

Financial Review

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Overview

A strong operational performance was delivered in 2007 with Revenue and Profit after Tax at €3.6 billion and €432 million respectively, both up on 2006. Close to €900 million was invested in capital programmes of which over €600 million was in the Networks business. Net Debt levels decreased by €163 million to €1,797 million with gearing and EBIT interest cover strong at 40% and 5.0 times respectively. Return on Capital employed at 10% was in line with expectations.

Revenue

Revenue including operating income at €3,570 million is up €174 million on 2006, mainly reflecting overall market growth and higher electricity tariffs partly offset by reduced valuations for CO₂ emission allowances.

Operating Profit

Operating Profit for the year was €523 million compared to €337 million in 2006. The strong outturn reflects increased revenues, lower energy and employee costs, offset by reduced profits from property disposals.

Share of Joint Venture Profits

Joint ventures had a very good year, with profits at €47 million up €27 million on 2006. A major scheduled outage in the Synergen plant in 2006 combined with increased availability and revenues in 2007 contributed to the improved outturn.

Taxation

The Group Tax Charge for 2007 was €48 million (2006: €41 million) reflecting an effective tax rate of 11.2% (2006:17%). The reduction in the effective tax rate was mainly due to a non tax deductible item relating to asset impairment taken as a charge in 2006 and the release of tax provisions in 2007.

Profit after Tax

Profit after tax at €432 million compares with €223 million in 2006. The increased outturn primarily reflects the higher operating profit in addition to the improvement in the profits from Joint Ventures outlined above.

Segmental Performance

The Profit after Tax arises in Power Generation €232 million, Networks €139 million, Supply €13 million and the unregulated businesses €48 million.

Power Generation's profits have increased by €27 million on 2006 mainly due to lower pension and interest charges than in 2006. The impact of lower fuel costs in 2007 has been offset by a reduction in market share.

Network's profits, which are up €70 million on 2006 are in line with regulatory targets for 2007 and reflect the return required to meet the significant capital investment programme undertaken in recent years.

The year on year Supply profits are up €58 million due to adjustments from over and under recoveries in the regulatory framework. Specifically the 2006 profits were reduced by €62 million due to over recoveries in 2005 and previous years.

Profits from the unregulated business are up €54 million on 2006, mainly reflecting the improved outturn from the independent generation plants in 2007 offset by lower property disposals income in the current year.

Key Performance Indicators

Key Performance Indicators for the year include:

	2007 €m	2006 €m	Change €m
Revenue & Operating Income	3,570	3,396	174
Operating Profit	523	337	186
Profit after Tax	432	223	209
Capital Expenditure	903	831	72
Net Debt	1,797	1,960	(163)
EBIT Interest Cover (times)	5.0	3.7	1.3
Gearing %	39.5	46.9	(7.4)
ROCE %	10	6.4	3.6

Capital Expenditure

€903 million was invested in capital programmes in 2007. Over €600 million was spent on the Distribution and Transmission Infrastructure alone bringing the total investment in this area to over €4.3 billion since 2001. A further €122 million was invested by Power Generation in the Environmental Retrofit Project in Moneypoint Station. This project, with an overall cost of €368 million, will significantly reduce the SO_x and NO_x emissions from the station over the next ten years and is due for completion in 2008.

Net Debt and Gearing

Net debt at €1,797 million is down €163 million on 2006. A cash surplus of €89 million was generated during the year with cash generated from operations more than offsetting funding for the 2007 capital programme and other funding requirements. Debt and finance leases of €73 million were repaid out of the cash surplus. The revaluation of debt at year end foreign exchange rates, as required under IAS 39, further reduced the debt balance by €74 million due to the fall in value of the USD versus the Euro. Gearing was 40% at year end and 70% of the debt portfolio was at fixed interest rates. The average coupon rate was 4.9%.

Employee Benefits

In compliance with EU IFRS, a portion of the net assets and liabilities of ESB's defined pension scheme, computed in accordance with IAS 19 have been included in the balance sheet under employee related liabilities. In accounting for the pension deficit ESB has availed of the option to defer the unrecognised portion of the pension deficit over the future service lives of employees. At the end of 2007 the recognised and unrecognised pension liabilities were €326 million and €1 billion respectively.

For financial reporting under EU IFRS, the full liability and pension costs have been considered in determining the appropriate liabilities to be recorded in the financial statements, notwithstanding that the scheme is not a typical balance of cost defined benefit scheme wherein the employer is liable to pay the balance of contributions required to fund the benefits.

Regulation

Some 73% of ESB's revenue is subject to regulation by the Commission for Energy Regulation (CER). Annual electricity tariffs are set in advance of the relevant year by the CER, based on a forecast of both customer demand and relevant costs. As with any forecast, there is almost invariably a difference with the actual outturn for the year which results in either an under or over recovery of revenue by ESB. Any such under or over recovery of allowed revenue is adjusted by the CER in setting the price determinations for subsequent years. In addition, specific costs reflected in the income statement may be recovered in the tariff in different, or over a number of, accounting periods.



ESB International in South Africa.

Such timing differences can cause material variations in the annual profits earned by the individual regulated businesses and cause distortions in reviewing the year on year performance of ESB's regulated businesses. Timing differences have resulted in the year on year outturn being increased by €49 million mainly due to the 2006 tariff for Supply being reduced due to over recoveries in earlier years.

Prior to the commencement of the Single Electricity Market (SEM) on 1 November 2007, ESB Power Generation's allowed revenues were agreed annually by CER based on estimated costs and demand with under and over recoveries adjusted in subsequent years as outlined above. Post SEM, the wholesale price of electricity is market driven with all electricity generated sold into a market pool overseen jointly by CER and the Northern Ireland Utility Regulator. ESB Power Generation is participating in the electricity market on a basis similar to all other generators and as a result distortions to Power Generation's results caused by under/over recoveries will be limited going forward.

Financial Risk Management

Framework for Treasury and Trading Operations

The main financial risks faced by the Group relate to foreign exchange, interest rate, operational risk and commodity (electricity and fuel) price movements. Policies to protect the Group from these risks, and other risk areas, such as liquidity risk and counterparty credit risk, are regularly reviewed, revised and approved by the Board as appropriate. Group Treasury is responsible for the day to day treasury activities of the Group.

The Board Finance Committee is updated on an ongoing basis on key treasury matters and an annual report covering the treasury activity is also submitted to the Committee for review. Commodity price risk is managed by the relevant business unit (Power Generation, Customer Supply and ESBI) in the context of an overall Group risk management framework. These activities are reviewed regularly by Group Internal Audit. The advent of the SEM has changed the nature of the risks posed by electricity and fuel price movements. As a result, the company has put in place a new Group Trading Risk Management function to ensure that the Group's market, credit and operational risks are managed in a way to protect the company from loss, while respecting the ring-fencing obligations in place between the business units.

Derivative instruments are used to mitigate financial risks and are executed in compliance with the Specification of the Minister for Finance issued under the aegis of the "Financial Transactions of Certain Companies and Other Bodies Act 1992". The Group does not hold or trade derivative instruments for speculative purposes. Hedge accounting pursuant to IAS 39 is used for hedges of foreign currency liabilities, interest rate risks from borrowings and other debt and is also used to cover commodity and foreign exchange hedges arising from the SEM.



ESB International Power Station at Amorebieta, Spain.

Foreign Exchange Management and Interest Rate Management

The majority of the Group's business is transacted in Ireland or within Europe. Operating and investing cash flows are mainly denominated in Euro. Foreign currency exposures arise from purchasing fuel and other materials or services, foreign currency denominated debt and from business that is carried on outside the Euro zone.

To 31 October 2007, the Group managed the majority of its fuel related foreign currency exposures against a fuel price recovery mechanism, based on indexation, which was agreed with the CER and approved by the Board in 2002. With the commencement of SEM on 1 November 2007, the Group's hedging strategy in relation to fuel related currency exposures changed and the Group now manages the majority of its exposures using currency derivatives such as forward purchase contracts and options. Other material foreign currency exposures are hedged as appropriate.

The Group's policy is to borrow directly in Euro or to convert any foreign currency borrowing to Euro through the use of derivative instruments. There are specific instances where foreign currency denominated debt is matched by a foreign currency denominated asset or net revenue flow. At the end of 2007, 91% of ESB's debt was effectively denominated in Euro. It is also the Group's policy to have a minimum of 50% of the debt portfolio at fixed rates of interest, subject to cost and market outlook. At year end 70% of the debt portfolio was at fixed interest rates.

Funding and Liquidity Management

The Group's debt management strategy targets a debt portfolio profile with a diverse mix of counterparties, funding sources and maturities. Structured non-recourse and limited recourse financing is used where appropriate, taking into account the compatibility between funding costs and risk mitigation. All borrowing facilities are in compliance with the Electricity Acts and relevant regulatory requirements and Group Treasury maintains diversity in ESB's lender base in order to achieve a strategic spread of risk.

ESB has in place adequate borrowing facilities in order to ensure that liquidity demands can be met as required. At year end ESB had over €550 million available in undrawn committed corporate facilities. The Group's policy is to hold minimal levels of surplus cash, other than in specific instances where favourable market conditions justify pre-funding. In such cases, the Group invests its excess cash in low risk instruments.

With a significant capital investment programme planned over the next few years, further long-term funding facilities will be required going forward. The Group continuously assesses the availability of funding in the bank and capital markets and opportunities to avail of funding in these areas are available.

ESB will continue to maintain strong cashflow generation, interest cover and gearing ratios while funding growth and capital investments.

Counterparty Credit Risk

The Group is exposed to credit risk from its financial and banking counterparties. The Group's policy is to limit its exposure to each financial institution based on accepted credit ratings. Exposures and related limits are subject to ongoing review and monitoring. Dealing activities are controlled by putting in place robust dealing mandates with counterparties.

ESB also has credit risks from commodity counterparties. These are managed in accordance with the Specification of the Minister for Finance. Credit exposures, potential exposures, and collateral requirements are monitored and reported on an ongoing basis.

Future Outlook

ESB's recently announced Strategic Framework to 2020 incorporates an unprecedented capital investment programme of €22 billion with half the expenditure geared towards investment in renewable projects. Maintaining strong financial disciplines will be essential in this environment. Looking forward key financial priorities for the Group will include:

- Maintaining strong cashflow generation, interest cover and gearing ratios while funding growth and capital investments.
- Continuing with performance improvement programmes to deliver sustained growth in Shareholder value.
- Management of the trading risk arising from the SEM while respecting the ring-fencing obligations between business units.
- Successfully operating the Networks business within the agreed regulatory framework.
- Continuing to successfully deliver the significant capital expenditure programmes.
- Effective fuel management to mitigate the volatility in market prices for coal, oil and gas.