

## Notes to the consolidated financial statements

### 1. General information

Drax Group plc (the "Company") is a company incorporated in England and Wales under the Companies Act 1985. The Company and its subsidiaries (together the "Group") operate in the electricity generation industry within the UK. The address of the Company's registered office and principal establishment is Drax Power Station, Selby, North Yorkshire YO8 8PH, United Kingdom. The operating companies of the Group are disclosed in note 3 of the Company's separate financial statements, which follow these consolidated financial statements.

### 2. Basis of preparation

The financial statements have been prepared in accordance with "IFRSs". The financial statements have also been prepared in accordance with IFRSs adopted by the European Union and therefore the consolidated financial statements comply with Article 4 of the EU IAS Regulations.

The financial statements have been prepared on the basis of a going concern, as set out in the Directors' report on page 38 and after considering the Group's capital resources as described on page 19.

The financial statements have been prepared under the historical cost basis, except for certain financial assets and liabilities that have been measured at fair value.

#### Adoption of new and revised accounting standards

At the date of authorisation of these financial statements, the following standards and relevant interpretations, which have not been applied in these financial statements, were in issue but not yet effective (and some of which were pending endorsement by the EU).

- IFRS 8 "Operating segments" - effective for accounting periods beginning on or after 1 January 2009
- IAS 23 "Borrowing costs" - effective for costs incurred from 1 January 2009
- IFRS 3 "Business combinations" - revision effective for accounting periods beginning on or after 1 July 2009
- IFRS 2 "Share-based payment" - revision effective for accounting periods beginning on or after 1 January 2009
- IFRIC 18 "Transfers of assets from customers" - effective for accounting periods beginning on or after 1 July 2009
- IAS 1 "Presentation of financial statements" - revision effective for accounting periods beginning on or after 1 January 2009
- IAS 27 "Consolidated and separate financial statements - cost of an investment in a subsidiary, jointly controlled entity or associate" - revision effective for accounting periods beginning on or after 1 July 2009
- IAS 39 "Financial instruments: recognition and measurement - eligible hedged items" - revision applies retrospectively for accounting periods beginning on or after 1 July 2009.

With the exception of IAS 23 "Borrowing costs", the adoption of these standards in future periods will have no material impact on the financial statements of the Group. IAS 23 is expected to impact the treatment of any borrowing costs incurred on the construction of any new plant, with such costs being capitalised as part of the construction cost.

### 3. Summary of significant accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below. These policies have been consistently applied to both years presented, unless otherwise stated.

#### (A) Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and entities controlled by the Company made up to the reporting date each year. Control is achieved where the Company has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities.

All intra-Group transactions, balances, income and expenses are eliminated on consolidation.

#### (B) Critical accounting judgements, estimates and assumptions

The preparation of financial statements in conformity with IFRSs requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's reasonable knowledge of the amount, event or actions, actual results ultimately may differ from those estimates. The critical accounting judgements, estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

**Fixed assets and depreciation** - Estimated useful lives and residual values are reviewed annually, taking into account prices prevailing at each balance sheet date. The carrying values of fixed assets are also reviewed for impairment where there has been a trigger event (that is, an event which may have resulted in impairment) by assessing the present value of estimated future cash flows and net realisable value compared with net book value. The calculation of estimated future cash flows and residual values is based on the directors' reasonable estimates of future prices, output and costs, and is, therefore, subjective.

## Notes to the consolidated financial statements

### 3. Summary of significant accounting policies (continued)

**Pensions** - The Group operates an approved defined benefit scheme. The cost of providing benefits is determined using the projected unit credit method and actuarial valuations of the plan assets and liabilities are carried out as at the balance sheet date. Inherent in these valuations are key assumptions, including discount rates, expected returns on scheme assets, salary and pension increases, and mortality rates.

These actuarial assumptions are reviewed annually and modified as appropriate. The Group believes that the assumptions utilised in recording obligations under the scheme are reasonable based on prior experience, market conditions and the advice of scheme actuaries. However, actual results may differ from such assumptions.

**Taxation** - In accounting for taxation the Group makes assumptions regarding the treatment of items of income and expenditure for tax purposes. The Group believes that these assumptions are reasonable based on prior experience and consultation with advisers.

Full provision is made for deferred taxation at the rates of tax prevailing at the period end dates unless future rates have been substantively enacted. Deferred tax assets are recognised where it is considered more likely than not that they will be recovered.

**Derivatives** - Derivative financial instruments are stated in the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in earnings unless specific hedge accounting criteria are met. The fair values of derivative instruments for commodities are determined using forward price curves. Forward price curves represent the Group's estimates of the prices at which a buyer or seller could contract today for delivery or settlement of a commodity at future dates. The Group generally bases forward price curves upon readily obtainable market price quotations, as the Group's commodity contracts do not generally extend beyond the actively traded portion of these curves. However, the forward price curves used are only an estimate of how future prices will move and are, therefore, subjective.

#### (C) Revenue recognition

Revenue represents amounts receivable for goods or services provided in the normal course of business, net of trade discounts, VAT and other sales-related taxes, and excluding transactions with or between subsidiaries.

Revenues from the sale of electricity are recorded based upon output delivered at rates specified under contract terms or prevailing market rates as applicable.

Revenues from sales of Renewables Obligation Certificates ("ROCs") are recorded at the invoiced value, net of VAT. Revenue is recognised when the risks and rewards of ownership have been transferred to a third party.

Where goods or services are exchanged for goods or services of a similar nature and value, the exchange is not treated as giving rise to revenue. Where goods or services are exchanged for goods or services of a dissimilar nature, the exchange is treated as giving rise to revenue. The revenue is measured at the fair value of goods or services received, adjusted by the amount of any cash or cash equivalents received or paid. If the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents received or paid.

#### (D) Segmental reporting

Turnover comprises primarily sales of electricity generated by the Group to the electricity wholesale market in Great Britain. As such, the Group has only one business segment and one geographical segment.

#### (E) Property, plant and equipment

Property, plant and equipment are initially measured at cost. Cost comprises the purchase price (after deducting trade discounts and rebates), any directly attributable costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, and the estimate of the present value of the costs of dismantling and removing the item and restoring the site. Property, plant and equipment are stated at cost less accumulated depreciation and any provision for impairment in value. Freehold land and assets in the course of construction are not depreciated.

Depreciation is provided on a straight-line basis to write-down assets to their residual value evenly over the estimated useful lives of the assets from the date of acquisition (limited to the expected decommissioning date of the power station). The estimated useful lives, beginning in 2004 when they were reset, are currently:

	Years
Main generating plant and freehold buildings	35
Other plant and machinery	4-20
Decommissioning asset	35
Plant spare parts	35

Estimated useful lives and residual values are reviewed annually, taking into account commercial and technological obsolescence as well as normal wear and tear, and any provision for impairment. Residual values are based on prices prevailing at each balance sheet date.

Costs relating to major inspections, overhauls and upgrades to the power station are included in the asset's carrying amount or recognised as a separate asset, as appropriate, if the recognition criteria are met; namely, when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are expensed as incurred.

**(F) Impairment of property, plant and equipment**

At each balance sheet date the Group reviews its property, plant and equipment to determine whether there is any indication that these assets may have suffered an impairment loss. If such an indication exists, the recoverable amount is assessed by reference to the net present value of expected future cash flows of the asset (value-in-use). If an asset is impaired, a provision is made to reduce its carrying amount to the estimated recoverable amount. The discount rate applied is a pre-tax rate based upon the Group's weighted average cost of capital and reflects the current market assessment of the time value of money and the risks specific to the business.

**(G) Decommissioning costs**

Provision is made for the estimated decommissioning costs at the end of the useful economic life of the Group's generating assets, when a legal or constructive obligation arises, on a discounted basis. The amount provided represents the present value of the expected costs. An amount equivalent to the discounted provision is capitalised within tangible fixed assets and is depreciated over the useful lives of the related assets. The unwinding of the discount is included in interest payable and similar charges.

**(H) Inventories**

Inventories primarily comprise coal stocks, together with other fuels and consumables. Coal stocks are valued at the lower of the weighted average cost of coal and net realisable value. Other stocks of fuel and consumables are valued at the lower of average cost and net realisable value.

The Group is able to claim ROCs from the Office of Gas and Electricity Markets ("OFGEM") as a result of burning renewable fuels. A market exists for sale of ROCs and the Group recognises income in the income statement at the point where the risks and rewards of ownership have been transferred to a third party. The attributable incremental cost of generating ROCs above that of burning coal is included within inventory in respect of ROCs earned but not yet sold. The inventory value is stated at the lower of cost and net realisable value.

**(I) CO<sub>2</sub> emissions allowances**

The Group recognises its free emissions allowances received under the National Allocation Plan at nil cost. Any additional allowances purchased in the market are recorded at cost. The Group also recognises a liability in respect of its obligations to deliver emissions allowances. The charge to the income statement within fuel costs and the related liability is measured based on an estimate of the amounts that will be required to satisfy the net obligation, taking into account generation, free allowances allocated under the National Allocation Plan, market purchases, sales and forward contracts already in place, and the market price at the year end.

**(J) Taxation**

Current tax is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax payable or recoverable on the difference between the carrying amounts of assets and liabilities in the balance sheet and the corresponding tax bases used in the computation of taxable profits. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is considered more likely than not that taxable profit will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated at the tax rates that are expected to apply in the period in which the liability is settled or the asset is realised, and is charged or credited in the income statement, except where it relates to items charged or credited to equity via the statement of recognised income and expense, in which case the deferred tax is also dealt with in equity and is shown in the statement of recognised income and expense.

**(K) Pension and other post-retirement benefits**

The Group provides pensions through an approved industry defined benefit scheme and a defined contribution scheme. The cost of providing benefits under the defined benefit scheme is determined using the projected unit credit method, and actuarial valuations of the plan assets and liabilities are carried out as at the balance sheet date. Actuarial gains and losses are taken to the statement of recognised income and expense as incurred.

The current service cost and finance cost of the pension charge are deducted in arriving at operating profit. The excess of the present value of the defined benefit obligation over the fair value of the plan assets is recognised as a liability in the balance sheet.

For the defined contribution scheme, the Group pays contributions to publicly or privately administered pension insurance plans on a mandatory, contractual or voluntary basis. The Group has no further payment obligations once the contributions have been paid. The contributions are recognised as employee benefit expense when they are due to be paid.

**(L) Share-based payments**

Share-based payments are measured at fair value at the date of grant and expensed on a straight-line basis over the relevant vesting period, based on an estimate of the shares that will ultimately vest.

**(M) Foreign currencies**

The Group's consolidated financial statements are presented in sterling, which is the functional and presentational currency of the Company and its principal subsidiaries. Transactions in foreign currencies are translated into sterling at the exchange rate ruling at the date of transaction. Foreign exchange gains and losses resulting from the settlement of such transactions, and from the translation at the exchange rate ruling at the balance sheet date of monetary assets and liabilities denominated in foreign currencies, are recognised in the income statement.

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## Notes to the consolidated financial statements

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### 3. Summary of significant accounting policies (continued)

#### (N) Financial instruments

##### Debt instruments

The Group measures all debt instruments, whether financial assets or financial liabilities, initially at the fair value of the consideration paid or received. Subsequent to initial measurement, debt instruments are measured at amortised cost using the effective interest method. Transaction costs (any such costs incremental and directly attributable to the issue of the financial instrument) are included in the calculation of the effective interest rate and are, in effect, amortised through the income statement over the life of the instrument.

##### Commodity contracts and treasury derivatives

Where possible, the Group takes the own use exemption for commodity contracts entered into and held for the purpose of the Group's own purchase, sale or usage requirements. Commodity contracts which do not qualify for the own use exemption are dealt with as derivatives and are recorded at fair value in the balance sheet with changes in fair value reflected through the hedge reserve to the extent that contracts are considered to be effective hedges, or the income statement to the extent the contracts are not effective as hedges.

The Group uses a number of treasury-related derivatives to manage exposure to interest rate and currency fluctuations. Treasury-related derivatives are recorded at fair value in the balance sheet with changes in fair value reflected through the hedge reserve to the extent that contracts are considered to be effective hedges, or the income statement to the extent the contracts are not effective as hedges. Income statement movements under interest rate hedges are accounted for as adjustments to finance cost/income for the period.

The Group designates certain hedging instruments used to address commodity price risk, foreign currency risk and interest rate risk as cash flow hedges. At the inception of the hedge, the relationship between the hedging instrument and hedged item is documented, along with its risk management objectives. Furthermore, at the inception of the hedge and on an ongoing basis, the Group documents whether the hedging instruments used in hedging transactions are highly effective in offsetting changes in cash flows of hedged items.

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are deferred in equity. The gain or loss relating to any ineffective portion is recognised immediately in profit or loss. Amounts deferred in equity are released in the periods when the hedged item is recognised in profit or loss.

The fair value of hedging derivatives is classified as a non-current asset or non-current liability if the remaining maturity of the hedge relationship is more than 12 months, and as a current asset or liability if the remaining maturity of the hedge relationship is less than 12 months. Derivatives not designated into an effective hedge relationship are classified as a current asset or current liability.

##### Other financial instruments

Share capital - Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares or options are shown in equity as a deduction, net of tax, from the proceeds. The share premium account records the difference between the nominal value of shares issued and the fair value of the consideration received.

Cash and cash equivalents - Cash and cash equivalents includes cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less, and bank overdrafts.

Trade receivables - Trade receivables are recognised initially at fair value. A provision for impairment of trade receivables is established subsequently where there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivable.

## 4. Exceptional operating income

	Years ended 31 December	
	2008 £m	2007 £m
Distributions under the TXU Claim	-	6.2

The Group received £6.2 million under the TXU Claim in April 2007, bringing the total received to £336 million, representing full recovery of the claim. This amount is net of VAT and costs, and all proceeds were used to prepay debt secured against the claim, which was repaid in full.

## 5. Operating profit

	Years ended 31 December	
	2008 £m	2007 £m
<b>The following charges have been included in arriving at operating profit:</b>		
Staff costs (note 27)	51.1	42.9
Depreciation of property, plant and equipment (all owned assets)	46.2	43.7
Repairs and maintenance expenditure on property, plant and equipment	56.3	50.4
Other operating expenses	121.2	102.4
<b>Total other operating expenses excluding exceptional items</b>	<b>274.8</b>	<b>239.4</b>

### Auditors' remuneration

During the year the Group obtained the following services from its auditors, Deloitte LLP, at costs as detailed below:

	Years ended 31 December	
	2008 £000	2007 £000
<b>Audit fees:</b>		
Fees payable for the audit of the Group's consolidated financial statements	261	272
Fees payable for the audit of the Company's subsidiaries pursuant to legislation	10	10
	<b>271</b>	<b>282</b>
<b>Other services:</b>		
Pursuant to legislation - interim review	59	55
<b>Total audit related fees</b>	<b>330</b>	<b>337</b>
Taxation services	-	195
Other services	8	66
<b>Total non-audit fees</b>	<b>8</b>	<b>261</b>
<b>Total auditors' remuneration</b>	<b>338</b>	<b>598</b>

In addition to the amounts set out above, the Drax Power Group of the Electricity Supply Pension Scheme paid fees of £190,000 (2007: £150,000) to Deloitte LLP in respect of pension advisory services.

## Notes to the consolidated financial statements

## 6. Finance costs

	Years ended 31 December	
	2008 £m	2007 £m
<b>Interest payable and similar charges:</b>		
Interest payable on bank borrowings	(25.8)	(30.7)
Amortisation of deferred finance costs	(3.0)	(3.6)
<b>Total interest payable and similar charges</b>	<b>(28.8)</b>	<b>(34.3)</b>
<b>Interest receivable:</b>		
Interest income on bank deposits	7.2	11.4
<b>Total interest receivable</b>	<b>7.2</b>	<b>11.4</b>

## 7. Taxation

The income tax expense reflects the estimated effective tax rate on profit before taxation for the Group for the year ended 31 December 2008 and the movement in the deferred tax balance in the year, so far as it relates to items recognised in the income statement.

The Finance Act 2007 introduced a reduction in the rate of UK corporation tax from 30% to 28% with effect from 1 April 2008, and accordingly the tax charge for the year ended 31 December 2007 included a credit of approximately £18 million to reflect the impact on deferred tax.

The Finance Act 2008 introduced the withdrawal of industrial buildings allowances, and accordingly tax for 2008 includes an additional deferred tax charge of £9 million to reflect the estimated impact of loss of tax base in April 2011.

	Years ended 31 December	
	2008 £m	2007 £m
<b>Tax charge comprises:</b>		
Current tax	81.2	112.2
Deferred tax:		
- Before impact of changes in tax legislation	19.6	1.2
- Impact of withdrawal of industrial buildings allowances	8.8	-
- Impact of reduction in tax rate	-	(17.9)
<b>Tax charge</b>	<b>109.6</b>	<b>95.5</b>

	Years ended 31 December	
	2008 £m	2007 £m
<b>Tax on items charged/(credited) to equity:</b>		
Deferred tax on actuarial losses on defined benefit pension scheme	(3.6)	(0.9)
Impact of reduction in tax rate on deferred tax on defined benefit pension scheme	-	0.4
Deferred tax on cash flow hedges	47.4	(171.1)
Impact of reduction in tax rate on deferred tax on cash flow hedges	-	(1.0)
	<b>43.8</b>	<b>(172.6)</b>

The tax differs from the standard rate of corporation tax in the UK of 28.5% (2007: 30%). The differences are explained below:

	Years ended 31 December	
	2008 £m	2007 £m
<b>Profit before tax</b>	<b>442.5</b>	<b>448.5</b>
Profit before tax multiplied by rate of corporation tax in the UK of 28.5% (2007: 30%)	126.1	134.6
<b>Effects of:</b>		
Adjustments in respect of prior periods	(2.6)	(0.4)
Expenses not deductible for tax purposes	1.4	1.5
Tax effect of funding arrangements	(24.0)	(22.9)
Other	(0.1)	0.6
Change in UK tax rate	-	(17.9)
Change to industrial buildings allowances	8.8	-
<b>Total tax charge</b>	<b>109.6</b>	<b>95.5</b>

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.

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 the Group is more certain they will be realised.

Further details of the Group's previous financing structure, and related contingent tax liability described above, are included on pages 78 and 79 of the listing particulars issued on 28 October 2005 in respect of the introduction of Drax Group plc to the Official List of the UK Listing Authority.

## 8. Dividends

	Years ended 31 December	
	2008 £m	2007 £m
<b>Amounts recognised as distributions to equity holders in the year (based on the number of shares in issue at the record date):</b>		
Final dividend for the year ended 31 December 2007 of 9.9 pence per share paid on 7 May 2008 (2007: 9.1 pence per share paid on 16 May 2007)	33.6	33.6
Special interim dividend for the year ended 31 December 2007 of 7.8 pence per share paid 7 May 2008 (2007: 32.9 pence per share paid on 16 May 2007)	26.5	121.4
Interim dividend for the year ended 31 December 2008 of 5.0 pence per share paid on 8 October 2008 (2007: 4.7 pence per share paid on 24 October 2007)	17.0	16.3
Special interim dividend for the year ended 31 December 2008 of 9.7 pence per share paid on 8 October 2008 (2007: £nil)	32.9	-
	<b>110.0</b>	<b>171.3</b>

The Company undertook a share consolidation in connection with the special interim dividend paid on 16 May 2007 (note 19).

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 (equivalent to approximately £130 million) payable on or before 22 May 2009. The final dividend has not been included as a liability as at 31 December 2008.

## Notes to the consolidated financial statements

## 9. Earnings per share

Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year. In calculating diluted earnings per share the weighted average number of ordinary shares outstanding during the year is adjusted to take account of outstanding share options in relation to the Group's Savings-Related Share Option Plan ("SAYE Plan") and contingently issuable shares under the Group's Executive Share Incentive Plan ("ESIP").

Reconciliations of the earnings and weighted average number of shares used in the calculation are set out below.

	Years ended 31 December	
	2008 £m	2007 £m
<b>Earnings attributable to equity holders of the Company for the purposes of basic and diluted earnings</b>	<b>332.9</b>	353.0
<b>Number of shares:</b>		
	2008	2007
<b>Weighted average number of ordinary shares for the purposes of basic earnings per share (millions)</b>	<b>339.3</b>	354.9
Effect of dilutive potential ordinary shares under share options	0.3	0.1
<b>Weighted average number of ordinary shares for the purposes of diluted earnings per share (millions)</b>	<b>339.6</b>	355.0
<b>Earnings per share - basic and diluted (pence)</b>	<b>98</b>	99

## 10. Property, plant and equipment

	Freehold land and buildings £m	Plant and equipment £m	Plant spare parts £m	Total £m
<b>Cost:</b>				
<b>At 1 January 2007</b>	134.5	1,139.4	30.6	1,304.5
Additions at cost	0.3	78.6	3.7	82.6
Disposals	-	(4.3)	-	(4.3)
Issues	-	-	(0.7)	(0.7)
<b>At 1 January 2008</b>	134.8	1,213.7	33.6	1,382.1
Additions at cost	18.7	80.2	2.8	101.7
Disposals	-	(13.5)	-	(13.5)
<b>At 31 December 2008</b>	<b>153.5</b>	<b>1,280.4</b>	<b>36.4</b>	<b>1,470.3</b>
<b>Accumulated depreciation:</b>				
<b>At 1 January 2007</b>	25.9	232.5	3.9	262.3
Charge for the year	3.5	39.6	0.6	43.7
Disposals	-	(4.3)	-	(4.3)
<b>At 1 January 2008</b>	29.4	267.8	4.5	301.7
Charge for the year	3.5	42.0	0.7	46.2
Disposals	-	(13.3)	-	(13.3)
<b>At 31 December 2008</b>	<b>32.9</b>	<b>296.5</b>	<b>5.2</b>	<b>334.6</b>
<b>Net book amount at 31 December 2007</b>	105.4	945.9	29.1	1,080.4
<b>Net book amount at 31 December 2008</b>	<b>120.6</b>	<b>983.9</b>	<b>31.2</b>	<b>1,135.7</b>

Assets in the course of construction amounted to £81.0 million at 31 December 2008 (2007: £61.4 million).

During the year ended 31 December 2008 depreciation was accelerated for plant and machinery which the Group expects to replace under its capital expenditure investment programme, resulting in an increase in depreciation for the year of approximately £4.0 million (2007: £7.0 million).

## 11. Inventories

	As at 31 December	
	2008 £m	2007 £m
Coal	142.3	86.0
Other fuels and consumables	25.1	12.6
Renewables Obligation Certificates (ROCs)	22.1	9.7
	189.5	108.3

## 12. Trade and other receivables

	As at 31 December	
	2008 £m	2007 £m
<b>Amounts falling due within one year:</b>		
Trade debtors	228.3	124.8
Prepayments and other debtors	31.6	4.8
	259.9	129.6

Prepayments and other debtors at 31 December 2008 include £26.4 million (2007: £nil) in relation to market purchases of CO<sub>2</sub> emissions allowances acquired in advance to satisfy part of the Group's 2009 obligation.

Trade debtors generally represent sales of electricity to a number of counterparties. At 31 December 2008, the Group had amounts receivable from six (2007: five) significant counterparties, and a number of smaller counterparties, representing 86% (2007: 96%) of trade debtors, all of which paid within 15 days of receipt of invoice in line with agreed terms. Counterparty risk is discussed in note 16.

Management do not consider there to be a significant concentration of credit risk and as a result, do not believe that a further credit risk provision is required in excess of the normal provision for doubtful debts of £0.1 million (2007: £0.1 million). This allowance has been determined by reference to past default experience.

## 13. Cash and cash equivalents

	As at 31 December	
	2008 £m	2007 £m
Cash and cash equivalents	130.2	59.7

The Group's policy is to invest available cash in short-term bank, building society or other low risk deposits.

## 14. Trade and other payables

	As at 31 December	
	2008 £m	2007 £m
<b>Amounts falling due within one year:</b>		
Trade payables	21.0	16.7
Other creditors	13.5	5.1
Accruals	259.6	71.5
Other tax and social security payable	0.9	0.8
	295.0	94.1

Accruals at 31 December 2008 include £158.3 million (2007: £15.9 million) with respect to the Group's estimated net liability to deliver CO<sub>2</sub> emissions allowances. Amounts due to trade creditors at 31 December 2008 represented approximately 21 days of average daily purchases through the year (2007: 22 days).

## Notes to the consolidated financial statements

## 15. Borrowings

	As at 31 December	
	2008 £m	2007 £m
<b>Current:</b>		
Term loans	14.9	9.9

	As at 31 December	
	2008 £m	2007 £m
<b>Non-current:</b>		
Term loans	350.0	387.0

**Maturity of borrowings**

The following table details the remaining contractual maturity, including interest payments, for the Group's borrowings at the balance sheet dates:

	As at 31 December	
	2008 £m	2007 £m
In less than one year	28.8	33.0
In more than one year but not more than two years	363.2	28.5
In more than two years but not more than five years	-	393.8
<b>Total contractual maturity</b>	<b>392.0</b>	<b>455.3</b>
Less interest payments	(27.1)	(58.4)
<b>Carrying amount of borrowings</b>	<b>364.9</b>	<b>396.9</b>

The term loans are subject to a fixed amortisation profile ending with full repayment on 31 December 2010 and debt service payments are made semi-annually on 30 June and 31 December. Payment profiles for repayment of debt set out above are based on the fixed minimum repayment profile. Repayments above the fixed minimum repayment profile are permitted subject to the amount of cash available for debt service.

Interest payments are calculated based on forward interest rates estimated at the balance sheet date based on publicly available information. The interest rates payable at the balance sheet dates were as follows:

	As at 31 December	
	2008 %	2007 %
Term loans	4.09	6.01

**Analysis of borrowings**

Borrowings at 31 December 2008 and 31 December 2007 consisted of bank loans held by the Company's subsidiary Drax Finance Limited as follows:

	As at 31 December 2008		
	Borrowings before deferred finance costs £m	Deferred finance costs £m	Net borrowings £m
Term loans	370.0	(5.1)	364.9
<b>Total borrowings</b>	<b>370.0</b>	<b>(5.1)</b>	<b>364.9</b>
Less current portion of debt	(15.0)	0.1	(14.9)
<b>Non-current borrowings</b>	<b>355.0</b>	<b>(5.0)</b>	<b>350.0</b>

	As at 31 December 2007		
	Borrowings before deferred finance costs £m	Deferred finance costs £m	Net borrowings £m
Term loans	405.0	(8.1)	396.9
<b>Total borrowings</b>	<b>405.0</b>	<b>(8.1)</b>	<b>396.9</b>
Less current portion of debt	(10.0)	0.1	(9.9)
<b>Non-current borrowings</b>	<b>395.0</b>	<b>(8.0)</b>	<b>387.0</b>

Term loan repayments of £17.5 million were made on each of 30 June 2008 and 31 December 2008. Previously, repayments of £40.0 million were made on each of 29 June 2007 and 31 December 2007. All repayments have been made in line with the target repayment profile as a result of the levels of cash available for debt service.

The Group's debt is guaranteed and secured directly by each of the principal subsidiary undertakings of the Company, as set out in note 3 to the Company's separate financial statements. Drax Group plc is not a guarantor of the Group's debt, but has granted a charge over the shares in its subsidiary, Drax Finance Limited.

#### Letter of credit facility and revolving credit facility

In addition to its borrowings, the Group has access to a letter of credit facility which provides credit support of up to £200 million to the Group's trading activities. The letter of credit facility, which has a final maturity date of 15 December 2012, provides a mechanism whereby it may be extended for a further 12 months at any time up to one year before the final maturity date. The Group guarantees the obligations of a number of banks in respect of the letters of credit issued by those banks to counterparties of the Group. As at 31 December 2008 the Group's contingent liability in respect of these guarantees amounted to £160.2 million (2007: £133.3 million).

In addition, the Group has access to an undrawn £100 million revolving credit facility, which may be used to issue letters of credit or for working capital, with a final maturity date of 15 December 2010.

## 16. Financial instruments

The Group issues or holds financial instruments for two purposes: financial instruments relating to the financing and risks of the Group's operations; and financial instruments relating to the financing and risks of the Group's debt portfolio.

The Group's financial instruments comprise borrowings, cash and liquid resources, items that arise directly from its operations and derivative contracts. The Group enters into short-term and medium-term forward contracts for the sale of electricity and the purchase of coal and CO<sub>2</sub> emissions allowances. The Group also enters into interest rate swap agreements and forward foreign currency exchange contracts.

#### Fair value

Cash and cash equivalents, trade and other receivables, and trade and other payables generally have short times to maturity. For this reason, their carrying values approximate their fair value. The Group's borrowings relate to term loans, the carrying amounts of which approximate their fair values by virtue of being floating rate instruments.

The fair values of the Group's derivative financial instruments which are marked to market and recorded in the balance sheet at 31 December 2008 and 31 December 2007 were as follows:

	As at 31 December 2008		As at 31 December 2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
<b>Commodity contracts:</b>				
In less than one year	172.9	(267.5)	10.4	(144.3)
In more than one year but not more than two years	63.9	(51.2)	0.7	(87.0)
In more than two years	41.6	(17.9)	0.2	(20.7)
<b>Interest rate swaps:</b>				
In less than one year	-	(5.8)	1.6	(0.3)
In more than one year but not more than two years	-	(1.5)	0.4	-
In more than two years	-	-	0.3	-
<b>Forward foreign currency exchange contracts:</b>				
In less than one year	113.6	(63.8)	3.0	(1.0)
<b>Total</b>	<b>392.0</b>	<b>(407.7)</b>	<b>16.6</b>	<b>(253.3)</b>
<b>Less: non-current portion</b>				
Commodity contracts	(105.5)	69.1	(0.9)	107.7
Interest rate swaps	-	1.5	(0.7)	-
<b>Total non-current portion</b>	<b>(105.5)</b>	<b>70.6</b>	<b>(1.6)</b>	<b>107.7</b>
<b>Current portion</b>	<b>286.5</b>	<b>(337.1)</b>	<b>15.0</b>	<b>(145.6)</b>

## Notes to the consolidated financial statements

## 16. Financial instruments (continued)

The amounts recorded in the income statement in respect of derivatives which are marked to market were as follows:

	As at 31 December	
	2008 £m	2007 £m
Unrealised gains on derivative contracts recognised in arriving at operating profit	56.3	3.3

The net unrealised gains on derivative contracts recorded in the income statement in 2008 primarily represent mark to market movements on CO<sub>2</sub> emissions allowances contracts, foreign currency exchange contracts and financial coal derivatives.

**Commodity contracts fair value**

Due to the nature of commodity contracts and the way they are managed, the own use exemption has been applied to a limited number of them, including the five-and-a-quarter year baseload contract with Centrica which commenced on 1 October 2007.

The fair value of commodity contracts qualifying as derivative financial instruments is calculated by reference to forward market prices which are available at the balance sheet date. As contracts are generally short term, forward market price curves are available for the duration of the contracts. The quoted market price used for financial assets held by the Group is the current bid price; the quoted price for financial liabilities is the current ask price.

- **Interest rate swaps fair value** - The fair value of interest rate swap contracts is determined by discounting the future cash flows using forward interest rate curves at the balance sheet date.
- **Forward foreign currency exchange contracts fair value** - The fair value of forward foreign currency exchange contracts is determined using forward currency exchange market rates at the balance sheet date.
- **Embedded derivatives fair value** - The Group has also reviewed all contracts for the presence of embedded derivatives. Where contracts were found to contain embedded derivatives, they were considered to be closely related to the economic characteristics and risks of the host contract, and therefore do not require separate valuation from their host contracts.

**Risk**

The Group's activities expose it to a variety of financial risks including commodity price risk, counterparty risk, interest rate risk and foreign currency risk. The Group's overall risk management programme focuses on the unpredictability of commodity and financial markets and seeks to manage potential adverse effects on the Group's financial performance.

The Group uses derivative financial instruments to hedge certain risk exposures. Risk management is carried out by a management committee and treasury function which identify, evaluate and hedge financial risks in close co-operation with the Group's trading function under policies approved by the Board of directors.

**Commodity price risk**

The Group is 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 the financial results of the Group and are expected to continue to do so.

The Group has a policy of making forward power sales with corresponding purchases of fuel and CO<sub>2</sub> emissions allowances when profitable to do so. All commitments to sell power under fixed price contracts are designated as cash flow hedges in order to reduce the Group's cash flow exposure resulting from fluctuations in the price of electricity.

The Group purchases coal under either fixed or variable priced contracts with different maturities from a variety of domestic and international sources. All physical coal purchase contracts transacted at a fixed price and financial coal contracts exchanging floating price coal for fixed price amounts are designated as cash flow hedges in order to reduce the Group's cash flow exposure resulting from fluctuations in the price of coal.

The Group purchases CO<sub>2</sub> emissions allowances under fixed price contracts with different maturity dates from a range of domestic and international sources. All commitments to purchase CO<sub>2</sub> emissions allowances under fixed price contracts are designated as cash flow hedges in order to reduce the Group's cash flow exposure resulting from fluctuations in the price of CO<sub>2</sub> emissions allowances.

**Commodity price sensitivity**

The sensitivity analysis below has been determined based on the exposure to commodity prices for outstanding monetary items at the balance sheet date. The analysis is based on the Group's commodity financial instruments held at each balance sheet date.

If commodity prices had been 5% higher/lower and all other variables were held constant, the Group's:

- profit after tax for the year ended 31 December 2008 would decrease/increase by £3.2 million (2007: decrease/increase by £2.1 million). This is mainly attributable to the Group's exposure to financial coal derivatives; and
- other equity reserves would decrease/increase by £64.2 million (2007: decrease/increase by £57.2 million) mainly as a result of the changes in the fair value of commitments to sell power.

**Interest rate risk**

The Group is exposed to interest rate risk principally in relation to its outstanding bank debt. In particular, it is exposed to changes in the LIBOR interest rate of sterling denominated debt, as all of its debt is both denominated in sterling and has a variable LIBOR rate. The Group mitigates this risk with interest rate hedges on a proportion of its debt facilities. Information about the Group's instruments that are exposed to interest rate risk and their repayment schedules is included in note 15.

All interest rate swap contracts exchanging floating rate interest amounts for fixed rate interest amounts are designated as cash flow hedges in order to reduce the Group's cash flow exposure resulting from variable interest rates on borrowings. The interest rate swap payments and the interest payments on the loan occur simultaneously and the amount deferred in equity is recognised in profit or loss over the loan period.

**Interest rate sensitivity**

The sensitivity analysis below has been determined based on the exposure to interest rates for both derivatives and non-derivative instruments at the balance sheet date. For floating rate liabilities, the analysis is prepared assuming the amount of liability outstanding at the balance sheet date was outstanding for the whole year.

If interest rates had been 1% higher/lower and all other variables were held constant, the Group's:

- profit after tax for the year ended 31 December 2008 would decrease/increase by £1.7 million (2007: decrease/increase by £1.8 million). This is mainly attributable to the Group's exposure to interest rates on its variable rate borrowings; and
- other equity reserves would decrease/increase by £2.0 million (2007: decrease/increase by £2.7 million) mainly as a result of the changes in the fair value of interest rate swaps.

**Foreign currency risk**

Foreign currency exchange contracts are entered into to hedge substantially all of the Group's fixed price international coal purchases in US dollars and CO<sub>2</sub> emissions allowances purchases in euros. Exchange rate exposures are managed within approved policy parameters utilising foreign currency exchange contracts.

**Foreign currency sensitivity**

If sterling exchange rates had been 5% stronger/weaker against other currencies, and all other variables were held constant, the Group's profit after tax and net assets for the year ended 31 December 2008 would increase/decrease by £10.7 million (2007: increase/decrease by £1.6 million).

**Liquidity risk**

The treasury function is responsible for liquidity, funding and settlement management under policies approved by the Board of directors. Liquidity needs are monitored using regular forecasting of operational cash flows and financing commitments. The Group maintains a mixture of cash and cash equivalents, long-term debt and committed facilities in order to ensure sufficient funding for business requirements. Note 15 includes details of undrawn facilities that the Group has at its disposal.

The following table sets out details of the expected maturity of derivative financial instruments which are marked to market based on the undiscounted net cash inflows/(outflows). Where the amount payable or receivable is not fixed, the amount disclosed has been determined by reference to projected commodity prices, interest rates, or foreign currency exchange rates, as illustrated by the yield or other forward curves existing at the reporting date.

	As at 31 December 2008			
	Within 1 year £m	1-2 years £m	>2 years £m	Total £m
Commodity contracts, net	456.7	563.2	291.0	1,310.9
Interest rate swaps	(5.8)	(1.5)	-	(7.3)
Forward foreign currency exchange contracts, net	(201.5)	1.6	(63.8)	(263.7)
	249.4	563.3	227.2	1,039.9

## Notes to the consolidated financial statements

## 16. Financial instruments (continued)

	As at 31 December 2007			Total £m
	Within 1 year £m	1-2 years £m	>2 years £m	
Commodity contracts, net	481.4	282.7	179.9	944.0
Interest rate swaps	1.3	0.4	0.3	2.0
Forward foreign currency exchange contracts, net	(52.3)	2.8	4.1	(45.4)
	430.4	285.9	184.3	900.6

Details of the contractual maturity of the Group's borrowings are included in note 15.

**Counterparty risk**

As the Group relies on third party suppliers for the delivery of coal and other goods and services, it is exposed to the risk of non-performance by these third party suppliers.

The Group purchases a significant portion of its 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.

The Group enters 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 the Group financial distress or increase the risk profile of the Group.

**Credit risk**

The Group's exposure to credit risk is limited to the carrying amount of financial assets recognised at the balance sheet date, as summarised below:

	As at 31 December	
	2008 £m	2007 £m
<b>Financial assets</b>		
Cash and cash equivalents	130.2	59.7
Trade and other receivables	259.9	129.6
Derivative financial instruments	392.0	16.6
	782.1	205.9

Credit exposure is controlled by counterparty limits that are reviewed and approved by a management committee. Counterparties without an investment grade rating are normally required to provide credit support in the form of a parent company guarantee, letter of credit, deed of charge, or cash collateral. Where deemed appropriate the Group has purchased credit default swaps.

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

**Capital risk management**

The Group manages its capital to ensure it is able to continue as a going concern while maximising the return to stakeholders through the optimisation of the debt and equity balance. The capital structure of the Group consists of the borrowings disclosed in note 15, cash and cash equivalents in note 13, and equity attributable to the equity holders of the parent, comprising issued capital, reserves and retained earnings in note 25.

The capital structure of the Group is as follows:

	As at 31 December	
	2008 £m	2007 £m
Borrowings	(364.9)	(396.9)
Cash and cash equivalents	130.2	59.7
<b>Net debt</b>	<b>(234.7)</b>	<b>(337.2)</b>
<b>Total shareholders' equity</b>	<b>693.3</b>	<b>361.0</b>

## 17. Provisions

	Re-instatement £m
<b>At 1 January 2007</b>	2.2
Unwinding of discount	0.2
<b>At 1 January 2008</b>	2.4
Unwinding of discount	0.2
<b>At 31 December 2008</b>	2.6

The provision for re-instatement represents the estimated decommissioning, demolition and site remediation costs at the end of the useful economic life of the Group's generating assets, on a discounted basis. The amount provided represents the present value of the expected costs. An amount equivalent to the initial provision is capitalised within tangible fixed assets and is being depreciated over the useful lives of the related assets. The unwinding of the discount is included in interest payable and similar charges.

The provision is estimated using the assumption that the re-instatement will take place between 2039 and 2045. The provision has been estimated using existing technology at current prices. The discount rate applied is the pre-tax rate based upon the Group's weighted average cost of capital and reflects the current market assessment of the time value of money and the risks specific to the business.

## 18. Deferred tax

The movement on the deferred tax account is as shown below:

	Year ended 31 December	
	2008 £m	2007 £m
<b>Deferred tax liability at 1 January</b>	201.6	390.9
Charged/(credited) to income statement	28.4	(16.7)
Deferred tax on actuarial losses on defined benefit pension scheme	(3.6)	(0.5)
Deferred tax on cash flow hedges	47.4	(172.1)
<b>Deferred tax liability at 31 December</b>	273.8	201.6

The movements in deferred tax assets and liabilities during each year are shown below. Deferred tax assets and liabilities are offset where there is a legally enforceable right of offset and there is an intention to settle the balances net.

### Deferred tax liabilities/(assets):

	Financial instruments £m	Accelerated capital allowances £m	Other liabilities £m	Other assets £m	Total £m
<b>At 1 January 2007</b>	103.3	282.8	15.8	(11.0)	390.9
Charged/(credited) to income statement	1.5	(21.6)	1.8	1.6	(16.7)
Credited to equity	(172.1)	-	-	(0.5)	(172.6)
<b>At 1 January 2008</b>	(67.3)	261.2	17.6	(9.9)	201.6
Charged to income statement	15.5	8.8	-	4.1	28.4
Charged/(credited) to equity	47.4	-	-	(3.6)	43.8
<b>At 31 December 2008</b>	(4.4)	270.0	17.6	(9.4)	273.8

Deferred tax assets are recognised to the extent that the realisation of the related tax benefit through future associated taxable profits is probable.

As described in note 7, no deferred tax asset has been recognised with respect to the unwind of the Eurobond financing structure.

## Notes to the consolidated financial statements

## 19. Called-up share capital

	As at 31 December	
	2008 £m	2007 £m
<b>Authorised</b>		
865,238,823 ordinary shares of £0.11 <sup>16</sup> / <sub>29</sub> each	100.0	100.0
<b>Issued and fully paid</b>		
2007 - 339,397,000 ordinary shares of £0.11 <sup>16</sup> / <sub>29</sub> each	-	39.2
2008 - 339,398,968 ordinary shares of £0.11 <sup>16</sup> / <sub>29</sub> each	39.2	-
	39.2	39.2

The movement in allotted and fully paid share capital of the Company during each year was as follows:

	Years ended 31 December	
	2008 Number	2007 Number
<b>At 1 January</b>	339,397,000	368,921,151
Effect of share consolidations	-	(16,518,847)
Cancelled under share buy-back programme	-	(13,005,304)
Issued under employee share schemes	1,968	-
<b>At 31 December</b>	339,398,968	339,397,000

**Effect of share consolidations**

The Company undertook a share consolidation in connection with the interim special dividend paid on 16 May 2007 (note 8). Following approval at the Annual General Meeting held on 26 April 2007, the share consolidation under which shareholders received 64 new ordinary shares of 11<sup>16</sup>/<sub>29</sub> pence each for every 67 existing ordinary shares of 11<sup>1</sup>/<sub>29</sub> pence each, became effective on 30 April 2007.

**Share buy-back programme**

Under a share buy-back programme completed between 7 September 2007 and 13 December 2007, the Company purchased 13,005,304 ordinary shares for an aggregate consideration (inclusive of all transaction costs) of £83.5 million. Transaction costs of share purchases under the programme amounted to £0.5 million. All shares purchased through the share buy-back programme were cancelled.

**Issued under employee share schemes**

During the year, a total of 1,968 ordinary shares of 11<sup>16</sup>/<sub>29</sub> pence each were issued in satisfaction of share options which were exercised in accordance with the rules of the SAYE Plan.

The Company has only one class of ordinary shares, which carry no right to fixed income. No shareholders have waived their rights to dividends.

## 20. Share-based payments

Costs recognised in the income statement in relation to share-based payments are as follows:

	Years ended 31 December	
	2008 £m	2007 £m
SIP	2.4	2.2
ESIP	1.3	0.8
SAYE	0.1	0.1
	3.8	3.1

### Share Incentive Plan ("SIP")

Under the 2008 SIP Free share award, the Company's employee benefit trust purchased a total of 295,776 shares (2007: 195,810 shares issued) in April 2008 to be held on behalf of qualifying employees, equating to 416 shares (2007: 305 shares) with a cash value of approximately £2,500 (2007: £2,500) per employee based on the Company's share price at the time of the award. The fair value of the 2008 Free share award (determined at the award date based on the price paid) of £1.8 million was charged in the income statement in full in the year ended 31 December 2008, on the basis that employees were granted specific rights in relation to shares held in trust on their behalf. Similarly, the fair value of the 2007 Free share award of £1.6 million was charged to the income statement in full in the year ended 31 December 2007.

In March 2007, the SIP was extended by introducing two further elements: Partnership shares and Matching shares. Qualifying employees can buy up to £1,500 worth (subject to an overriding maximum of 10% of salary) of Partnership shares (out of pre-tax pay) in any one tax year. Matching shares are awarded to employees to match any Partnership shares they buy, in a ratio of one-to-one, with the cost of Matching shares borne by the Group. As at 31 December 2008, a total of 230,790 Matching shares had been purchased and were held in trust on behalf of qualifying employees (2007: 104,367). The fair value of Matching shares awarded in the year to 31 December 2008 (determined at the award dates based on the price paid) of £0.6 million is being charged in the income statement on a straight-line basis over a one-year vesting period. Similarly, the fair value of the 2007 Matching shares award of £0.8 million was charged to the income statement on a straight-line basis over a one-year vesting period now ended.

Shares in the Company held under trust and under the Company's control as a result of the SIP (i.e. the Matching shares) were as follows:

	Year ended 31 December 2008						
	Shares held at 1 January 2008 Number	Shares acquired during year Number	Shares transferred during year Number	Shares held at 31 December 2008 Number	Cost at 31 December 2008 £000	Nominal value at 31 December 2008 £000	Market value at 31 December 2008 £000
SIP	104,367	130,681	(4,258)	230,790	1,583	27	1,295

### Executive Share Incentive Plan ("ESIP")

Under the ESIP, annual awards of performance shares are made at nil consideration to executive directors and other senior staff up to a normal maximum of 100% of salary (200% in exceptional circumstances). Shares vest according to whether Drax's TSR matches or outperforms an index (determined in accordance with the scheme rules) over three years.

ESIP awards over 604,753 shares (2007: 361,582 shares) were granted to executive directors and other senior staff in 2008, with performance measured over the three years to December 2010 and potential vesting in April 2011. The fair value of the 2008 ESIP awards (determined at the grant date using a Monte Carlo simulation model, which takes into account the estimated probability of different levels of vesting) of £1.2 million, is being charged to the income statement on a straight-line basis over the three-year vesting period to April 2011. Similarly, the fair value of the 2006 and 2007 ESIP awards of £1.9 million and £0.9 million are being charged to the income statement on a straight-line basis over the three-year vesting period to September 2009 and April 2010 respectively.

## Notes to the consolidated financial statements

## 20. Share-based payments (continued)

**Savings-Related Share Option Plan ("SAYE Plan")**

In July 2006, participation in the SAYE Plan was offered to all qualifying employees. Options were granted for employees to acquire shares at a price of £6.36 (representing a discount of 20% to the prevailing market price determined in accordance with the scheme rules), exercisable at the end of the three and five year savings contracts. The fair value of the 899,396 options granted in connection with the SAYE Plan of £0.5 million is being charged to the income statement over the life of the respective contracts. There have been no further offers under the SAYE Plan since that made in July 2006.

During the year, a total of 1,968 ordinary shares of 11<sup>16</sup>/<sub>29</sub> pence each were issued in satisfaction of share options which were exercised in accordance with the rules of the SAYE Plan. No other shares have been issued or repurchased to date with respect to the SAYE Plan or ESIP. Given that these share-based incentive plans have commenced only recently, the level of forfeitures is not significant. Additional information in relation to the Group's share-based incentive plans is included in the Remuneration Committee report.

## 21. Capital redemption reserve

	Years ended 31 December	
	2008 £m	2007 £m
<b>At 1 January</b>	1.5	-
Redemption of ordinary shares under share buy-back programme	-	1.5
<b>At 31 December</b>	1.5	1.5

## 22. Merger reserve

	Years ended 31 December	
	2008 £m	2007 £m
<b>At 1 January and 31 December</b>	710.8	710.8

The merger reserve arose on the financial restructuring of the Group which took place in 2005.

## 23. Hedge reserve

	Years ended 31 December	
	2008 £m	2007 £m
<b>At 1 January</b>	(161.3)	250.9
Gains/(losses) recognised:		
- Commodity contracts	49.0	(317.7)
- Interest rate swaps	(5.9)	(0.8)
Released from equity:		
- Commodity contracts	123.2	(264.1)
- Interest rate swaps	(1.6)	(1.7)
Related deferred tax, net	(47.4)	172.1
<b>At 31 December</b>	<b>(44.0)</b>	<b>(161.3)</b>

The Group's cash flow hedges relate to commodity contracts, principally commitments to sell power and interest rate swaps. Amounts are recognised in the hedge reserve as the designated contracts are marked to market at each period end for the effective portion of the hedge, which is generally 100% of the relevant contract. Amounts held within the hedge reserve are then released as the related contract matures and the hedged transaction impacts profit or loss. For power sales contracts, this is when the underlying power is delivered. Further information in relation to the Group's accounting for financial instruments is included in notes 3 and 16.

The expected release profile from equity of post-tax hedging gains and losses is as follows:

	As at 31 December 2008			
	Within 1 year £m	1-2 years £m	>2 years £m	Total £m
Commodity contracts	(67.4)	9.1	18.0	(40.3)
Interest rate swaps	(2.7)	(1.0)	-	(3.7)
	(70.1)	8.1	18.0	(44.0)

	As at 31 December 2007			
	Within 1 year £m	1-2 years £m	>2 years £m	Total £m
Commodity contracts	(86.3)	(62.1)	(14.5)	(162.9)
Interest rate swaps	1.2	0.3	0.1	1.6
	(85.1)	(61.8)	(14.4)	(161.3)

## 24. Retained losses

	Years ended 31 December	
	2008 £m	2007 £m
<b>At 1 January</b>	<b>(649.9)</b>	<b>(746.0)</b>
Profit for the year	332.9	353.0
Equity dividends paid (note 8)	(110.0)	(171.3)
Purchase of own shares under share buy-back programme (note 19)	-	(83.5)
Actuarial losses on defined benefit pension scheme (note 28)	(12.9)	(3.3)
Deferred tax on actuarial losses on defined benefit pension scheme	3.6	0.9
Impact of reduction in tax rate on deferred tax on defined benefit pension scheme	-	(0.4)
Net movements in equity associated with share-based payments	1.4	0.7
<b>At 31 December</b>	<b>(434.9)</b>	<b>(649.9)</b>

## Notes to the consolidated financial statements

## 25. Shareholders' funds and statement of changes in shareholders' equity

	Share capital £m	Capital redemption reserve £m	Share premium £m	Merger reserve £m	Hedge reserve £m	Retained losses £m	Total £m
<b>At 1 January 2007</b>	40.7	-	420.7	710.8	250.9	(746.0)	677.1
Profit for the year	-	-	-	-	-	353.0	353.0
Equity dividends paid	-	-	-	-	-	(171.3)	(171.3)
Purchase and redemption of own shares under share buy-back programme	(1.5)	1.5	-	-	-	(83.5)	(83.5)
Actuarial losses on defined benefit pension scheme	-	-	-	-	-	(3.3)	(3.3)
Deferred tax on actuarial losses on defined benefit pension scheme	-	-	-	-	-	0.9	0.9
Impact of reduction in tax rate on deferred tax on defined benefit pension scheme	-	-	-	-	-	(0.4)	(0.4)
Fair value losses on cash flow hedges	-	-	-	-	(584.3)	-	(584.3)
Deferred tax on cash flow hedges	-	-	-	-	171.1	-	171.1
Impact of reduction in tax rate on deferred tax on cash flow hedges	-	-	-	-	1.0	-	1.0
Movement in equity associated with share-based payments	-	-	-	-	-	3.1	3.1
Own shares held by employee trust	-	-	-	-	-	(0.8)	(0.8)
Own shares purchased and vested with employees	-	-	-	-	-	(1.6)	(1.6)
<b>At 1 January 2008</b>	39.2	1.5	420.7	710.8	(161.3)	(649.9)	361.0
Profit for the year	-	-	-	-	-	332.9	332.9
Equity dividends paid	-	-	-	-	-	(110.0)	(110.0)
Actuarial losses on defined benefit pension scheme	-	-	-	-	-	(12.9)	(12.9)
Deferred tax on actuarial losses on defined benefit pension scheme	-	-	-	-	-	3.6	3.6
Fair value gains on cash flow hedges	-	-	-	-	164.7	-	164.7
Deferred tax on cash flow hedges	-	-	-	-	(47.4)	-	(47.4)
Movement in equity associated with share-based payments	-	-	-	-	-	3.8	3.8
Own shares held by employee trust	-	-	-	-	-	(0.6)	(0.6)
Own shares purchased and vested with employees	-	-	-	-	-	(1.8)	(1.8)
<b>At 31 December 2008</b>	39.2	1.5	420.7	710.8	(44.0)	(434.9)	693.3

## 26. Cash flow from operating activities

	Years ended 31 December	
	2008 £m	2007 £m
<b>Profit for the year</b>	<b>332.9</b>	<b>353.0</b>
Adjustments for:		
Interest payable and similar charges	28.8	34.3
Interest receivable	(7.2)	(11.4)
Tax charge	109.6	95.5
Depreciation	46.2	43.7
Unrealised gains on derivative contracts	(56.3)	(3.3)
Defined benefit pension scheme charge	4.1	2.3
Non-cash charge for share-based payments	3.8	3.1
<b>Operating cash flows before movement in working capital</b>	<b>461.9</b>	<b>517.2</b>
Changes in working capital:		
Increase in inventories	(81.2)	(31.4)
(Increase)/decrease in receivables	(130.3)	43.8
Increase/(decrease) in payables	190.1	(87.5)
Defined benefit pension scheme contributions	(9.9)	(4.6)
Increase in provisions	0.2	0.2
<b>Cash generated from operations</b>	<b>430.8</b>	<b>437.7</b>

## 27. Employees and directors

### Staff costs (including executive directors)

	Years ended 31 December	
	2008 £m	2007 £m
<b>Included in other operating expenses excluding exceptional items (note 5):</b>		
Wages and salaries	39.0	33.5
Social security costs	3.1	3.2
Other pension costs (note 28)	5.2	3.1
Share-based payments (note 20)	3.8	3.1
	<b>51.1</b>	<b>42.9</b>

### Average monthly number of people employed (including executive directors)

	Years ended 31 December	
	2008 Number	2007 Number
Operations	566	520
Business services	146	138
	<b>712</b>	<b>658</b>

## Notes to the consolidated financial statements

## 28. Pensions

The Group operates an approved defined benefit scheme on behalf of the Drax Power Group of the Electricity Supply Pension Scheme ("DPG ESPS"). This scheme was closed to new members as from 1 January 2002 unless they qualify through being existing members of another part of the ESPS. The Group also operates a defined contribution scheme.

**Defined benefit scheme**

The most recent actuarial valuation of the DPG ESPS was 31 March 2007. This has been updated as at 31 December 2008 to reflect relevant changes in assumptions. The principal assumptions were as follows:

	Years ended 31 December	
	2008 % p.a.	2007 % p.a.
Discount rate	6.1	5.8
Inflation	3.0	3.4
Rate of increase in pensions in payment and deferred pensions	3.0	3.4
Rate of increase in pensionable salaries	4.5	4.9
Expected return on plan assets	5.4	6.5

The mortality assumptions are based on standard mortality tables which incorporate an adjustment to allow for future mortality improvements. The assumptions are that a member who retired in 2008 at age 60 will live on average for a further 25 years (2007: 25 years) after retirement if they are male, and for a further 27 years (2007: 27 years) after retirement if they are female. Similarly life expectancy at age 60 for male and female non-pensioners (currently aged 45) is assumed to be 27 years and 28 years respectively (2007: 27 years and 28 years respectively).

The amounts recognised in the balance sheet are determined as follows:

	As at 31 December	
	2008 £m	2007 £m
Present value of funded obligations	114.4	118.6
Fair value of plan assets	(93.8)	(105.1)
Net liability recognised in the balance sheet	20.6	13.5

The amounts recognised in the income statement, entirely within other operating expenses, are as follows:

	Years ended 31 December	
	2008 £m	2007 £m
Current service cost	3.7	3.3
Past service cost	0.3	-
Interest cost	7.0	5.6
Expected return on plan assets	(6.9)	(6.6)
Total included in staff costs (note 27)	4.1	2.3

The actual return on plan assets was a loss of £19.2 million (2007: gain of £4.4 million).

The amounts recognised in the statement of recognised income and expense are as follows:

	Years ended 31 December	
	2008 £m	2007 £m
Cumulative actuarial losses on defined benefit pension scheme at 1 January	(25.7)	(22.4)
Actuarial losses on defined benefit pension scheme recognised in the year	(12.9)	(3.3)
Cumulative losses recognised in the statement of recognised income and expense at 31 December	(38.6)	(25.7)

Changes in the present value of the defined benefit obligation are as follows:

	Years ended 31 December	
	2008 £m	2007 £m
Defined benefit obligation at 1 January	118.6	109.4
Service cost	3.7	3.3
Past service cost	0.3	-
Employee contributions	1.0	1.0
Interest cost	7.0	5.6
Actuarial (gains)/losses	(13.2)	1.1
Benefits paid	(3.0)	(1.8)
Defined benefit obligation at 31 December	114.4	118.6

Changes in the fair value of plan assets are as follows:

	Years ended 31 December	
	2008 £m	2007 £m
Fair value of plan assets at 1 January	105.1	96.9
Expected return	6.9	6.6
Actuarial losses	(26.1)	(2.2)
Employer contributions	9.9	4.6
Employee contributions	1.0	1.0
Benefits paid	(3.0)	(1.8)
Fair value of plan assets at 31 December	93.8	105.1

Employer contributions included a special payment to reduce the actuarial deficit of £3.5 million in June 2008. This payment was subsequently invested in fixed interest bonds.

The major categories of plan assets as a percentage of total plan assets were as follows:

	As at 31 December	
	2008 %	2007 %
Equities	48.4	65.2
Fixed interest bonds	47.9	34.8
Cash	3.7	-

The pension plan assets do not include any ordinary shares issued by Drax Group plc or any property occupied by the Group.

The Group employs a building block approach in determining the long-term rate of return on pension plan assets. Historical markets are studied and assets with higher volatility are assumed to generate higher returns consistent with widely accepted capital market principles. The overall expected rate of return on assets is then derived by aggregating the expected return for each asset class over the actual asset allocation for the scheme.

The net liability recognised in the balance sheet is particularly sensitive to the discount rate assumption, which is determined by reference to market yields at the balance sheet date on high quality corporate bonds, allowing for the duration of the scheme's liabilities. Recent volatility in financial markets has caused the range of yields on corporate bonds to widen significantly. It is estimated that a change of +/-0.5% in the discount rate would have the effect of decreasing/increasing the net liability recognised in the balance sheet by approximately £11 million.

## Notes to the consolidated financial statements

## 28. Pensions (continued)

The history of experience adjustments is as follows:

	Years ended 31 December				
	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Defined benefit obligation	(114.4)	(118.6)	(109.4)	(107.0)	(85.0)
Fair value of plan assets	93.8	105.1	96.9	62.3	48.5
Deficit	(20.6)	(13.5)	(12.5)	(44.7)	(36.5)
Experience adjustments on plan liabilities	13.2	(1.1)	5.3	(15.1)	(7.6)
Experience adjustments on plan assets	(26.1)	(2.2)	3.3	6.9	1.5

## Defined contribution plans

Pension costs for the defined contribution scheme are as follows:

	Years ended 31 December	
	2008 £m	2007 £m
Total included in staff costs (note 27)	1.1	0.8

The Group expects to contribute £9 million to its pension plans during the 12 months ended 31 December 2009.

## 29. Capital and other financial commitments

	As at 31 December	
	2008 £m	2007 £m
Contracts placed for future capital expenditure not provided in the financial statements	110.9	94.8
Future support contracts not provided in the financial statements	65.2	45.6
Future commitments to purchase fuel under fixed and variable priced contracts	1,211.3	996.5
Future commitments to sell power under fixed and variable priced contracts	2,873.1	2,558.2

## 30. Related party transactions

### Subsidiary companies

The Company's subsidiary undertakings including the name, country of incorporation and proportion of ownership interest for each are disclosed in note 3 to the Company's separate financial statements which follow these consolidated financial statements. Transactions between subsidiaries and between the Company and its subsidiaries are eliminated on consolidation.

### Remuneration of key management personnel

The remuneration of the directors, who are considered to be the key management personnel of the Group, is set out below in aggregate for each of the categories specified in IAS 24 "Related party disclosures". Further information about the remuneration of individual directors, together with the directors' interests in the share capital of Drax Group plc, is provided in the audited part of the Remuneration Committee report on pages 56 and 57.

	Years ended 31 December	
	2008 £m	2007 £m
Salaries and short-term benefits	2,080	1,702
Termination payment	485	-
Aggregate amounts receivable under share-based incentive schemes	343	247
Company contributions to money purchase pension schemes	190	173
	3,098	2,122

Amounts receivable under long-term incentive schemes represents the expenses arising from share-based payments included in the income statement, determined based on the fair value of the related awards at the date of grant (note 20).

There were no other transactions with directors for the periods covered by these consolidated financial statements.