

Chief Executive's Review



Padraig McManus

Overview

On a global basis 2005 saw the profile of the energy sector raised dramatically. Driven by events in the Middle East, hurricanes in the Mexican Gulf, a growing awareness of the economic impact of CO₂ and elevated security of supply concerns across many fuels, the prices of all fuel commodities rose significantly. The volatility of these fuel prices has also increased with price spikes occurring frequently. This fundamental shift in the way global fuel commodities are priced has affected many industries and in particular it has dramatically effected the electricity sector in both the short and perhaps more significantly the long term.

At the same time there have been further changes in Ireland. The deregulation of the supply sector, the rapid change in ESB's market share in both the generation and supply business, continued record demand for new connections, the buoyant demand coupled with the age of the generation portfolio and genuine concerns over security of supply have placed an unprecedented strain on resources.

Staff numbers are 20% down on the level employed 10 years ago, but ESB is spending 5 times more per annum on capital, connecting 3 times as many new customers, while distributing significantly higher volumes of electricity to the growing market.

It is against this backdrop that the performance both financially and operationally in 2005 is particularly pleasing. ESB is reporting for the first time under the new International Financial Reporting Standards. Comparative figures for 2004 have been restated on the same basis.

ESB has exited from the Retail appliance business through the sale to Bank of Scotland (Ireland) (BOSI), and has disposed of the UK electrical contracting business (ESBI UK). The sale of 50% of the Spanish IPP to Osaka Gas of Japan has also been completed.

These transactions are all clear signs of ESB's commitment to keeping the focus on delivering long-term value by growing the electricity business while maintaining an acceptable risk profile. All of these one-off transactions have had a positive impact on 2005's financial performance.

During 2005 ESB staff demonstrated their capacity to deal with the changes facing the organisation

The scale of the financial and operational challenge that faces ESB cannot be underestimated. The continuing growth in the Irish economy is driving large capital expenditure in the Networks business. The renewal of an ageing generation portfolio is a priority, including the need to expand the thermal and renewable generation portfolio to meet the major demand growth in Ireland, in addition to investing to meet environmental targets. As a result, it is estimated that ESB will invest an average of €1 billion per annum over the next 5 years. Importantly, even with this level of spend ESB's share of the generation market will fall below 45% in 2006.

By late 2007 when the Single Electricity Market is formed, ESB Power Generation will generate approximately 30% of all electricity generated on the island. To compensate for this loss of market share ESB is pressing ahead with international growth more aggressively than before. International investments to date have been particularly successful and the Group's aim is to balance the reduced domestic market share by expanding the resources devoted to the international business. ESB has been separated from other activities to maintain the appropriate focus on such expansion. Through this approach, ESB can achieve significant profit growth, in line with its overall strategy.

The investment requirements in the ESB Networks, Power Generation and International businesses are challenging both financially and operationally. During the last 5 years ESB has debt funded capital investment of €5 billion. This has seen balance sheet gearing rise from 15% to 47% over that period. This cannot continue and other ways must be sought to complement this debt funding.

The agreement with staff and their Unions in early 2006 on a Pay, Pension and Change agreement

will address the actuarial deficit on the pension fund and will maintain a strong and relevant ESB into the future. Addressing the funding requirements of the business and continuing to adapt to market changes are issues that must be addressed over the next few years.

Operational Review

Irish economic growth continued strongly in 2005, resulting in a 3.7% rise in electricity demand. Over 89,000 new customer connections were made during the year, just short of the record level achieved in 2004. Since 2001, more than 370,000 new customer connections have been provided, the largest growth in customer numbers in ESB's history.

Capital expenditure for the year was in excess of €900 million with nearly €700 million spent on the networks infrastructure alone.

In 2005 over 1,300MW of generation plant was brought into commercial operation in Ireland and Spain.

- The 150MW West Offaly power plant commenced commercial operation at the beginning of 2005.
- The 800MW power station in Amorebieta in Spain was completed ahead of schedule and commenced commercial operation in August 2005. This plant is the first Independent Power Producer (IPP) in the Spanish market and clearly demonstrates ESB's ability to compete successfully in a liberated European market.
- A 400MW plant began generating in Coolkeeragh, near Derry, underlying ESB's support for the All Island Market.

ESB is a strong supporter of the All Island Market and has been fully participating in the development of arrangements for the Single Electricity Market, which is due to come into operation in 2007

Work has commenced on a €368 million environmental retrofit project at Moneypoint coal station, to meet its environmental targets over the next 10 years. The project will be completed in 2008.

The "Programme to Achieve Competitiveness and Transformation" (PACT) came to a successful conclusion at the end of 2005.

Over a number of years this major change programme achieved annual cost savings of over €135 million and total staff reductions of almost 2,000.

Power station availability improved and, at 83%, was in line with the target for the year. However, availability performance in 2006 is likely to be adversely affected by the environmental project in Moneypoint and an unavoidable extensive overhaul programme.

Challenging customer service targets have been set by the Commission for Energy Regulation (CER). While ESB's Network Renewal Programme and the investment in new market systems initially adversely affected the achievement of these targets, they are now bringing tangible long term benefits to all customers.

Safety

ESB is committed to ensuring the safety of staff, contractors and the public. Working safely is a core value for ESB. The target is to achieve zero lost time injuries and real progress is being made towards achieving this.

Public safety is of equal importance and it is immensely regrettable that three fatalities occurred during 2005 – one contractor and two members of the public.

These tragedies bring home the need for continuous vigilance by everyone dealing with electricity. There is an extensive safety leadership programme in place throughout ESB, with structured safety management systems. ESB continues to focus on contractor safety and in a new initiative has also introduced a comprehensive safe driving programme for the vehicle fleet.

ESB, in a unique development, has formed a strategic partnership with the Health and Safety Authority (HSA) to promote awareness of electrical hazards in the construction and agricultural sectors.

These initiatives covering staff, contractors and the public will continue to be pursued vigorously in 2006.

Regulatory Developments

The electricity market in the Republic of Ireland was opened fully to supply competition in February 2005. ESB played a major part in the achievement of this milestone by delivering a €120 million IT project to enable all suppliers equal access to the network and customers.

The company has also supported the development of the generation market by offering off-take agreements for 500MW of new capacity. This led to the development of generating plants at Tynagh (400MW) and Aughinish (150MW) both of which came into operation in early 2006.

Under the EU Electricity Directive, Ireland is pledged to producing 13.2% of its energy from renewables by 2010. ESB fully supports this target and is actively investing in the development of wind farm projects throughout the country.

Service to customers is critically important to ESB. This is about people delivering a service to other people and it is at this interface that ESB staff make one of their most important contributions to the reputation of the company

ESB is a strong supporter of the All Island Market and has been fully participating in the development of arrangements for the Single Electricity Market (SEM), which is due to come into operation in 2007. This is a positive development which can aid competition, improve system stability and minimise costs going forward. In the short term however it will require significant effort by all involved to achieve successful implementation.

Price Reviews

The first 5 year regulatory price review period concluded in 2005. The second 5 year review (2006 – 2010) was completed by the CER during the year. These reviews have resulted in a significant reduction in the allowed revenues of ESB's regulated businesses. This presents a challenge for these businesses which also have large ongoing capital investment programmes.

Recent electricity price increases have been mainly driven by surging fuel prices on international markets. It is not possible to protect customers from the impact of these rising prices. Future prices will be largely dependent on the direction of prices for the fuels used to generate electricity and there is an increased exposure to gas, one of the more volatile and now one of the highest priced fuels. The short term outlook is for continuing high prices.

People

During 2005 ESB staff have continued to demonstrate their capacity to deal with the changes facing the organisation. The pace of change has continued and the industry is becoming even more complex. As part of ESB's response to this, staff have delivered

a wide range of initiatives, from the investment in new and efficient networks through to investment in new cleaner technology that will extend the life of coal burning plant and thus ensure that Ireland continues to have fuel diversity.

Such change can only be delivered though the expertise, commitment and skills of all staff, underpinned by a willingness to embrace new ways of working, new ways of organising and new technologies. Achieving this is only possible through the operation of a genuine and robust partnership with the Trade Unions.

Service to customers is critically important to ESB. This is about delivering a consistently high quality of service to all customers and it is at this interface that ESB staff make one of their most important contributions to the reputation of the company, whether through the familiar yellow vans, through our Contact Centres or through 24 hour production of energy from our power stations.

The company also recognises the pressures on its staff in dealing with the changes in contemporary society and is fully aware that staff have, as well as their commitment to the company, increasing pressures in their private lives from issues such as longer commuting distances and times, as well as caring for both young and aged dependents. Over the last year ESB has concentrated on reinvigorating the approach to Life-Work balance and has elevated this issue to the highest levels in the organisation.

With the closure of the retail appliance shops and receipting facilities, it is important to acknowledge the tremendous service to customers, provided by the loyal and dedicated staff in these areas over many years.

Looking Ahead

The pace of change in the electricity industry is relentless and 2006 will bring its own set of challenges. The key operational priorities for the year will include:

- Continuing to embed in ESB the concept of safety as a core value.
- Driving performance improvement and delivering a competitive cost base.
- Enhancing customer service in all areas of the business.
- Delivering the significant capital investment programme.
- Ensuring that ESB businesses can compete successfully in the Single Electricity Market (SEM).
- Completing the separation of EirGrid from ESB.
- Supporting EU and national commitment to producing increased energy from renewable energy sources.
- Supporting the growth potential of ESB International (ESBI) and fostering a healthy pipeline of international electricity projects.

ESB has positioned its business to respond to the challenges ahead and can look to 2006 with every confidence. ESB looks forward to bringing customers world class service through the years ahead.

Finally I would like to pay tribute to our former Chief Executive, Joe Moran, who died in early 2006. Joe devoted a remarkable 47 years of his life to ESB. His foresight and an enduring legacy of partnership set the framework for the peaceful

introduction of enormous change in ESB. Joe is remembered with affection and respect throughout ESB.



Padraig McManus

Chief Executive

18 May 2006