be taken. The Risk Report is reviewed by the full Board and the Audit Committee. Schematically the annual Risk Report system functions as follows:



In order to compare risks across the Group on a systematic basis we segment our activities as shown below. In reality, certain exposures interact and other exposures apply to more than one 'risk area' (for example regulatory risk applies to all of our activities). Such cross-segment risks are assessed in each of the areas in which they occur.

- Financial risks
- Market and trading risks
- Fuel supply risks
- Country and political risks
- Construction and operational risks
- Health, safety and environmental risks
- Staffing and HR risks

Principal risks and exposures

Financial risks

Our business can be subject to financial volatility. This can originate from a number of sources, including project company and counterparty related events. One example is the insolvency of TXU Europe in 2002 which resulted in the termination of the Rugeley Tolling Agreement (a long-term agreement to purchase coal and sell power), which caused a shortfall in revenues for that asset. Our capital structure is designed to address these risks.

At the corporate level we have a number of loan facilities which provide us with a prudent level of financial headroom (cash plus outstanding credit lines, less known obligations) which can be applied to any aspect of our business should the need arise. These facilities will meet the short to medium-term funding requirements envisaged by the business. Longer-term funding requirements or funding for a particularly large transaction (e.g. the acquisition of the EME international asset portfolio in 2004) may be sourced from a combination of these facilities and suitable long-term instruments, such as bonds or by raising additional equity. The actual choice of funding instrument(s) will depend on market conditions at that time.

In merchant markets we are sometimes required to provide trading credit support for our trading operations. Fuel and electricity markets periodically experience sharp price movements. When price movements occur this has an immediate knock-on effect on our trading credit

- We own or have equity stakes in over 40 plants and businesses in 20 countries on four continents
- Overall, the majority of our portfolio entered service less than 15 years ago
- There is a continuous process for identifying, evaluating and managing key risks faced by the Group
- The centrepiece of our risk management activities is an annual, Group-wide risk review

support requirements, which can be volatile as a consequence. The maintenance of financial headroom offers protection against escalating margin calls (payments we are required to make when power prices increase above the contract price).

Project development can, on occasions, require credit support. This support can take the form of parent company guarantees or credit support instruments issued by banks. In the unlikely event that credit support facilities are unavailable to support the growth developments that we are planning, this could require us to reduce our development activities. We consider it highly unlikely that we will have to forego opportunities as a result of this constraint due to the prudent level of financial headroom that we maintain and the availability of additional bilateral facilities with banks.

At the individual business level we finance our projects with non-recourse debt. We use non-recourse finance as this insulates the Group from adverse events occurring at the project level, limiting our balance sheet exposure to a given project to the loss of the equity in that project. Other financial exposures and their mitigants are set out below.

Counterparty risk

We manage our credit exposure to trading and financial counterparties by establishing clearly defined limits, policies and procedures. Energy trading activities are strictly monitored and controlled through delegated authorities and procedures, which include specific criteria for the management of credit exposures in each of our key regions. With respect to our treasury activities, the financial counterparty credit exposure is limited to arrangements with relationship banks and to commercial paper that has an investment grade credit rating.

Counterparty exposures arising from sale and purchase agreements with our customers are monitored and managed locally with assistance from Group treasury. In addition, Group treasury manages the consolidated (Group-wide) counterparty credit positions, with the active involvement of the global risk manager.

Currency and interest rate exposures

Project company borrowings are normally made in the project company's functional currency. Hence exchange rate fluctuations do not affect the financial stability of our assets. In countries with historically weak currencies we aim to have power purchase agreement (PPA) tariffs denominated in a major international currency. This protects future returns against large and rapid devaluations.

Variability in interest payments can introduce further volatility into project returns. We mainly mitigate this risk by fixing borrowing rates, principally by using interest rate swaps. A limited number of our PPAs also have interest rate pass through mechanisms. Overall, 77% of our borrowings were protected from interest rate fluctuations in these ways, at the end of 2006.

In order to hedge the net assets of non-UK 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 not our policy, however, to hedge currency translation exposures through foreign exchange contracts or currency swaps. This exposes our sterling profits and our balance sheet assets and liabilities to fluctuations that are not related to underlying business performance.

For 2006 and 2005 average and year-end sterling rates for major currencies, which are significant to the Group, were:

	Average		At 31 December	
	2006	2005	**2006**	2005
US dollar	**1.85**	1.82	**1.96**	1.72
Australian dollar	**2.44**	2.39	**2.48**	2.34
Euro	**1.47**	1.46	**1.48**	1.46
Czech koruna	**41.51**	43.56	**40.85**	42.27

When one of our projects makes sales and purchases in a currency other than its functional currency this gives rise to a currency transaction exposure. Transaction exposures also arise when dividends or other funds are remitted from our overseas companies. We match transaction exposures in advance where possible, and hedge any unmatched transactions as soon as they are committed. We use foreign currency contracts and similar instruments for this purpose.

Investment structures and contingent liabilities

Going forward, the complexity of the Group and its investment structures, together with the rapidly growing body of tax legislation, will make tax planning and forecasting an increasingly complex and uncertain process. We closely monitor actual and potential changes in tax legislation in order to assess the continued effectiveness of our corporate structures and financial planning assumptions. We are supported by a major global specialist firm in making these assessments.

International Power has a number of contingent liabilities. These arise from certain tax planning assumptions that are not yet confirmed by the relevant fiscal authorities and from ongoing legal actions, one of which dates back more than a decade. We have fully provided for all sums that we believe will become due.

Funding of pensions obligations

The Group operates a number of defined benefit pension schemes. These schemes guarantee their members that they will receive pensions related to their final salary at retirement, which gives rise to a risk that our pension funds will not be sufficient to meet these obligations. This risk crystallised during the first part of the decade as share prices fell worldwide and more onerous actuarial valuation assumptions were mandated by government. The Group's defined benefit pension funds recorded a deficit of £15 million when they were last reviewed, and actuarial assumptions updated, in December 2006. Whilst this is not large compared to a number of other UK groups, the adequacy of our pension funds will remain an area of focus for some time.

In order to address this we have increased the level of contributions. Furthermore, the comparatively small number of staff within our defined benefit pension schemes (approximately 1,400 as at 31 December 2006) significantly reduces the level of our potential exposure relative to many other FTSE 100 companies.

Financial processes

We consider that we have an appropriate and robust internal control system. During the past year our systems of financial control have been subject to a comprehensive review to meet the requirements of Section 404 of the US Sarbanes-Oxley Act. We anticipate that the systems will meet the standards of this Act and the rules that have been developed during its implementation.

In order to identify variances to our forecasts in a timely manner and provide an early warning of changing circumstances, we monitor a number of performance indicators. The principal financial KPIs are profit from operations (PFO), EPS, and free cash flow, details of which are set out on pages 20 to 22.

Insurance risk management

Our risk management processes assist us in the identification of events that can be partly or entirely mitigated through use of insurance, or which we can self-insure. Risks that we insure include business interruption, Directors' and officers' liability and property damage. Insurance providers recognise the robust nature of our processes and this is reflected in the cost of our policies.

Market and trading risks

A significant number of the projects in which we have an interest operate without PPAs and are, therefore, vulnerable to market forces, which determine the price and amounts of power sold and fuel purchased. In particular, the majority of our plants in the UK, North America and Australia operate on a merchant basis. In order to limit our exposure to market movements, we hedge a proportion of our anticipated output by forward selling power and buying forward related commodities including fuel, transmission rights, capacity and emission credits. The key risks facing our market and trading activities and their mitigants are set out below.

Hedging activities

Unhedged output is subject to price and volume volatility. To reduce this uncertainty, we operate a 'rolling hedge' programme under which we increase the proportion of output that is sold forward as the production date approaches. As at 20 February 2007 around 90% of expected output at Rugeley and Saltend was contracted for 2007 and approximately 80% for 2008. In Texas 60% of our expected output at Midlothian and Hays, and 95% at Coleto Creek, has been forward contracted for 2007 and for our Blackstone and Bellingham, New England plants, 55% has been forward contracted. In Australia, both Loy Yang B and Hazelwood are highly contracted for 2007, with 85% and 75% of output sold forward respectively. Due to market liquidity considerations the majority of our hedging activity is for a maximum period of two years ahead.

It is not always possible to achieve an exact match between power sales and purchases, and the purchases and sales of related commodities. Mismatched positions have the potential to result in substantial losses. This potential exposure is addressed in our trading policies, which do not allow us to take significant unmatched positions.

In addition to asset-backed trading we carry out some proprietary trading (trading not linked to the expected output of our power plants). Our proprietary trading activities are limited in scope and any exposures are correspondingly small.

Framework for trading activities

Our trading activities operate within a robust framework of policies and oversight functions. Trading and forward contracting strategies are continually reviewed by regional and corporate trading and risk management professionals, to ensure they are best suited to both local market conditions and corporate risk guidelines. Company-wide oversight of our trading operations is provided by a global commodities risk committee (GCRC) which includes the Chief Executive Officer (CEO), the CFO, and the global trading and risk managers. The GCRC acts under the authority of the Board, and delegates limits and authorities to local risk committees, which have been established in each of our trading operations to oversee the management of the market, operational and credit risks arising from our marketing and trading activities. The local risk committees include the trading manager, global and local risk managers, Directors and senior managers.

Energy market risks and counterparty exposures on our asset and proprietary portfolios are measured and managed using various statistical techniques.

Midlothian, Texas

Investments in new projects

When we invest in assets that operate, or will operate, on a merchant basis we make assumptions regarding long-term spreads. There is a large degree of uncertainty in these forecasts, which include assumptions concerning:

- supply and demand characteristics;
- new entrant economics used to forecast power prices from the date at which new capacity is required;
- market and environmental regulation, particularly the cost of carbon dioxide (CO_2) allowances and limits on other emissions;
- correlations between power prices and fuel prices.

We carry out detailed investigations and develop sophisticated market models prior to investing in new merchant plants.

Fuel supply risks

Fuel supply security is fundamental to our business. Most of our markets have robust supply infrastructures, and other measures that further enhance our position. These include: mines local to the power plant, fuel storage, dual-fuel capability and sourcing from a number of reputable suppliers. Consequently, we have experienced very few supply interruptions that have had an impact on operations, and none that have had material adverse effects on financial performance.

We procure fuel under a variety of contractual arrangements ranging from long-term fuel supply agreements (FSAs) to on-the-day merchant gas purchases. The principal determinant of our fuel supply activity is the need to match purchases to power sales, both in terms of volume and price. Hence, we operate long-term FSAs at assets where we have long-term PPAs and predominantly merchant supply arrangements in our merchant power markets.

It is not always possible to achieve an exact balance between fuel purchases and power production. This is particularly an issue for our projects with PPAs, where the associated FSAs often have minimum fuel purchase obligations. By structuring the purchases flexibly and incorporating appropriate force majeure protection, we are able to mitigate this risk to ensure as far as possible that the price and volume obligations in the PPA and FSA mirror one another.

Country and political risks

Most of our projects with PPAs are in countries with some degree of country risk. In the past, some PPA tariffs have been reopened by our offtakers and renegotiated. We do not currently foresee the prospect of further renegotiations but this remains a possibility.

We address country risk exposures in several ways. Country risk assessment is an important element of our due diligence prior to participating in a project and we favour projects where international arbitration is available for resolving disputes. Once projects are operational, International Power always strives to be a 'good neighbour', supporting the local, regional and national communities wherever possible. We also attempt to maintain good relationships with political institutions and our customers.

The size of our portfolio dilutes the effect of a dispute, at any given asset, on the Group as a whole. Furthermore, non-recourse debt arrangements limit our financial exposure to the loss of our equity investment and the future cash flows from the project. Thus, whilst the loss or impairment of a project would affect the financial performance of the Group, other operating companies would remain unaffected.

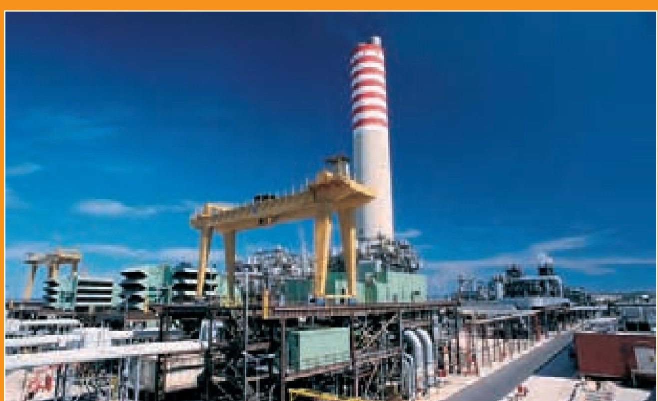
Construction and operational risks

Costs of new power plants are significant, and the build phase has programme (delayed completion) and technical performance risk. It is our policy, wherever possible, to award major projects on an engineering, procurement and construction (EPC) basis to suitably qualified contractors. EPC contracts transfer the majority of the design and construction risks to the contractor, and provide substantial protection through liquidated damages, in the event of failure on the part of the contractor to meet contractual completion or plant performance targets. We supplement this contractual protection with insurances.

As with many other industrial sectors, the power plant sector has consolidated over the past two decades. Whilst there is currently a competitive market, further consolidation could change this situation, increasing prices and reducing our ability to secure commercial protection within EPC contracts. We would also be exposed to concentration risk, becoming dependent on a very small number of suppliers for replacement parts, overhaul and maintenance contracts. Currently we have long-term relationships with a number of original equipment manufacturers across our fleet, including Alstom, General Electric, Mitsubishi and Siemens.

Power plants are characterised by extremely high temperatures, pressures, rotational velocities and voltages. Providing a safe environment for people on our sites and in surrounding areas is a major priority. We achieve this by a combination of engineering and operational procedures and standards, provision of training, performance monitoring and by employing experienced staff.

ISAB, Italy



We are a minority partner in a number of projects and do not set operational standards in all cases. In such circumstances we provide support where appropriate and attempt to use our influence to achieve standards that are equivalent to our own. However, our ability to influence partners varies.

During the build period we closely monitor the progress of four major factors: construction programme, cost, quality and safety. Once a plant is in operation we monitor performance by reference to a number of performance indicators, including the technical availability KPI, which is a measure of reliability.

Health, safety and environmental (HS&E) risks

Poor health, safety and environmental performance has the potential to adversely affect our business. Risks range from enforced plant closures and substantial fines to damage to the well-being of our staff and to our reputation in the wider community.

HS&E compliance activities

At plant level, HS&E requirements are set by local and national standards and regulations, and individual plants operate within site specific environmental licensing limits. We have an ongoing HS&E audit programme to provide assurance in this area and we closely monitor accident frequency rate (AFR) statistics and breaches of environmental permits. AFR and reportable environmental incidents are amongst our KPIs.

Plant operating and monitoring procedures are effective in ensuring that we comply with the conditions of our environmental licenses and consents. Whilst we have experienced occasional breaches of our environmental operating limits, there have been no recent incidents that have posed a significant threat to the environment or to our ability to run our plants.

Sites are required to adhere to a set of corporate health and safety standards and to local regulations. Health and safety performance is the responsibility of our plant managers, who are supported by local health and safety specialists. Our global health and safety manager is responsible for ensuring that our corporate standards remain current and are understood by all of our sites.

Global warming and development of environmental regulation

Environmental legislation is one of the key drivers of the long-term development of the electricity industry. Initiatives to reduce greenhouse gas emissions are expected to increasingly restrict our ability to emit CO_2, and hence our ability to use fossil fuels to generate power without the use of carbon capture and storage. The impact of carbon reduction measures is currently most apparent at our European plants, where we are required to ensure that we have sufficient carbon credits to support our expected levels of generation. Certain of our projects have change of law protection, which enables us to pass on any carbon costs to the offtaker. In such cases carbon risk is removed.

In the US and Australia there are active discussions at both the state and federal level that could lead to CO_2 limitations being introduced some time in the future. The absence of single, centrally sponsored, debates increases the unpredictability of final outcomes. At the global level there is uncertainty over what, if anything, will replace the Kyoto convention on climate change when it expires at the end of 2012.

Most governments in developed countries have introduced legislation to incentivise renewable generation to the point where growth in renewable generation may have a material impact on our fossil fuelled plants. In response, we made a major investment in renewable energy during 2006 and we are implementing clean coal and carbon capture technology at Hazelwood.

We have also dedicated resources to reviewing technology trends in order to ensure that we are well positioned to participate in the drive towards a lower carbon environment.

Staffing and HR risks

The power industry has a history of long-term employment at plant and corporate level and staffing is not generally a day-to-day risk issue.

Our industry is highly competitive and we have to balance resources against the need to contain costs. We utilise our extensive experience to make these judgements and have the ability to mobilise people at short notice to mitigate the risk of loss of key staff. To date we have not experienced any disruption of note as a result of unexpected staff unavailability.

We anticipate that terrorism will remain a threat to our staff and assets for the foreseeable future. In order to reduce this threat we liaise with local law enforcement organisations on security issues and our corporate security specialist assists vulnerable sites to assess and reduce their exposures. We also utilise the services of a global security consultancy to ensure that our risk assessments and physical security measures fully reflect local conditions. The consultancy additionally has the capacity to provide personal security services if required.

Certain of our sites are highly unionised. We have not been affected by industrial action for several years but this remains a risk. We maintain active dialogues with staff unions to ensure that we are aware of any potential issues in good time to mitigate our risks.