
Business review

Chief Executive's statement

The year has been characterised by extreme movements in commodity market prices, making for uncertain times. However, the market fundamentals for generators have remained strong amidst a variety of generation capacity issues, and this has allowed Drax to demonstrate the strength of its strategic role within the UK power generation sector.



Introduction

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 narrowing dark green spreads, as plant was returned to service and fears of a capacity shortfall were allayed, together with reduced peak electricity demand, reflecting the economic climate.

We advised shareholders in October 2008 of the significant attractive long-term opportunities from embarking on a growth strategy. The projected shortfall in UK generating capacity in the coming years and the UK's commitment to a challenging renewable energy target provide a real opportunity to exploit the core competencies of the Drax business and leverage existing business relationships to transform Drax into a multi-site, multi-fuel business that should yield value-enhancing returns for our investors.

An opportunity for growth

For the last few years we have had a clear focus on carbon abatement, firmly believing that we have a significant part to play in the UK's transition to a low carbon economy. In pursuing carbon abatement we have always maintained that, whilst there may be new technologies on the horizon, our role is to deliver valuable carbon reductions here and now and, importantly, continue to deliver reliable and secure supplies of electricity.

Our efforts to move along this path started at Drax Power Station. We already enjoy an environmental leadership position in the coal-fired generation sector, and we are determined to strengthen that position through targeted investment. Our two key strategic investments, upgrading all our high and low pressure turbines and building a 500MW co-firing capability at the power station, have put us on the path to reducing significantly our carbon footprint, and have opened up new opportunities for the future of our business.

Our decision in 2008 to develop a 900MW dedicated biomass-fired generation business with Siemens Project Ventures GmbH ("Siemens Project Ventures") builds on the competence and focus that have been developed at Drax over recent years. In addition, through this strategic partnership, we are able to further the excellent working relationship that we already enjoy with one of the principal manufacturers in the market.

Under a Joint Development Agreement with Siemens Project Ventures, together we intend to build, own and operate three 300MW dedicated biomass-fired generation plants in the UK. Once operational, almost one-third of the generation capacity under Drax's management, some 1,400MW, would come from renewable sources. These sources will be both reliable and sustainable, and will power a generation technology that has the availability and reliability similar to that of coal. On current estimates, Drax would be responsible for around 15% of the UK's renewable electricity, equivalent to the output of some 2,000 wind turbines, and for producing around 10% of the UK's total electricity, enough to power around seven million homes.

We believe our strategy will provide a diversified and sustainable business growth path and deliver value with a clear focus on return on investment. Given the outlook for the UK power generation market and the incentives to invest in renewable generation, we firmly believe this strategy is right. We are now in the advanced feasibility stage of developing and planning, but we have been clear to our investors that we will only commit to investment once it can be plainly demonstrated that we will secure attractive returns.

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Investing in growth

We intend to finance expansion of the business through a combination of new debt and cash generated from operations, and this required a change to our distribution policy. We notified investors of this change when we announced our growth strategy in October 2008. With respect to earnings in 2008 and 2009, the Company will distribute all excess cash generated from operations after meeting business requirements in each year. For 2010 and beyond, Drax will target a pay-out ratio of 50% of underlying earnings adjusted for non-cash accounting items (principally unrealised gains and losses on derivative contracts) in each year.

Our current debt levels are modest and our debt matures in December 2010. Any net refinancing proceeds will be used to fund Drax's equity investment in the new biomass business. We remain confident that financing will be available as we approach financial close for the first plant.

The core business

The Drax Power Station asset remains central to the business and we are continuing the recent trend of investing in the core business to prepare ourselves for the future. We intend to maintain our competitive edge and in so doing we are continually assessing future challenges and milestones whilst mindful of the need to deliver shareholder value.

Our long-term strategic plan for the core business develops the case for investment to 2020 and beyond. Environmental constraints represent the key challenge to the future of Drax Power Station and we are considering how best commercially to address these constraints with the options that are available to us under probable future legislation emanating from the EU.

Our successes to date make us well placed to continue to operate with high availability and reliability for many years to come. Our plant has been both well maintained and enhanced in terms of efficiency and environmental performance improvements over recent years.

During the year, we demonstrated our competence in both project execution and biomass procurement; both vital skills that are necessary as we grow the business. Our turbine upgrade project is now just over one-third complete. Following the fast-track upgrade of one high pressure turbine in 2007, we upgraded the high and low pressure turbines of two of our six generating units during the major planned outages of 2008. I am pleased to report that together these units are delivering their expected 5% efficiency improvement. 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 carbon dioxide ("CO₂") each year.

Great strides were made in advancing our biomass co-firing 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.

Having successfully identified sources of biomass in excess of the requirements for our new 400MW direct injection facility, now we will be able to run it alongside our existing capability. This means that from mid-2010 we will have a total co-firing capacity of 500MW which will produce the equivalent output of over 600 wind turbines. The biomass co-firing facility will be the largest in the world, and will reduce Drax Power Station's emissions of CO₂ by over two and a half million tonnes a year.

Together our completed turbine upgrade and biomass co-firing projects will save over three and a half million tonnes of CO₂ emissions each year, amounting to a saving of up to 17.5% on historic levels.

In addition to these two strategic projects, we have successfully executed a suite of smaller projects specifically targeting efficiency and environmental performance improvements. Control instrumentation and emission reduction technologies are amongst the measures implemented, together allowing optimal and reliable operation of the plant.

Delivering on our core competencies:

Trading

Our trading strategy is to progressively hedge our output whilst targeting market or better dark green spreads and retaining balanced market exposure. We sell approximately one-third of our power in the near-term markets and the remaining two-thirds in the forward markets.



Read more: Pages 15 and 16

Operations

Once again we delivered a strong performance in plant reliability and availability, ranking us highly amongst our sector peers. Two major planned outages were carried out in 2008, along with an increased amount of project work. As a result, we saw a significant increase in the man-hours worked, particularly by contractors. Despite this our safety record was commendable.



Read more: Pages 17 and 31

Project execution

Our two major strategic carbon abatement projects made real progress during 2008. Our £100 million turbine upgrade project is now just over one-third complete and delivering to expectations. Our biomass co-firing project is taking shape and is on track to deliver significant CO₂ savings from mid-2010.



Read more: Pages 20 and 26

Biomass procurement

During 2008, we made excellent progress in delivering our biomass procurement strategy. The identification of attractive supplies of biomass has enabled us to increase our target co-firing capacity to 500MW, equating to 12.5% of our output. A key achievement of the year was the establishment of our sustainability policy for procuring biomass.



Read more: Pages 20 and 27

Looking ahead

For 2009 and beyond, we are continuing to see narrow dark green spreads compared to those in 2008, driven principally by falling forward gas prices compared to those of coal, but also by the effects of foreign currency exchange rates, with sterling depreciating against both the US dollar and the euro.

Although we have seen demand reduction in the short term, all the analysis we have conducted continues to reinforce our view that the electricity market will provide increasing returns to available capacity as the retirement of some of the older power stations on the system reduce the generation capacity margin. This should put upward pressure on spreads.

As a country we need to develop available and sustainable forms of renewable generation if we are to achieve the 2020 UK target of 15% renewable energy. Biomass has been identified as a key growth area for attaining this target and the proposed regulatory regime incentivises the uptake of this technology.

Both these aspects will be positive for the business and we firmly believe that we are in a position to take advantage of this opportunity and secure value for our shareholders.

Dorothy Thompson
Chief Executive
2 March 2009