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## Business review

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### Business and financial review

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The Group's principal performance indicators are highlighted on page one of this report. Solid operating performance, an improvement in our average achieved electricity price and an increase in net power sold were offset by an increase in coal prices, the cost of CO<sub>2</sub> emissions allowances and operating expenses, resulting in EBITDA of £454 million compared to £506 million in 2007. The Business and financial review includes further explanation and commentary in relation to our principal performance indicators and the results for the year.



	Year ended 31 December 2008 £m	Year ended 31 December 2007 £m
<b>Continuing operations</b>		
<b>Total revenue</b>	<b>1,752.8</b>	1,247.4
<b>Fuel costs<sup>(1)</sup></b>		
Fuel costs in respect of generation	(858.4)	(470.6)
Cost of power purchases	(211.8)	(75.5)
	(1,070.2)	(546.1)
<b>Gross profit</b>	<b>682.6</b>	701.3
Other operating expenses excluding depreciation, amortisation, exceptional items and unrealised gains on derivative contracts <sup>(2)</sup>	(228.4)	(195.7)
<b>EBITDA<sup>(3)</sup></b>	<b>454.2</b>	505.6
Depreciation, amortisation and loss on disposal of fixed assets	(46.4)	(43.7)
Exceptional operating income - final TXU Claim proceeds	-	6.2
Unrealised gains on derivative contracts	56.3	3.3
<b>Operating profit</b>	<b>464.1</b>	471.4
Interest payable and similar charges	(28.8)	(34.3)
Interest receivable	7.2	11.4
<b>Profit before tax</b>	<b>442.5</b>	448.5
Tax charge		
- Before changes in tax legislation	(100.8)	(113.4)
- Impact of industrial building allowances withdrawal on deferred tax	(8.8)	-
- Impact of reduction in tax rate on deferred tax	-	17.9
	(109.6)	(95.5)
<b>Profit for the year attributable to equity shareholders</b>	<b>332.9</b>	353.0
<b>Earnings per share</b>	<b>Pence per share</b>	<b>Pence per share</b>
- Basic and diluted	98	99

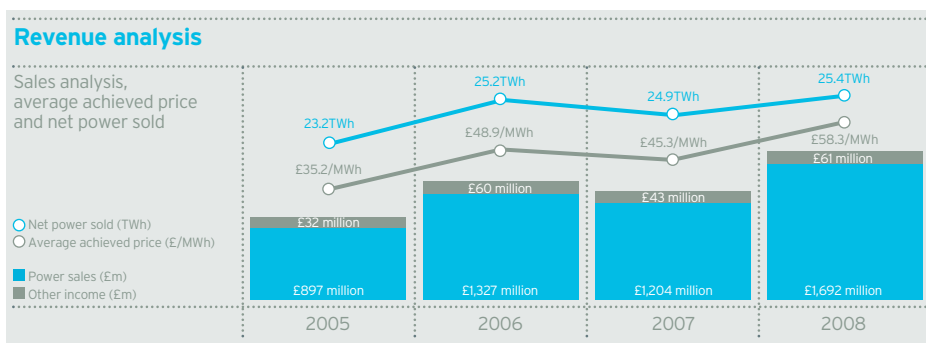
Notes:

- (1) Fuel costs comprise the fuel costs incurred in the generation process, predominantly coal and CO<sub>2</sub> emissions allowances, together with oil and biomass. Fuel costs also include the cost of power purchased to meet power sales commitments.
- (2) Other operating expenses excluding depreciation, amortisation, exceptional items and unrealised gains on derivative contracts principally include salaries, maintenance costs, transmission network use of system charges ("TNUoS"), balancing services use of system charges ("BSUoS") and business rates.
- (3) EBITDA is defined as profit before interest, tax, depreciation and amortisation, exceptional items and unrealised gains on derivative contracts.

## Results of operations

Total revenue for the year ended 31 December 2008 was £1,753 million compared to £1,247 million in 2007. Power sales were £1,692 million in 2008 compared to £1,204 million in 2007, reflecting a 29% improvement in our average achieved electricity price to £58.3/MWh (see Price of electricity) and an increase in net power sold to 25.4TWh, compared to 24.9TWh in 2007 (see Outages and plant utilisation levels).

In addition to power sales, total revenue also includes income from the provision of ancillary services, the sale of by-products (ash and gypsum), and the sale of ROCs, LECs and SO<sub>2</sub> emissions allowances. In the year ended 31 December 2008, these revenues were £61 million compared to £43 million in 2007. Significantly higher ROC sales in 2008 were driven by our growing biomass burn. Lower ancillary services revenues were a result of stronger competition in the market to provide frequency response services to National Grid plc ("National Grid").



Fuel costs in respect of generation during the year ended 31 December 2008 were £858 million, compared to £471 million in 2007. The increase was primarily due to higher generation, an increase in the price of coal and other fuels, and the impact of higher prices for and increased purchases of CO<sub>2</sub> emissions allowances (see Price of coal and other fuels and CO<sub>2</sub> emissions allowances).

We purchase power in the market when the cost of power in the market is below our marginal cost of production in respect of power previously contracted for generation and delivery by us, and to cover any shortfall in generation.

The cost of power purchased is included within fuel costs. For the year ended 31 December 2008, the cost of purchased

power increased to £212 million compared to £76 million in 2007, primarily due to higher market prices for electricity.

As a result of these factors, gross profit for the year ended 31 December 2008 was £683 million compared to £701 million in 2007.

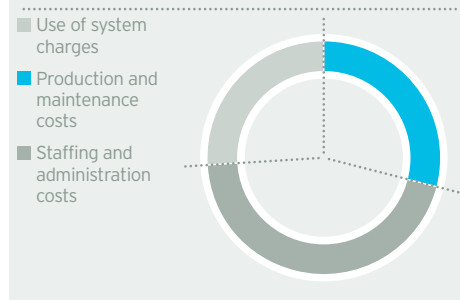
Other operating expenses were £228 million for the year ended 31 December 2008 compared to £196 million in 2007. In 2008, we experienced an increase of £11 million in use of system charges, following National Grid price uplifts in response to market conditions. Higher operating expenses in 2008 also reflect the impact of increased generation on maintenance costs.

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Operating expenses include the impact of growth in our average headcount to 712 compared to 658 in 2007. This reflects planned investments in our business, including operational support for the implementation of our large capital projects, the growth of our biomass procurement activities and investments to support the development of the biomass growth strategy.

## Operating cost analysis



EBITDA for the year ended 31 December 2008 was therefore £454 million compared to £506 million in 2007.

Depreciation and amortisation for the year ended 31 December 2008 was £46 million compared to £44 million in 2007, reflecting significant asset additions over the last two years, as well as accelerated depreciation on plant and equipment we expect to replace under our capital expenditure investment programme.

The Group recognises unrealised gains and losses on forward contracts which meet the definition of derivatives under IASs. Where possible, we take the own use exemption for derivative contracts entered into and held for our own purchase, sale or usage requirements, including forward domestic coal contracts. As such, the unrealised gains and losses recognised in the balance sheet principally relate to the mark to market of our forward contracts for power yet to be delivered. The following table describes the movements in unrealised gains and losses and where they are recorded in our financial statements.

	Year ended 31 December 2008 £m	Year ended 31 December 2007 £m
Net unrealised (losses)/gains in balance sheet at 1 January	(236.7)	344.3
Unrealised gains recognised in the income statement	56.3	3.3
Fair value gains/(losses) recognised in the hedge reserve (a component of equity)	164.7	(584.3)
Net unrealised losses in balance sheet at 31 December	(15.7)	(236.7)

As a consequence of increases in power prices throughout 2007, the average price relating to power which had been contracted but had yet to be delivered at 31 December 2007 was much lower than market prices at that time, resulting in the recognition of a net unrealised loss of £237 million in the balance sheet (included in captions described as derivative financial instruments). As a result of falling power prices over the last quarter of 2008, the difference narrowed considerably, resulting in a reduction in the net unrealised loss to £16 million at 31 December 2008. These trends in forward power prices, which determine the movements in our net unrealised gains/losses position, are illustrated in the chart on page 16.

The unrealised gains recognised in the income statement of £56 million for the year ended 31 December 2008 and £3 million in 2007 represent mark to market movements on a small proportion of our derivative contracts which do not qualify for hedge accounting.

Mark to market movements on most of our derivative contracts, considered to be effective hedges, have been recognised through the hedge reserve, a component of shareholders' equity in the balance sheet. Movements in unrealised gains and losses recognised in the hedge reserve are mainly the result of unwinding mark to market positions relating to power delivered during a reporting period, and the recording of mark to market positions on power yet to be delivered at the end of that period. The net unrealised gain recognised through the hedge reserve in the year ended 31 December 2008 was £165 million, compared to a net unrealised loss of £584 million in 2007, both reflecting the forward power price trends described above.



**Trading in the commodity markets**

The commodity markets in which we operate were highly volatile in 2008. We have a dedicated and experienced team in place to deliver our trading strategy of targeting market or better dark green spreads, while retaining balanced market exposure.



In considering mark to market movements, it is important to recognise that EBITDA is driven by our strategy to deliver market level or better dark green spreads, not by the absolute price of electricity at any given date.

After allowing for the unrealised gains on derivative contracts, operating profit for the year ended 31 December 2008 was £464 million compared to £471 million in 2007.

Net finance costs for the year ended 31 December 2008 were £22 million compared to £23 million in 2007, as a result of lower interest rates and debt levels.

The tax charge for the year ended 31 December 2008 was £110 million, compared to £96 million in 2007. Tax for 2008 includes a one-time charge of £9 million to reflect the estimated impact on deferred tax of the withdrawal of industrial buildings allowances introduced by the Finance Act 2008. The tax charge for 2007 included a one-time credit of £18 million to reflect the impact on deferred tax of a reduction in the rate of UK corporation tax from 30% to 28% with effect from 1 April 2008.

As a result of the above factors, profit attributable to equity shareholders for the year ended 31 December 2008 was £333 million compared to £353 million in 2007, and basic and diluted earnings per share were 98 pence compared to 99 pence in 2007.

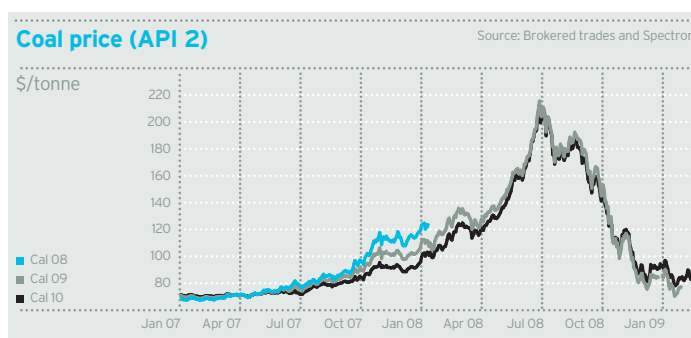
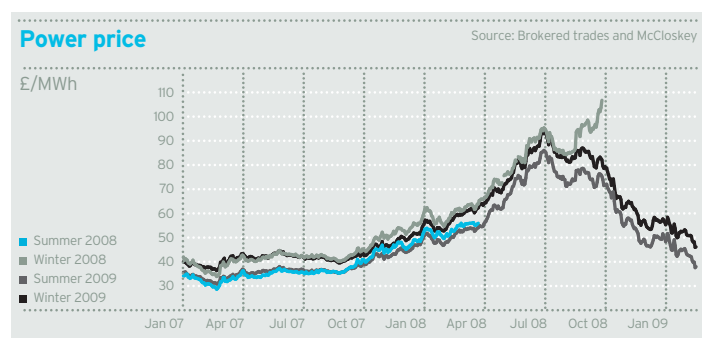
**Key factors affecting the business**

**General commodity market conditions**

Commodity market conditions were generally favourable for Drax in the first half of the year. During the third quarter, trading conditions continued to improve primarily as a consequence of low capacity reserve margins in the electricity market. However, in the last quarter we saw dark green spreads narrow and significant falls in power, coal and CO<sub>2</sub> emissions allowances prices. These trends in forward power, coal and CO<sub>2</sub> emissions allowances prices, are illustrated in the charts on pages 16 and 17, and described further in the following paragraphs.

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**Price of electricity**

The table below shows the average achieved electricity price we realised for the years ended 31 December 2008 and 31 December 2007, together with the market closing price on the last day of each season illustrated.

	Year ended 31 December 2008	Year ended 31 December 2007
Average achieved price (£/MWh)	<b>58.3</b>	45.3
Summer baseload market close (£/MWh)	<b>55.8</b>	23.0
Winter baseload market close (£/MWh)	<b>106.9</b>	40.4

Average achieved price for the year ended 31 December 2008 was £58.3 per MWh compared to £45.3 per MWh in 2007. Average capture price (being the price attained prior to Balancing Mechanism activity) for the year ended 31 December 2008 was £57.4 per MWh compared to £44.2 per MWh in 2007. The forward baseload power prices for Summer 2009 and Winter 2009/2010 were approximately £37.1 per MWh and £46.3 per MWh respectively as at 20 February 2009.

The increase in average achieved price primarily followed the impact of forward sales contracts secured in the last six months of 2007 and through the first six months of 2008, during which time power prices were generally increasing relative to the levels of late 2006 and early 2007, for power delivered in 2008.

Increasing power prices through the early part of 2008 followed strengthening oil and gas prices. High power prices were sustained through the third quarter, with fears that outages, Large Combustion Plant Directive ("LCPD") constraints and delays in Flue Gas Desulphurisation ("FGD") installations at other UK generating plant might result in a capacity shortfall.

Power price falls towards the end of the year followed weaker oil and gas prices. In addition, other plants returned to service, which allayed fears of a capacity shortfall, and peak electricity demand fell, reflecting the economic climate.

**Price of coal and other fuels**

We burnt approximately 9.5 million tonnes of coal in the year ended 31 December 2008 compared to approximately 9.8 million tonnes in 2007. This coal was purchased from a variety of domestic and international sources under either fixed or variable priced contracts with different maturities.

Spot prices for internationally traded coal delivered into North-West Europe (as reflected by the TFS API 2 index) increased dramatically over the second half of 2007, reaching US\$127 per tonne by the end of the year. Spot prices continued to increase to record levels over the first six months of 2008, reaching US\$218 per tonne by 30 June 2008. Price increases were driven by continued tight markets for both coal and freight, caused by strong demand from China, India and Japan, combined with some production and logistical issues in China, as well as South Africa and Australia. However, spot coal prices fell significantly over the final quarter, down to US\$81 per tonne by 31 December 2008, as supply constraints eased in both the coal and freight markets. The fall in coal prices was partially offset by the depreciation of sterling against the US dollar through the second half of 2008.

We also burn biomass, petcoke and fuel oil, although coal comprised around 93% of total fuel costs in the year ended 31 December 2008 (excluding CO<sub>2</sub> emissions allowances) compared to 95% in 2007, primarily as a result of improved fuel diversity. The average cost of fuel per MWh (excluding CO<sub>2</sub> emissions allowances) was £25.1 for the year ended 31 December 2008, compared to £18.5 in 2007, with high coal prices in the first nine months of 2008 relative to the levels of last year.

**CO<sub>2</sub> emissions allowances**

For Phase II of the EU ETS (2008-2012), Drax has an allocation of 9.5 million tonnes of CO<sub>2</sub> emissions allowances per annum under the UK NAP, compared to 14.6 million tonnes per annum for Phase I (2005-2007).

Our CO<sub>2</sub> emissions allowances requirement for the year ended 31 December 2008, in excess of those allocated under the UK NAP, was approximately 12.8 million tonnes compared to approximately 7.6 million tonnes in 2007, as a result of the lower UK NAP allocation and higher generation, partially offset by plant efficiency improvements and increased biomass burn.

The price for Phase I CO<sub>2</sub> emissions allowances began 2007 at approximately €6.6 per tonne, and as a result of over-supply, fell steadily over the first six months to €0.13 per tonne on 30 June 2007, subsequently falling away further to €0.04 per tonne by 31 December 2007.

The price for Phase II CO<sub>2</sub> emissions allowances began 2008 at approximately €22.4 per tonne, and in common with power and coal prices rose steadily over the first half of the year to €28.4 per tonne at 30 June 2008. However, carbon prices also fell significantly over the final quarter, down to €15.4 per tonne by 31 December 2008, as commodity prices fell back and industrial demand reduced in response to the economic climate.

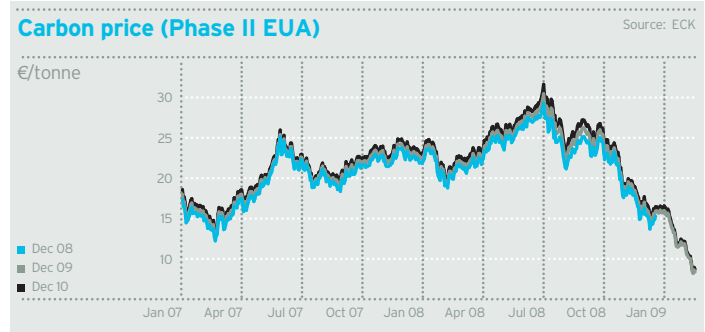
As a result, the average price expensed for purchased CO<sub>2</sub> emissions allowances during the year ended 31 December 2008 was £17.4 per tonne (equivalent to £223 million), compared to £1.5 per tonne in 2007 (equivalent to £11 million).

**Outages and plant utilisation levels**

	Year ended 31 December 2008	Year ended 31 December 2007
Electrical output (net sales) (TWh)	<b>25.4</b>	24.9
Load factor (%)	<b>76.3</b>	75.0
Availability (%)	<b>85.8</b>	85.7
Winter forced outage rate (%)	<b>6.5</b>	4.2
Forced outage rate (%)	<b>5.8</b>	6.9
Planned outage rate (%)	<b>8.9</b>	8.1
Total outage rate <sup>(1)</sup> (%)	<b>14.2</b>	14.3

Notes:

(1) The forced outage rate is expressed as a percentage of planned capacity available (that is, it includes a reduction for planned losses). The planned outage rate is expressed as a percentage of registered capacity. Accordingly, the aggregation of the forced outage rate and planned outage rate will not equate to the total outage rate.



The load factor for the year ended 31 December 2008 was 76.3% compared to 75.0% in 2007. The improvement arises from an increase in electrical output (net sales) to 25.4TWh in 2008 compared with 24.9TWh in 2007, with higher generation in 2008 in what have historically been low margin periods. Commodity market conditions through the Summer were such that it was profitable to generate these additional volumes, albeit at moderate margins.

Plant availability was approximately 86% for both years ended 31 December 2007 and 2008.

The planned outage rate achieved for the year ended 31 December 2008 was 8.9% compared to 8.1% in 2007. Our maintenance regime includes a major planned outage for each of our six units once every four years. Consequently, there is an irregular pattern to planned outages and associated expenditure, since in two of the four years two units will each undergo a major planned outage. Two major planned outages were completed in both 2007 and 2008.

The forced outage rate for the year ended 31 December 2008 was 5.8%, compared to 6.9% in 2007.

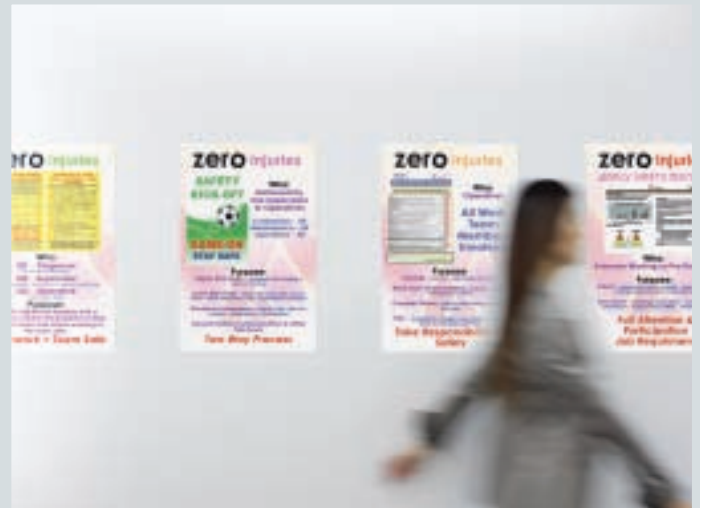
The Winter forced outage rate was 6.5% for the year ended 31 December 2008, compared to 4.2% in 2007.

**Health and safety**

Our lost time injury rate was 0.10 for the year ended 31 December 2008 compared to 0.34 in 2007. This continues to demonstrate that the safety programmes implemented in the last few years are becoming well entrenched and are delivering sound performance. Our safety record compares favourably with our sector peers and international benchmarks.

**Attaining leading performance in health and safety**

Our safety record continues to compare favourably with that of our sector peers and international benchmarks. Safety programmes are now becoming well entrenched and we are seeing the results through sound performance.



## Business review

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#### Liquidity and capital resources

Net debt was £235 million as at 31 December 2008 compared to £337 million at 31 December 2007. Cash and cash equivalents were £130 million as at 31 December 2008 compared to £60 million at 31 December 2007. An analysis of cash flows for both years is set out in the following table.

##### Analysis of cash flows

	Year ended 31 December 2008 £m	Year ended 31 December 2007 £m
Net cash generated from operating activities	<b>309.5</b>	312.8
Net cash used in investing activities	<b>(91.4)</b>	(67.8)
Net cash used in financing activities	<b>(147.6)</b>	(340.1)
Net increase/(decrease) in cash and cash equivalents	<b>70.5</b>	(95.1)

Net cash generated from operating activities was £310 million in the year ended 31 December 2008 compared to £313 million in 2007. The small decrease was a result of a reduction of £51 million in EBITDA, largely offset by lower working capital utilisation in 2008.

Net cash used in investing activities, which represented payments in respect of capital expenditure in both periods, was £91 million for the year ended 31 December 2008 compared to £68 million in 2007 (see Capital expenditure).

Net cash used in financing activities was £148 million in the year ended 31 December 2008 compared to £340 million in 2007. The 2008 amount includes equity dividends paid of £110 million, term loan repayments of £35 million, and purchases of our own shares to meet commitments under share-based incentive plans of £3 million. The 2007 amounts included equity dividends paid of £171 million and payments under a share buy-back programme of £84 million, together representing returns to shareholders totalling £255 million. Also included in 2007 were term loan repayments of £80 million, the final bridge loan repayment of £3 million, and purchases of our own shares to meet commitments under share-based incentive plans of £2 million.

The increase in cash and cash equivalents was therefore £71 million in the year ended 31 December 2008, compared to a decrease of £95 million in 2007. Drax's policy is to invest available cash in short-term bank, building society or other low risk deposits.



##### Investing in plant improvements

In addition to our major strategic investments, plant improvements have also been delivered through a suite of smaller projects. A focus on upgrades, process control and plant optimisation has brought efficiency, reliability and availability benefits, all strengthening the leadership position of Drax Power Station in the coal-fired generation sector.



**Turbine upgrade project**

The largest steam turbine modernisation project in the UK being undertaken at Drax Power Station is now just over one-third complete.

**Capital resources and refinancing**

Following scheduled repayments of £35 million during the year, senior secured debt was £370 million at 31 December 2008 (before deferred finance costs). Scheduled debt repayments are £65 million in each of 2009 and 2010, under an amortisation profile ending with a final repayment of £240 million on 31 December 2010.

Conditions in the debt markets have continued to be turbulent. We continue to monitor the situation, and will seek to achieve an optimal balance between refinancing risk and the cost of refinancing before maturity of the existing facilities.

We acknowledge recent guidance on going concern for companies preparing financial statements, in the light of recent volatility in financial markets which has created a general level of uncertainty. However, we have significant headroom on our existing facilities, and a reasonable expectation that these will be renewed when required. We also have a recent history of cash generation, strong covenant compliance, and good visibility in medium-term forecasts, due to our progressive hedging strategy.

We notified investors of a change in distribution policy when we announced our biomass growth strategy in October 2008 (see Distribution policy). At the same time, we also notified investors that any net refinancing proceeds will be used to fund our equity investment in the 900MW dedicated biomass-fired generation business we intend to develop with Siemens Project Ventures (see Biomass growth strategy).

**Seasonality of borrowing**

Our business is seasonal with higher electricity prices and despatch in the Winter period and lower despatch in the Summer months, when prices are lower and plant availability is affected by planned outages.

Accordingly, cash flow during the Summer months is materially reduced due to the combined effect of lower prices and output, while maintenance expenditures are increased during this period due to major planned outages. The Group's £100 million revolving credit facility assists in managing the cash low points in the cycle where required. The revolving credit facility was undrawn at 31 December 2008 and has a final maturity date of 15 December 2010.

**Capital expenditure**

In March 2008, we announced that we expected to incur total capital expenditure of approximately £250 million over the three years 2008 to 2010. Of this, around £150 million specifically related to the turbine upgrade project and investments in extending our biomass capability. The remainder comprised smaller value enhancing investments and other expected capital expenditure in support of current operations. Following fixed asset additions of £102 million in the year ended 31 December 2008 (£83 million in 2007), we remain on track to achieve this target. In addition, we expect to incur expenditure of around £20 million in 2009 in relation to our plans to develop the dedicated biomass-fired generation business (see Biomass growth strategy).

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In relation to the turbine upgrade project, we expect to invest up to £100 million over the five-year period from 2007 to 2011, including approximately £60 million over the three years 2008 to 2010, to upgrade the high pressure and low pressure turbine modules on all six generating units to improve efficiency. Using proven technology we expect to achieve an overall baseload efficiency (that is, the ratio of energy out to energy in when operating at full capacity) approaching 40%. This will represent a 5% improvement on current baseload efficiency of around 38%. When complete, the project is expected to deliver annual savings of one million tonnes of CO<sub>2</sub> emissions allowances and approximately half a million tonnes of coal.

During the two major planned outages of 2008 we successfully completed the upgrade of the high and low pressure turbines on two of our six generating units. Together these units are now delivering the 5% efficiency improvement target. Translated into carbon savings this means that, from the third quarter of 2008, two of our generating units have been operating at an overall efficiency that will save one-third of a million tonnes of CO<sub>2</sub> emissions allowances each year.

With regard to extending our biomass capability, we expect to invest around £80 million to develop a 400MW direct injection co-firing biomass facility. We will extend our direct-injection capability from one generating unit to all six generating units, and install the necessary processing and handling infrastructure to enable us to handle an additional one and a half million tonnes of biomass material per annum. Delivery of the 400MW facility is expected to result in savings of over two million tonnes of CO<sub>2</sub> emissions allowances, the displacement of approximately one million tonnes of coal and the generation of in excess of one and a quarter million ROCs per annum.

We have made good progress in advancing the project. Early in 2008, planning permission was received to construct biomass handling, processing and co-firing facilities on the Drax Power Station site. During the year, contracts were awarded to Alstom Power Limited for the construction and installation of the main processing works associated with the co-firing facility, and to Doosan Babcock Energy Limited for the supply and installation of direct injection biomass co-firing systems to all six generating units.

We anticipate commissioning phase one of the project towards the end of 2009, with achievement of the full 400MW capacity around the middle of 2010.

We have also developed our biomass procurement strategy, and identified attractive biomass supplies which greatly exceed the requirements of the new 400MW direct-injection co-firing facility. Confidence in our fuel supplies will allow us to operate the new co-firing facilities alongside our existing, through the mill delivery, co-firing capacity of 100MW. This will provide us with a total co-firing capacity of 500MW when the new 400MW direct-injection project is fully commissioned.

As part of our development of biomass supply sources, we are also in the process of constructing a pilot project for the production of pellets from locally sourced straw.

A pellet plant is being constructed in Goole, approximately three miles from the Drax site. The plant will take straw from the local area and produce around 100,000 tonnes of straw pellets annually, to be brought to Drax for combustion in the co-firing facility. If successful, similar pellet plants could be developed in other, local cereal growing regions.

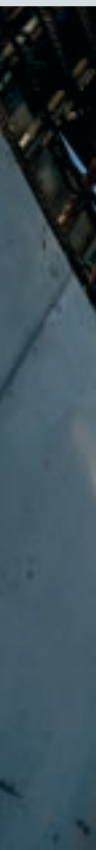
We firmly believe in procuring biomass from sustainable sources and to this end we have established a sustainable sourcing policy framework.

We will also continue to evaluate other investment opportunities which may result in additional capital expenditure. Further investment will be required beyond 2009 and prior to 2016 to meet the requirements of the LCPD.

#### Biomass growth strategy

Under a Joint Development Agreement with Siemens Project Ventures, we intend to build, own and operate three 300MW dedicated biomass-fired power plants in the UK.

We expect each plant to be funded with a debt/equity mix, and we are targeting 60% non-recourse project finance debt. Under the terms of the Joint Development Agreement, the intended ownership will be split 60% Drax and 40% Siemens Project Ventures.





**Biomass handling and processing**

Construction of the main biomass handling and processing works at Drax Power Station is now well underway. The facility will deliver processed biomass material to the direct injection co-firing systems of all six generating units.

Drax will manage and operate the biomass businesses, and will also be responsible for all biomass procurement and trading. It is proposed that the plants will use Siemens' turbine technology.

Current estimates of the total capital cost of this business are around £2 billion, including investments in ancillary biomass logistics and processing facilities. Construction of the first plant is targeted to commence in late 2010, following execution of the construction and financing contracts and agreed capital commitment, with the first plant expected to be operational in 2014.

We are now in the advanced feasibility stage of developing and planning but we will only commit to investment once it can be plainly demonstrated that we will secure attractive returns. Whilst no commitments to construction contracts or financing have been made to date, we expect to finalise these arrangements by the second half of 2010. We expect to incur expenditure of around £20 million in 2009 in developing this business.

Since we made the announcement in October 2008, we have made good progress. We now have five site options under review. We expect to accept a grid connection date shortly for the Drax site (October 2012) and have already accepted a connection date for the Immingham site (October 2014).

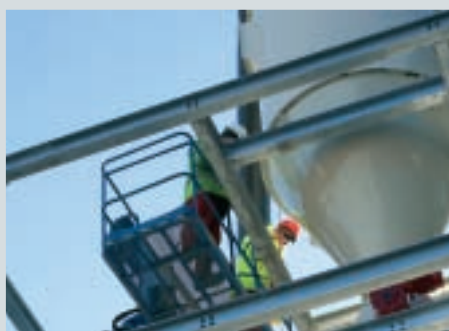
We have also moved forward on the engineering design, with our strategic partner, Siemens Project Ventures.

We believe that the long-term investment case for this business remains strong, particularly in the light of the UK's need for reliable renewable generation capacity by 2020.



**Straw pellet plant**

The straw pellet plant development at Goole, some three miles from Drax Power Station, is rapidly taking shape. With commercial operation due to commence in the first half of 2009, the plant will produce 100,000 tonnes of straw pellets a year for co-firing alongside our coal.



## Business review

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#### Principal risks and uncertainties

We manage the commercial and operational risks faced by the Group in accordance with policies approved by the Board.

##### Regulatory market risk

The UK Government and other relevant regulatory bodies have significantly changed the applicable regulatory regimes in Great Britain over the past few years, in an attempt to improve market information and transparency, enhance competition and liquidity, reduce the likelihood of market abuse and implement new EU legislation. In particular, new UK and EU legislation applicable to our sector continues to target reductions in emissions. We are exposed to further regulatory developments, which may favour other types of fuel or sources of power, and which could result in additional costs or lower output levels and reduce our profitability.

##### Plant operating risk

Extended forced outages or prolonged planned outages could have a significant adverse effect on our revenue and profitability. We may also incur additional costs in recovering from these outages, and penalties if we cannot fulfil our contractual obligations.

Forced outages may be caused by the underperformance or outright failure of our power generation plant, or other equipment and components including the information technology systems used to operate the plant or conduct trading activities. The duration of forced outages is influenced by the lead time to manufacture and procure replacement components and to carry out repairs. Although we always try to optimise our holding of spare components for use in the event of plant failure, we may not always have ready access to the relevant replacement parts.

##### Environmental and health and safety risks

The EU, UK and local environmental and health and safety laws and regulations which affect the power station are complex, frequently changing and are becoming ever more stringent. They cover many aspects of our operations, including limits on emissions of particulate, SO<sub>x</sub> and NO<sub>x</sub>, discharges to air and water, noise emissions, soil/groundwater contamination, waste and health and safety standards.

Changes in these laws and regulations may cause increased compliance costs, the need for additional capital expenditure and could affect output levels. Whilst we have robust systems in place to support and monitor compliance with these regulations, failure to do so could result in fines or penalties, civil or criminal liability, or even the limitation or suspension of operations.

##### Electricity market liquidity risk

Liquidity in the market for wholesale electricity is dependent on there being a sufficient number of counterparties willing to trade actively. Changes in the market structure or consolidation of the existing generation and supply businesses in the UK could result in a reduction in the number of active participants in the market with whom we are able to trade.

If we are not able to rely on wholesale market trading as a means of hedging our short to medium-term exposure to electricity prices, it may affect our ability to sell all of our output and/or the prices at which we sell it. As a result we could suffer reduced revenues and incur higher costs to achieve our trading objectives.

##### Refinancing risk

Recent volatility in financial markets has created a general level of uncertainty and increased refinancing risk.

Our senior secured debt matures under an amortisation profile ending on 31 December 2010. We have significant headroom under our existing facilities, and a reasonable expectation that these will be renewed when required.

##### Commodity risk

We are exposed to the effect of fluctuations in commodity prices, particularly the price of electricity, the price of coal (and other fuels) and the price of CO<sub>2</sub> emissions allowances. Price variations and market cycles have historically influenced our financial results and are expected to continue to do so.

Our policy is to make forward power sales with corresponding purchases of fuel and CO<sub>2</sub> emissions allowances when profitable to do so. We purchase coal under either fixed or variable priced contracts with different maturities from a variety of domestic and international sources. We purchase CO<sub>2</sub> emissions allowances under fixed price contracts with different maturity dates from a variety of domestic and international sources.

##### Counterparty risk

As we rely on third-party suppliers for the delivery of coal and other goods and services, we are exposed to the risk of non-performance by these third-party suppliers.

We purchase a significant portion of our coal requirement under contracts with a number of UK suppliers. There is a risk that if a large supplier falls into financial difficulty and/or fails to deliver against the contracts, there would be additional costs associated with securing coal from other suppliers.

We enter into fixed price and fixed margin contracts for the sale of electricity to a number of counterparties. The failure of one or more of these counterparties to perform their contractual obligations may cause us financial distress or increase our risk profile.

The investment of surplus cash is undertaken to maximise the return within Board approved policies. These policies set out minimum rating requirements, maximum investment with any one counterparty and the maturity profile.

##### Interest rate risk

We are exposed to interest rate risk principally in relation to our outstanding bank debt. In particular, we are exposed to changes in the LIBOR interest rate of sterling denominated debt, as all of our debt is both denominated in sterling and has a variable LIBOR rate. We mitigate this risk with interest rate hedges on a proportion of our debt facilities.

##### Foreign currency risk

Foreign currency exchange contracts are entered into to hedge substantially all of our fixed price international coal purchases in US dollars, and our CO<sub>2</sub> emissions allowances purchases in euros.

### Tax risk

Under the Group's previous financing structure, Drax Holdings Limited (a subsidiary company) was partially funded by a Eurobond payable to another group company. The whole of the coupon was previously prepaid, and an accounting based tax deduction has been claimed for the corresponding interest charged in the Drax Holdings Limited income statement each year. Were HMRC to successfully challenge the deductions claimed in respect of the Eurobond coupons for open years to 31 December 2008, it is estimated that the additional tax liability would be up to £90 million, together with interest and penalties.

In November/December 2008, HMRC issued draft legislation concerning the "Principles based approach to financial products avoidance" and the "Taxation of foreign profits of companies". These provisions updated rules on, amongst other things, the tax deductibility of interest and were generally expected to reduce the tax effectiveness of the Eurobond financing arrangements.

Following consultation with leading tax counsel and after taking professional advice, we decided to unwind the Eurobond financing arrangements. The Eurobond was formally waived by the lending group company on 30 December 2008. As a result the whole of the remaining prepaid coupon was charged in the Drax Holdings Limited income statement giving rise to potential additional interest deductions with a tax effect of around £220 million. Because of the risks related to the unwind of the Eurobond structure, no benefit will be recognised in the Group's financial statements with respect to the potential additional deductions until we are more certain they will be realised.

### Closing cash position guidance

We issued a Pre-close Trading Update on 16 December 2008 in which we reported management's expectation that the cash position as at 31 December 2008 would be in the range of £125 million to £130 million. The reported cash position as at 31 December 2008 was £130 million.

### Positions under contract for 2009, 2010 and 2011

We continue to follow our stated trading strategy of making steady forward power sales with corresponding purchases of CO<sub>2</sub> emissions allowances and fuel purchases. Our aim is to deliver market level or better dark green spreads across all traded market periods and, as part of this strategy, we retain power to be sold into the prompt (within season) power markets.

As at 20 February 2009, the positions under contract for 2009, 2010 and 2011 were as follows:

	2009	2010	2011
Power sales (TWh) comprising:	20.7	17.3	10.3
- Fixed price power sales (TWh) at an average achieved price (per MWh)	16.2 at £51.0	11.2 at £56.6	4.6 at £62.6
- Fixed margin and structured power sales (TWh)	4.5	6.1	5.7
CO <sub>2</sub> emissions allowances hedged, including UK NAP allocation, market purchases, structured contracts, and benefit of biomass co-firing (TWh equivalent)	20.5	17.5	18.0
Solid fuel at fixed price/hedged, including structured contracts (TWh equivalent)	22.1	15.2	9.8

Fixed price power sales include approximately 0.7TWh supplied to Centrica in the period 1 January 2009 to 20 February 2009 under the five-and-a-quarter year baseload contract with Centrica which commenced on 1 October 2007.

Fixed margin power sales include approximately 4.5TWh in 2009 and 5.3TWh in each of 2010 and 2011 in connection with the contract.

Under this contract we will supply power on terms which include Centrica paying for coal, based on international coal prices, and delivering matching CO<sub>2</sub> emissions allowances amounting to approximately 4.8 million tonnes per annum. The contract provides Drax with a series of fixed dark green spreads which were agreed in the first quarter of 2006.

### Distributions

#### Distribution policy

We notified investors of a change to our distribution policy when we announced our biomass growth strategy in October 2008. With respect to 2008 and 2009, the Company will distribute all excess cash generated from operations after meeting business requirements in each year. For 2010 and beyond, we will target a pay-out ratio of 50% of underlying earnings (being profit attributable to equity shareholders adjusted to exclude the impact of unrealised gains and losses on derivative contracts) in each year.

#### Dividends paid

On 3 March 2008, the Board resolved, subject to approval by shareholders at the Annual General Meeting on 17 April 2008, to pay a final dividend for the year ended 31 December 2007 of 9.9 pence per share (£34 million). Also on 3 March 2008, the Board resolved to pay a further interim dividend for the year ended 31 December 2007 (payable as a special dividend) of 7.8 pence per share (£27 million). The final and special dividends were subsequently paid on 7 May 2008.

On 4 August 2008, the Board resolved to pay an interim dividend for the six months ended 30 June 2008 of 5.0 pence per share (£17 million). Also on 4 August 2008, the Board resolved to pay a further interim dividend (payable as a special dividend) of 9.7 pence per share (£33 million). The interim and special dividends were subsequently paid on 8 October 2008.

#### Dividends proposed

At the forthcoming Annual General Meeting the Board will recommend to shareholders that a resolution is passed to approve payment of a final dividend for the year ended 31 December 2008 of 38.3 pence per share (£130 million) payable on or before 22 May 2009. Shares will be marked ex-dividend on 6 May 2009.

This Business and financial review was approved by the Board on 2 March 2009.

Tony Quinlan  
Finance Director  
2 March 2009

