NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

for the year ended 31 December 2007

1 Accounting policies

a) General information

International Power plc (the Company) is a public limited company incorporated and domiciled in the United Kingdom. The address of its registered office is disclosed on the last page of this *Annual Report*. The consolidated financial statements of the Company for the year ended 31 December 2007 comprise the Company and its subsidiaries (together referred to as the Group) and the Group's interest in joint ventures and associates. The parent company financial statements present information about the Company as a separate entity and not about its Group. The principal activities of the Group are described in note 2.

b) Statement of compliance

European Union (EU) law (IAS Regulation EC 1606/2002) requires that the consolidated financial statements, for the year ended 31 December 2007, be prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU (Adopted IFRSs). These Group financial statements have been prepared and approved by the Directors in accordance with Adopted IFRSs.

The Company has elected to prepare its parent company financial statements in accordance with UK GAAP. The parent company financial statements are presented on pages 165 to 174.

c) Adoption of new and revised Standards

The following standards, amendments and interpretations to existing standards, issued by the International Accounting Standards Board and the International Financial Reporting Interpretations Committee, are applicable to the Group for the first time in the current year and have been adopted by the Group with no impact on the Group's accounting policies or on its results or net assets included within these consolidated financial statements:

- IFRS 7 (Financial Instruments: Disclosures), effective for annual accounting periods beginning on or after 1 January 2007, and a complementary amendment to IAS 1 (Presentation of Financial Statements – Capital Disclosures). IFRS 7 supersedes IAS 30 (Disclosures in the Financial Statements of Banks and Similar Financial Institutions) and the disclosure requirements of IAS 32 (Financial Instruments: Disclosure and Presentation). The application of IFRS 7 and the amendment to IAS 1 have not affected the results or net assets of the Group as they only require additional disclosures relating to the Group's use of financial instruments and the exposures to the risks they create, and the management of capital;
- IFRIC 7 (Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies);
- IFRIC 8 (Scope of IFRS 2);
- IFRIC 9 (Reassessment of Embedded Derivatives);
- IFRIC 10 (Interim Financial Reporting and Impairment).

The Group has applied the following EU adopted interpretation in advance of its effective date.

- IFRIC 11 (IFRS 2 – Group and Treasury Share Transactions) is applicable to the Group for years commencing on or after 1 January 2008. It provides guidance on the application of IFRS 2 (Share-based Payment) to transactions which are settled by the purchase of own shares and transactions in which employees of a subsidiary receive rights to shares of a parent company. The application of this interpretation had no impact on the Group's results or net assets.

The following Adopted IFRS was available for early application but has not been applied by the Group in these financial statements:

- IFRS 8 (Operating Segments) is applicable for years commencing on or after 1 January 2009. The new standard replaces IAS 14 (Segment Reporting) and requires an entity to report segment information on the same basis as that reported to management for decision making purposes. The application of IFRS 8 in 2007 would not have affected the results or net assets as the standard is concerned only with disclosure. The adoption of this standard is not expected to have a significant impact on the Group's disclosures as management identify and measure the results of reportable operating segments on a regional basis as set out in these consolidated financial statements;

The following standards and interpretations have been issued by the IASB and IFRIC, but have not been adopted by the European Commission (and published in the EU Official Journal) for their application to become mandatory:

- IAS 23 (Borrowing Costs – Revised), effective for annual accounting periods beginning on or after 1 January 2009. The revised standard requires the capitalisation of borrowing costs, to the extent they are directly attributable to the acquisition, production or construction of a qualifying asset as part of the cost of that asset. Previously there was an option to expense all borrowing costs as incurred. Because the Group always capitalises borrowing costs incurred on qualifying assets, the revisions to IAS 23 have no impact on either the Group's accounting policies or its results or net assets;
- IAS 1 (Presentation of Financial Statements – Revised), effective for accounting periods beginning on or after 1 January 2009. The revised standard aims to enhance the usefulness of information presented in the financial statements including the introduction of a new statement of comprehensive income that combines all items of income and expense recognised in profit or loss together with 'other comprehensive income'. The application of the revised standard will not affect the results or net assets of the Group as it is only concerned with presentation and disclosures;
- IFRS 3 (Business Combinations – Revised), complementary amendments to IAS 27 (Consolidated and Separate Financial Statements – Revised), and consequential amendments to IAS 28 (Investments in Associates) and IAS 31 (Interests in Joint Ventures), effective for business combinations in annual accounting periods of the Group beginning on or after 1 January 2010. The revised standard will make many changes to how future business combinations will be accounted for, including accounting for acquisition costs, contingent consideration, step acquisitions, partial disposals of an investment in a subsidiary and partial disposals of associates and joint ventures. As the revised standard is to be applied prospectively it is not possible to quantify its likely impact;
- IFRIC 12 (Service Concession Arrangements) is effective for annual accounting periods beginning on or after 1 January 2008. This interpretation sets out general principles on recognising and measuring the obligations and related rights in service concession arrangements. As the Group's long-term power purchase agreements which are affected by the adoption of IFRIC 12 are already determined to be or to contain finance leases, and the consideration receivable by the operator in each case gives rise to financial assets, the impact of adopting IFRIC 12 is not expected to have a material impact on the Group;
- IFRIC 13 (Customer Loyalty Programmes) is applicable to the Group for the years commencing on or after 1 January 2009. It addresses the accounting of an entity that grants loyalty award credits to its customers as part of a sales transaction. The adoption of this interpretation is not expected to have any significant impact on the Group's results because it does not have any customer loyalty programmes;
- IFRIC 14 (IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction) is effective for annual accounting periods beginning on or after 1 January 2008. It addresses when refunds or reductions in future contributions to defined benefit pension schemes can be regarded as a defined benefit asset, particularly when a minimum funding requirement exists. Based on actuarial advice, management does not currently expect adoption of this interpretation to a have a significant impact on the Group's results.

1 Accounting policies continued

d) Basis of preparation

These consolidated financial statements have been prepared using the historical cost convention, modified for certain items carried at fair value, as stated in these accounting policies.

In order to allow a better understanding of the financial information presented, and specifically the Group's underlying business performance, the Group presents its income statement in three columns such that it identifies (i) results excluding exceptional items and specific IAS 39 mark to market movements, (ii) the effect of exceptional items and specific IAS 39 mark to market movements and (iii) results for the year. For the purposes of clarity, in the explanation of the basis of preparation applied in these consolidated financial statements, we describe these columns as the 'left hand column', the 'middle column' and the 'right hand column' respectively.

Those items that the Group separately present as exceptional are items which, in the judgement of the Directors, need to be disclosed separately by virtue of their size or incidence in order to obtain a proper understanding of the financial information. The Group discloses exceptional items in the middle column.

The Group enters into derivative contracts to economically hedge certain of its physical and financial exposures. In relation to commodities trading, the Group considers economic hedges to be those which are asset backed, i.e. where the Group is either forward selling electricity from its own generation capacity or forward buying fuel for its own generation capacity. In respect of interest rate swaps and other treasury related derivatives the Group considers economic hedges to be those which hedge existing assets, liabilities and firm commitments.

Some of these economic hedges achieve own use treatment under IAS 39 and are accounted for on an accruals basis. Some are accounted for as cash flow hedges under IAS 39 with fair value gains and losses recorded in the hedging reserve. Where derivative contracts do not achieve the own use treatment and the Group could not, or has not sought to, apply cash flow hedge accounting, IAS 39 requires the derivative contract to be measured at fair value (marked to market) with fair value gains and losses recognised in the income statement. The Group separately presents these mark to market movements on economic hedges, in the middle column, to assist the reader's understanding of underlying business performance and to provide a more meaningful presentation.

For economic hedges, where fair value gains and losses are recorded in the income statement, in the period in which the economically hedged transaction settles, the settlement amount of the derivative, being the cumulative fair value gains and losses recognised in the current and prior periods, is presented in the left hand column so that the transaction is measured at its contracted price (i.e. the spot price less the fair value gain or loss on the derivative contract at that date).

As the cumulative mark to market movements have already been recognised in the middle column in the current and prior periods, an equal but opposite amount is presented in the middle column so that cumulatively the amount recognised in the middle column in respect of such economic hedges is zero.

By presenting fair value gains and losses in this manner, the left hand column is not affected by mark to market movements and therefore reflects the underlying business performance at contracted prices.

The amortisation of derivatives, which are acquired with a fair value other than zero, is always recorded in the left hand column. This is achieved by presenting an equal but opposite amount in the middle column, such that specific IAS 39 mark to market movements presented in the middle column are shown net of the amortisation during the period.

Ineffectiveness in qualifying cash flow hedges under IAS 39 can arise from business combinations, where the fair value of the derivatives at acquisition is not equal to zero, or as a result of the difference between the contractual profile of the economic hedge and the profile of transactions defined as the hedged item. IAS 39 requires ineffectiveness in qualifying cash flow hedges to be recorded in the income statement, and therefore the Group records this ineffectiveness in the middle column when it relates to an economic hedge.

Mark to market movements of the fair value of embedded derivatives in convertible bonds, which relate to conversion features where the functional currency of the issuer and other factors preclude the conversion feature being treated as equity in the consolidated financial statements, are treated as specific IAS 39 mark to market movements and as such are presented in the middle column. The Directors consider the fair value gains and losses of these embedded derivatives should be appropriately disclosed within specific IAS 39 mark to market movements, in the middle column, so as to separately identify a non-cash movement which, if the conversion option is exercised, will ultimately be extinguished by the issue of equity.

Mark to market movements relating to proprietary trading activities, the revaluation of assets held for trading and amortisation of derivatives which are acquired with a fair value other than zero comprise part of the Group's underlying business performance and are appropriately, in the judgement of the Directors, included within the left hand column.

The right hand column presents the results for the year, showing all gains and losses recorded in the consolidated income statement.

To the extent that exceptional items are separately identified in the income statement, they are also separately identified in the cash flow statement under the respective heading to which they relate.

The fair values of certain assets and liabilities acquired as part of the Levanto wind farm portfolio in November 2006 have been revised following the completion of an independent third party valuation exercise during 2007 (refer to note 31). In accordance with IFRS 3 (Business Combinations) the 2006 balance sheet has been re-presented.

e) Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and entities controlled by the Company (its subsidiaries) up to 31 December 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. In assessing control, the potential voting rights that are currently exercisable or convertible are taken into account.

On acquisition, the assets, liabilities and contingent liabilities of a subsidiary are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired (i.e. discount on acquisition) is credited to the income statement in the period of acquisition.

The interest of minority shareholders is stated at the minority's proportion of the fair values of the assets, liabilities and contingent liabilities recognised. Subsequently, any losses applicable to the minority interest in excess of the minority interest in the subsidiary's equity are allocated against the interests of the parent, except when there is a binding obligation to fund those losses and the minority is in a position to do so.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from when control commences or up to when control ceases, as appropriate.

Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group.

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

f) Revenue recognition

Certain power plants sell their output in merchant markets, where electricity is sold through existing power exchanges, pool arrangements or through bilateral contracts with third parties. In these markets, revenue from energy sales is either recorded at the spot price obtained through pool or spot mechanisms when the electrical output is delivered, or as set out below, when electricity is delivered in accordance with the terms of any related hedging or forward contracts.

(i) Because power is a non-financial item, forward contracts entered into and which continue to be held for the purpose of delivery (and sale) of power generated by our own power plants (known as 'own use' contracts) can be accounted for under accruals accounting, i.e. revenue for energy sales is recognised as output is delivered in accordance with the forward contract;

(ii) All other forward contracts, which are considered to be derivatives and do not qualify for 'own use', are recognised at fair value with changes in fair value recorded in the income statement. Where the Group applies cash flow hedge accounting changes in fair values are deferred in a hedging reserve within equity and only reclassified to earnings when the hedged transaction affects earnings. In addition, to the extent that there is ineffectiveness in the cash flow hedge accounting of forward contracts, changes in fair values of the forward contracts are taken to the income statement in the period.

Other power plants sell their output under power purchase agreements (PPAs). Under such arrangements it is usual for the Group to receive payment for the provision of electrical capacity whether or not the offtaker requests the electrical output (capacity payments) and for the variable costs of production (energy payments). In such situations, revenue is recognised in respect of capacity payments as:

(i) finance income (in accordance with note 1(r)) where the PPA is considered to be or to contain a finance lease;

(ii) operating lease minimum lease payments, on a straight-line basis (in accordance with note 1(r)) where the PPA is considered to be or to contain an operating lease; or

(iii) service income in accordance with the contractual terms, to the extent that the capacity has been made available to the contracted offtaker during the period. Where the PPAs extend over more than one accounting period, service income is recognised in each accounting period at the fair value of the Group's performance under the contract in each period.

Under lease arrangements, those payments which are not included within minimum lease payments are accounted for as service income (outlined in (iii) above).

Energy payments under PPAs are recognised in revenue in all cases as the contracted output is delivered.

Liquidated damages (LDs), in respect of late commissioning, are included in other operating income.

Proprietary trading income is recognised on the basis of completed contracts and the mark to market value of outstanding contracts at the period end.

Interest income is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount.

g) Foreign currencies

These Group financial statements are presented in sterling, which is the functional and presentational currency of the Company. The functional currencies of Group entities are principally determined by the primary economic environment in which the respective entity operates. Transactions entered into by Group entities are translated into the functional currencies of those entities 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.

Foreign currency non-monetary items measured in terms of historical cost are translated at the rate of exchange at the date of the transaction. Exchange differences on non-monetary items are recognised in line with whether the gain or loss on the non-monetary item itself is recognised in the income statement or in equity.

In order to hedge its exposure to certain foreign exchange risks, the Group enters into forward contracts and options (refer note 1(q)), the accounting policy on derivative financial instruments for details of the Group's accounting policies in respect of such derivative financial instruments.

The net assets of the Group's overseas subsidiaries, joint ventures and associates are translated at exchange rates prevailing on the balance sheet date. Income and expense items are translated at the average exchange rates for the period which approximate to actual rates.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

Exchange differences arising are recognised in the Group's translation reserve, which is a component of equity. Such translation differences are recognised as income or as expenses in the income statement in the period of disposal of the net investment in foreign operations.

In respect of foreign operations, any differences that have arisen before 1 January 2004, the date of transition to Adopted IFRSs, are presented as part of retained earnings.

h) Goodwill

Goodwill arising on consolidation represents the excess of the cost of acquisition over the Group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of a subsidiary, joint venture or associate at the date of acquisition.

Goodwill arising on acquisition of joint ventures and associates is included in the carrying amount of the investment.

Goodwill arising on acquisitions before the date of transition to Adopted IFRSs has been retained at the previous UK GAAP amounts subject to being tested for impairment at that date. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

Goodwill is recognised as an asset and reviewed for impairment annually and when there are indications of impairment. Any impairment is recognised immediately in the income statement and is not subsequently reversed.

On disposal of a subsidiary, joint venture or associate, the attributable amount of goodwill is included in the determination of the profit or loss on disposal.

i) Other intangible assets

Emission allowances An intangible asset is recognised on receipt of allocated emission allowances and recorded at the fair value on allocation. The fair value of the grant is also recognised on receipt and deducted from the value of the intangible asset. As a result no net asset or liability is shown on the balance sheet at initial recognition.

Emission allowances are recognised at cost when purchased. As emission allowances are utilised they are charged to the income statement within cost of sales. To the extent that these allowances were received by way of grant there is nil charge to the income statement for their utilisation. At the balance sheet date the net carrying amount of emission allowances held is compared with the fair value to assess for impairment.

Forward contracts for sales and purchases of emission allowances are measured at fair value.

A provision is made for the estimated shortfall between emission allowances held and the anticipated requirement and is charged to the income statement on a pro-rata basis according to current and expected future emissions throughout the accounting period based on the market value of those allowances.

Contracts and rights 'Contracts and rights' is the term we use to describe intangible assets, acquired in business combinations separately from goodwill, arising from identifiable contractual or other legal rights where their fair values can be measured reliably. These include 'in the money' commodity contracts, which qualify as 'own use' contracts in accordance with the requirements of IAS 39. On acquisition, these contracts and rights are classified as intangible assets and carried at cost less accumulated amortisation and impairment losses (refer accounting policy note 1(o)) where cost represents fair value at the acquisition date. The intangible asset is then amortised on a systematic basis in accordance with the pattern in which the future economic benefit of the contract is expected to be consumed by the entity. Intangible assets with indefinite useful lives are not amortised. An intangible asset with an indefinite useful life is tested for impairment by comparing its recoverable amount with its carrying amount annually, and whenever there is an indication that the intangible asset may be impaired.

1 Accounting policies continued

j) Property, plant and equipment

Property, plant and equipment are stated at original cost less accumulated depreciation and any provision for impairment in value. The property, plant and equipment of certain of the Group's US operations, which had been revalued to fair value on 1 January 2004, the date of transition to IFRSs, are measured on the basis of deemed cost, being the revalued amount at the date of that revaluation. In the case of assets constructed by the Group, related works, commissioning and borrowing costs as defined under IAS 23 (Borrowing costs) (refer accounting policy note 1(w)) are included in cost. Assets in the course of construction are included in property, plant and equipment on the basis of expenditure incurred at the balance sheet date.

Depreciation is calculated on a component part basis so as to write-down the cost of property, plant and equipment to its residual value systematically over its estimated useful life. Estimated useful lives, residual values and depreciation methods are reviewed annually, taking into account commercial and technological obsolescence as well as normal wear and tear, provision being made where the carrying value exceeds the recoverable amount.

The depreciation charge is based on the following estimates of useful lives:

	Years
Civil works	25-80
Power stations and wind farms	20-60
Fixtures, fittings, tools and equipment	3-10
Computer equipment and software	3-5
Combined cycle gas turbine (CCGT) hot gas path parts, on average	2-4
Leasehold improvements	Life of lease

Freehold land is not depreciated.

k) Government grants

Contributions received towards the cost of property, plant and equipment are recognised at fair value. The grant is deducted from the cost of the related property, plant and equipment to derive the carrying amount of the asset. The grant is recognised as income over the life of a depreciable asset by way of a reduced depreciation charge.

l) Project development costs

Project development costs are principally incurred in identifying and developing investment opportunities and typically include feasibility studies, pre-bid costs, legal, professional and other related advisory costs. These costs (including appropriate direct internal costs) are recognised as expenses as incurred, except that directly attributable costs are capitalised when it is virtually certain that the project will proceed to completion and income will be realised. Such capitalised costs are amortised over the life of the related property, plant and equipment or contract.

m) Investments in joint ventures and associates

A joint venture is an entity over whose activities the Group has joint control, established by contractual agreement.

An associate is an entity over which the Group is in a position to exercise significant influence, but not control or joint control, through participation in the financial and operating policy decisions of the investee. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over these policies.

The results, assets and liabilities of joint ventures and associates are incorporated in these financial statements using the equity method of accounting except when classified as held for sale. The results are presented after interest, tax and minority interests. Investments in joint ventures and associates are carried in the balance sheet at cost as adjusted by post-acquisition changes in the Group's share of the net assets of the joint venture or associate, less any impairment in the value of individual investments. Losses of the joint ventures and associates in excess of the Group's interest in those joint ventures and associates are not recognised unless the Group has a legal or constructive obligation to fund those losses.

Any excess of the cost of acquisition over the Group's share of the fair values of the identifiable assets, liabilities and contingent liabilities of the joint venture or associate at the date of acquisition is recognised as goodwill within the carrying amount. Any deficiency of the cost of acquisition below the Group's share of the fair values of the identifiable net assets of the joint venture or associate at the date of acquisition (i.e. discount on acquisition) is credited to the income statement in the period of acquisition.

Where a Group company transacts with a joint venture or associate of the Group, profits and losses are eliminated to the extent of the Group's interest in the relevant joint venture or associate. Losses may provide evidence of an impairment of the asset transferred in which case appropriate provision is made for impairment.

n) Other investments

Other investments consist of available for sale investments in debt and equity instruments which are measured at market prices where available. Where quoted market prices in an active market are not available, and where fair value cannot be reliably measured, unquoted equity instruments are measured at cost less impairment.

o) Impairment of assets excluding goodwill

At each balance sheet date, the Group reviews the carrying amounts of its property, plant and equipment, other intangible assets and those other investments measured at cost, to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (or cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised as an expense immediately.

At each balance sheet date, an assessment is made to determine whether there is any indication that an impairment loss recognised in prior periods may no longer exist or has decreased. Where such an indication exists, an impairment loss is reversed to the extent that the asset's carrying value does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

p) Non-current assets held for sale

Non-current assets classified as held for sale are measured at the lower of the asset's previous carrying amount and fair value less costs to sell. No depreciation is charged on assets classified as held for sale.

Non-current assets are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the asset is available for immediate sale in its present condition. Management must be committed to the sale, which should be expected to qualify for recognition as a completed sale within one year from the date of classification.

q) Derivative financial instruments

The Group's operating activities expose it to price risks associated with selling its generation output. The Group is also exposed to price risks associated with the purchase of its fuel requirements and to financial risks of changes in foreign currency exchange rates and interest rates. The Group uses a range of derivative instruments, including energy based futures and forward contracts, swaps and options to hedge its risk to changes in power prices, fuel costs, foreign exchange rates and interest rates. Derivative financial instruments are only used for hedging purposes apart from energy based futures contracts, some of which are used for proprietary trading purposes.

The use of financial derivatives is governed by the Group's risk management policies approved by the Board of Directors, which provide written principles on the use of financial derivatives consistent with the Group's risk management strategy.

Derivative financial instruments are recognised at fair value at the date a derivative contract is entered into and are subsequently remeasured to their fair value at each balance sheet date. The gain or loss on subsequent fair value measurement is recognised in the income statement unless the derivative qualifies for hedge accounting when recognition of any resultant gain or loss depends on the nature of the item being hedged. Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in an active market are based on bid prices for assets held and offer prices for liabilities held. If the market for a financial instrument is not active, its fair value is established by using valuation techniques. These valuation techniques include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

All regular way purchases and sales of financial assets are recognised on the trade date, being the date that the Group commits to purchase or sell the assets. Regular way transactions require delivery of assets within the time frame generally established by regulation or convention in the market place.

Cash flow hedges Changes in the fair value of derivative financial instruments that are designated and are effective as hedges of future cash flows are recognised directly in equity and the ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled to the income statement in the period in which the hedged item also affects the income statement. However, if the hedged item results in the recognition of a non-financial asset or liability, the amounts accumulated in equity on the hedging instrument are transferred from equity and included in the initial measurement of the cost of the asset or liability.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, exercised, or no longer qualifies for hedge accounting. At that time, for forecast transactions, any cumulative gain or loss on the hedging instrument recognised in equity is retained in equity until the forecasted transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the income statement.

Changes in the fair value of derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement as they arise.

Fair value hedges For an effective hedge of an exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, the hedged item is adjusted for changes in fair value attributable to the risk being hedged with the corresponding entry in net income. Gains or losses from remeasuring the derivative, or for non-derivatives, the foreign currency component of its carrying amount, are recognised in net income.

Hedge of a net investment in a foreign operation Hedges of net investments in foreign operations are accounted for on a similar basis to cash flow hedges. Effective gains or losses on the hedging instrument are recognised in the translation reserve, with ineffective gains or losses recognised in finance costs in the income statement. Cumulative gains or losses in equity are taken to the income statement on disposal of the foreign operation.

Embedded derivatives Derivatives embedded in other financial instruments or other non-financial host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of the host contracts and the host contracts are not carried at fair value.

Any unrealised gains or losses on such separated derivatives are reported in the income statement.

r) Leasing

A lease is defined as an agreement whereby the lessor conveys to the lessee, in return for a payment or a series of payments, the right to use a specific asset for an agreed period of time. The definition can include arrangements such as long-term PPAs, where power plants are specifically designated to fulfil the requirements of an agreement.

Finance leases – Group as lessor Where the Group determines a long-term PPA to be or to contain a lease, and where the offtaker has the principal risks and rewards of ownership of the power plant through its contractual arrangements with the Group, the arrangement is considered a finance lease. As discussed in note 1(f), capacity payments are apportioned between capital repayments relating to the provision of the plant, finance income and service income. The finance income element of the capacity payment is recognised as revenue, using a rate of return specific to the plant to give a constant periodic rate of return on the net investment in each period. The service income element of the capacity payment is the difference between the total capacity payment and the amount recognised as finance income and capital repayments and recognised as revenue as it is earned.

Arrangements that do not convey the right to use a specific asset through the term of the agreement result in the continued recognition of property, plant and equipment, rather than a finance lease receivable, which is depreciated over its economic life.

The amounts due from lessees under finance leases are recorded in the balance sheet as financial assets, classified as finance lease receivables, at the amount of the net investment in the lease after making provision for bad and doubtful debts.

Operating leases – Group as lessor An operating lease is any lease other than a finance lease. Thus where the Group determines a long-term PPA to be or to contain a lease, and where the Group retains the principal risks and rewards of ownership of the power plant, the arrangement is considered an operating lease.

For operating leases, the power plant is capitalised as property, plant and equipment and depreciated over its economic life.

Rental income from operating leases is recognised on a straight-line basis over the term of the arrangement.

Operating leases – Group as lessee Rentals payable under operating leases are charged to income on a straight-line basis over the term of the relevant lease.

Benefits received and receivable as an incentive to enter into an operating lease are also spread on a straight-line basis over the lease term.

Where a leasehold property is vacant, or sublet under terms such that the rental income is less than the head lease rental cost, provision is made for the best estimate of unavoidable lease payments during the vacancy or on the anticipated future shortfall of sub-lease income compared with the head-lease expense.

s) Inventories

Plant spares, operating stocks of fuel and consumables are valued at the lower of cost and net realisable value. Cost comprises direct materials and, where applicable, direct labour costs and those overheads that have been incurred in bringing the inventories to their present location and condition. Cost is calculated using the weighted average method.

t) Cash and cash equivalents

Cash and cash equivalents comprise bank balances and cash held by the Group and short-term deposits with an original maturity of three months or less. Bank overdrafts that are repayable on demand and form part of the Group's cash management are included as a component of cash and cash equivalents for the purpose of the cash flow statement.

u) Loans and bonds

Interest-bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortised cost with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

v) Convertible bonds

Convertible bonds are regarded as compound instruments, consisting of a liability component and either an equity component or an embedded derivative component.

At the date of issue, the fair value of the liability component is estimated using the prevailing market interest rate for similar non-convertible debt. The difference between the proceeds of issue of the convertible bonds and the fair value assigned to the liability component represents the value of either an equity component or an embedded derivative component attributable to the embedded option to convert the bonds into equity of the Group.

1 Accounting policies continued

IAS 32 states that a derivative contract that will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. It also states that a contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. For the purposes of the consolidated financial statements, when making the assessment of whether a convertible bond, when exercised, gives rise to the exchange of a fixed or variable amount of cash, or other financial asset, the functional currency of the issuing company relative to the currency denomination of the bonds is considered in addition to other features within the bond.

For convertible bonds issued by the Group where there is a difference between the currency of the bond and the functional currency of the issuing company, the embedded option to convert the bonds is recorded as a derivative liability because it is not a contract to exchange a fixed number of shares for a fixed amount of bonds. The embedded derivative liability component is separately identified and measured at fair value through profit or loss.

For convertible bonds issued by the Group where the currency of the bond and the functional currency of the issuing company are the same, i.e. where on conversion of the bonds a fixed number of shares is exchanged for a fixed amount of bonds, the value of the embedded option to convert the bonds is recorded within equity on initial recognition.

Issue costs are apportioned between the liability and embedded option components of the convertible bonds (recorded as equity or as a derivative liability) based on their relative carrying amounts at the date of issue.

The interest expense on the liability component is calculated by applying the prevailing market interest rate for similar non-convertible debt to the liability component of the instrument. This interest expense, recognised in the income statement, is calculated using the effective interest method, i.e. the difference between the interest expense on the liability component and the interest paid is added to the carrying amount of the convertible bond.

w) Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to be prepared for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale. As referred to in note q), to the extent that variable rate borrowings are used to finance a qualifying asset and are hedged in an effective cash flow hedge of interest rate risk, the hedging gain or loss relating to the effective portion of the derivative is removed from the hedging reserve and recognised as part of the initial carrying amount of the asset. Investment income earned on the temporary investment of specific borrowings pending their expenditure on qualifying assets is deducted from the borrowing costs eligible for capitalisation.

All other borrowing costs are recognised in profit or loss in the period in which they are incurred.

x) Provisions

Provisions are recognised when the Group has a present obligation as a result of a past event, it is probable that the Group will be required to settle that obligation and the amount can be reliably estimated. Provisions are measured at the Directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material.

y) Decommissioning costs

Provision is made for reliably estimated decommissioning costs at the end of the useful economic life of the Group's power stations and generating assets, if and 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 initial provision is capitalised within property, plant and equipment and is depreciated over the useful lives of the related assets. The unwinding of the discount is included within finance costs.

Where there is a subsequent change in estimate of decommissioning costs, the present value of the change is recognised in the cost of property, plant and equipment.

z) Environmental liabilities

Provision for environmental liabilities is made when expenditure on remedial work is probable, the Group is obliged, either legally or constructively through its environmental policies, to undertake such work and the amount can be reliably estimated. Where the amount is expected to be incurred over the long-term, the amount recognised is the present value of the estimated future expenditure and the unwinding of the discount is included within finance costs.

aa) Tax

The tax expense represents the sum of the expected tax payable on taxable income for the year, including adjustments in respect of prior periods and deferred tax. Taxable profit differs from accounting profit, as reported in the income statement, because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from goodwill, not deductible for tax purposes, or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries, joint ventures and associates. Where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future, no deferred tax liability is recognised.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

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

Deferred tax assets and deferred tax liabilities are only offset to the extent that there is a legally enforceable right to offset current tax assets and current tax liabilities, they relate to taxes levied by the same taxation authority and the Group intends to settle its current tax assets and liabilities on a net basis or to realise an asset and settle a liability simultaneously.

ab) Pension schemes

Payments to defined contribution pension plans are charged as an expense as they fall due. Payments made to state managed defined benefit pension plans are dealt with as payments to defined contribution plans where the Group's obligations under the plans are equivalent to those arising in a defined contribution pension plan.

For defined benefit pension plans, the cost of providing benefits is determined using the projected unit credit method, with actuarial valuations being carried out at each balance sheet date.

The corridor method is applied in recognising actuarial gains and losses. Gains and losses in an individual scheme are recognised to the extent they exceed the greater of 10% of the gross assets or gross liabilities of the scheme. The amount recognised in the following year is the excess amortised over the remaining average service lives of the employees in the scheme and is recognised in the income statement.

The net defined benefit obligation recognised in the balance sheet represents the present value of the defined benefit obligations adjusted for unrecognised actuarial gains and losses and unrecognised service costs and as reduced by the fair value of the plan assets. Any asset resulting from this calculation is limited to unrecognised actuarial losses and past service cost plus the present value of available refunds and reductions in future contributions to the plan.

ac) Share-based payments

The Group issues equity-settled share-based payments to certain employees. Equity-settled share-based payments are measured at fair value (excluding the effect of non-market-based vesting conditions) at the date of grant. The fair value determined at the date of grant of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the Group's estimate of the shares that will eventually vest and where applicable, adjusted for the effect of non-market-based vesting conditions including service conditions.

For the Group's Executive Share Option Plans the fair values are measured using the Black-Scholes pricing model. The expected lives used in these models have been adjusted, based on management's best estimate, for the effects of non-transferability, any exercise restrictions and behavioural considerations.

For conditional awards, made under the 2002 Performance Share Plan, without a market-related performance condition, the fair values have been calculated as the face value of the award, discounted for the non-entitlement to dividends during the vesting period.

Where conditional awards, made under the 2002 Performance Share Plan, contain a market-related performance condition, the fair values are measured using a Monte Carlo simulation method.