DRAX GROUP LIMITED

(Incorporated in the Cayman Islands with company number WK-129356)

Directors:
Gordon Horsfield (Executive Chairman)
Gordon Boyd (Finance Director)
Peter Emery (Production Director)
Tim Barker (Non-Executive Director)
Mike Grasby (Non-Executive Director)

Registered office:
Walkers SPV Limited
PO Box 908GT
Mary Street
George Town
Grand Cayman
Cayman Islands
British West Indies

14 July 2005

Dear Investor

Group Reorganisation and capital losses tax planning
FRS 25 planning
Provision of half-yearly information

As foreshadowed on several occasions during the last few months, there remain certain steps that the group needs to take to improve its tax position in the face of the need to implement the new financial reporting standard, FRS 25, and to reduce the prospect of tax leakage from the receipt of the remaining proceeds from the TXU claim ("**TXU Proceeds**"). As proposed these steps will also yield the additional benefit of streamlining the group's cashflows and corporate structure. Although not driven by the proposed refinancing and listing of the group, the steps proposed are indirectly beneficial in helping to start the process of tidying up what is clearly a complex group structure. The board further considers that, since these actions must be taken by the year-end, it is preferable to address them now in order to secure certainty.

Accordingly, as a separate letter, Drax Holdings Limited has today written seeking your consent to undertake the steps necessary to deal with these matters. Whilst these steps may appear, on their face, to be relatively complex (as are so many of the processes which need to be undertaken under Drax's current finance and equity documents), the underlying objectives remain relatively straightforward. In short, the proposed reorganisation of the Drax Electric sub-group is intended to simplify the group's cashflows and to enable latent group losses to be available to shelter the receipt of the remaining TXU Proceeds from tax. Similarly, the steps proposed in connection with FRS 25 are intended to mitigate any potentially adverse tax consequences for the group as a result of the introduction of this new reporting standard.

Although the rationale for these steps is clear, I appreciate that investors may seek further clarification in relation to one or more of the detailed steps outlined in the letter. Whilst we shall respond to any direct enquiries, in order to make doubly sure that investors' queries are addressed, Drax will host a conference call on Thursday 4 August 2005 to discuss the matters outlined in the letter further. Details of the conference call are set out in the letter attached.

The final request to investors (in their capacity as lenders) relates to the consequences of making arrangements for audited financial information to be prepared for the half year ended 30 June 2005 as a preparatory step for the proposed refinancing and listing. The audit process (which is not required for the half-year information under the finance documents) will take incremental time. As a result, the financial information required under the finance documents will not be available until 13 September 2005. To ensure that investors will still have access to what we believe is the key trading data, Drax will be providing investors with a trading statement on Thursday 11 August 2005 (which is within the period set for the provision of financial information under Drax's finance documents) and Drax believes this will afford investors helpful and relevant information on Drax's performance during the first half-year.

The Board unanimously believes that it is in the best interests of Drax for these steps to be taken and would therefore recommend that the consents sought be approved.

Please note that both the actions to be taken in connection with the TXU Proceeds, and those to be taken in connection with the introduction of FRS 25, also require "Majority Holder" approval under the Drax Group Articles of Association and the Drax Group Shareholders' Agreement. In this context, if you are in favour of the proposed steps, it is important that you actually vote in favour as failure to actively give your approval will register as a vote against the proposals. This is because a vote in favour is required from more than 50% of the shares in issue and not simply more than 50% of the votes cast. Further, if you are an A2 Lender or A2 Noteholder, you will receive a voting form in your capacity as such, and, if you are also a shareholder of Drax Group Limited, in your capacity as a shareholder. It is important that you complete both voting forms and return to the addresses indicated on the forms.

Thank you for your co-operation

Yours faithfully,

Gordon Horsfield
Executive Chairman, Drax Group Limited

CFD-#3549345-v5

Drax Group Limited

(Incorporated in the Cayman Islands with registered number WK-129356)

<u>Registered office:</u>

Walkers SPV Limited
Walker House
PO Box 908GT
Mary Street
George Town
Grand Cayman
Cayman Islands
British West Indies

To: All Shareholders

14 July 2005

Dear Shareholder

1 SHAREHOLDER CONSENT REQUEST

1.1 On 11 February 2005, the board of directors (the "**Directors**") of Drax Group Limited (the "**Company**") wrote to you requesting your consent to the capitalisation of Drax Power Limited. In that letter the Directors referred to proposals to reorganise the Group as part of a capital losses tax planning exercise, the principal effects of which are to simplify the Group's cash flows and to make available losses to shelter the TXU Proceeds from tax. The Directors also stated that these proposals were likely to require various consents from the Company's shareholders pursuant to the Company's Articles of Association (the "**Articles**") and the shareholders agreement of the Company dated 22 December 2003 (the "**Shareholders Agreement**") and that further information concerning the proposed reorganisation would be circulated in due course.

1.2 The Directors are now writing to request your consent to the Company and other Group Members (together, the "**Group**") taking the steps detailed below.

1.3 This letter is being placed on the Drax web site (<u>www.draxpower.com</u>). Drax will also host a conference call on **Thursday 4 August 2005** at **2.30 p.m.** (London time) to discuss the matters outlined in this letter in further detail. The UK and international dial-in telephone number is **+44 (0)20 7162 0084**. The US dial-in telephone number is **+1 334 323 6201**. Any information or presentations for this conference call, additional to that set out in this letter, will be placed on the Drax web site on the morning of the conference call.

1.4 This letter requests certain consents in connection with:

1.4.1 **Group reorganisation and capital losses tax planning** - a reorganisation of the Group and associated capital loss planning, the principal effects of which are to simplify the Group's cashflows and to realise latent Group losses to shelter the TXU Proceeds from corporation tax; and

1.4.2 **FRS 25 planning** - amendments to the Preference Share Subscription Agreement so as to ensure continuity of accounting treatment of that agreement and the related original Eurobonds and so as to avoid potential adverse tax consequences arising as a result of the introduction of FRS 25, <u>which are otherwise likely to occur if no action is taken</u>.

1.5 Each of the above matters is dealt with in detail below.

1.6 Capitalised terms used but not defined in this letter will have the meaning given to them in the InPower 2 Facility Agreement dated 22 December 2003 between, amongst others, InPower 2 Limited as the Borrower and Deutsche Bank AG London as the Agent (the "**InPower 2 Facility Agreement**") or the Drax Intercreditor and Security Trust Deed, as the context requires.

2 GROUP REORGANISATION AND CAPITAL LOSSES TAX PLANNING

2.1 The directors have been considering ways to simplify the Group structure with a view to streamlining cashflows up to Drax Holdings and (ultimately in the case of debt repayments) InPower 2 Limited and to the Lenders and to mitigate to the extent legally possible the tax impact on Group Members of receipt of the TXU Proceeds. Lenders will be aware of this as a consequence of various statements made and consents sought in connection with this stated aim. Indeed, consent of the Bond Trustee has already been granted to certain initial steps in this regard (comprising the incorporation of Drax Investments Limited ("**Drax Investments**") (consent for which was granted on 30 December 2004) and the £200 million capitalisation of Drax Power (consent for which was granted on 16 March 2005)), and approval is now being sought for further steps to be undertaken.

2.2 The steps outlined below (the "**Reorganisation Steps**") involve reorganising the inter-company balances owed between Drax Holdings and/or its Subsidiaries, the creation of distributable reserves through reductions of capital and carrying out certain corporate actions, in order to enable latent capital losses inherent in the Group to be realised, and to utilise these losses against any capital gains arising in respect of the TXU Proceeds.

2.3 A detailed description of each of the Reorganisation Steps is set out in Schedule 1 (*Group reorganisation and capital losses planning*) to this letter.

Summary

2.4 The Reorganisation Steps are as follows:

2.4.1 reorganising the inter-company balances owed between Drax Holdings and/or its Subsidiaries;

2.4.2 conversion of Drax Ouse into an unlimited company;

2.4.3 effecting a reduction of share capital of Drax Ouse following its re-registering as an unlimited company;

2.4.4 effecting a reduction of share capital of Drax Electric. This would be a Court-sanctioned reduction of share capital requiring the approval of the Cayman Court;

2.4.5 creating (by reductions of share capital in the case of Drax Ouse and Drax Electric) the necessary distributable reserves in Drax Ouse, Drax Limited and Drax Electric to allow the distribution to Drax Holdings by Drax Ouse (via Drax Limited and Drax Electric) of certain intra-group receivables. These receivables will be transferred to Drax Holdings by way of distributions in specie (i.e. dividends of non-cash assets) and the repayment of the remaining debt due from Drax Electric to Drax Holdings;

2.4.6 transferring to Drax Holdings, Drax Electric's right to receive the "**Excess Proceeds**" (being such gross sums as Drax Power would otherwise have received pursuant to the TXU Claim in aggregate from TXU Europe Energy Trading Limited (in administration and subject to company voluntary arrangement) ("**TXU EET**") and/or TXU Europe Group plc (in administration and subject to company voluntary arrangement) ("**TXU EG**") in excess of £253,500,000). For the purposes of calculating the Excess Proceeds, no account is taken of the £25 million Sum referred to in paragraph 2.5.1 since this represents a receipt by Drax Holdings and therefore does not fall within the Excess Proceeds. Following a previous consent from the Majority B Lenders, Drax Power assigned to Drax Electric the right to receive the Excess Proceeds on 30 December 2004. As a consequence, the B Facility Bond

Trustee is being asked to consent to the assignment of the Excess Proceeds to Drax Holdings (the "**Assignment of the Excess Proceeds**").

The directors consider that such Assignment of the Excess Proceeds will not adversely affect the interests of the B Facility Bond Trustee or the B Lenders since (1) the Excess Proceeds will not be transferred outside the Group, (2) the Excess Proceeds will be transferred subject to the existing security package and will continue to be "ring-fenced" for the benefit of the B Lenders (3) it will result in the right to receive the Excess Proceeds being held by Drax Holdings, the issuer of the B Facility Bonds and (4) the company voluntary arrangements for TXU EET and TXU EG and the compromise agreement dated 30 December 2004 entered into by Drax with, *inter alios*, TXU EET and TXU EG provide mechanisms by which the Excess Proceeds can be paid to Drax Holdings, in accordance with the terms of the Group Account Agreement. The consent of the B Facility Bond Trustee granted on 30 December 2004 to the assignment of the Excess Proceeds to Drax Electric, which does not trade, gave the opportunity and flexibility for further planning in 2005 to utilise the latent capital losses in the Group and offset these losses against any capital gains arising in respect of the TXU Proceeds. The Group now considers therefore, as an integral part of the Reorganisation Steps (which are in the best interests of all shareholders), that the Excess Proceeds should be assigned to Drax Holdings and this requires the consent of the B Facility Bond Trustee, acting on the instruction of the Majority B Lenders;

2.4.7 incorporating a newly formed Subsidiary of Drax Holdings, Newco (being a company limited by shares), to assist in retaining control of Drax Ouse if Drax Electric and its Subsidiaries were subsequently to leave the Group, as further referred to in Step 3 of Schedule 1 (*Group reorganisation and capital losses planning*) to this letter; and

2.4.8 incorporating a newly formed Subsidiary of Drax Holdings, GCo (being a company limited by guarantee), to hold shares in Drax Investments in order to leave the ownership of Drax Investments split 50:50 between Drax Holdings and GCo. This is to de-group Drax Investments from Drax Holdings and thereby crystallise a capital loss, as further set out in Step 4 of Schedule 1 (*Group reorganisation and capital losses planning*) to this letter.

The steps set out in paragraphs 2.4.7 and 2.4.8 above will not occur until on or after 28 December 2005 (but must occur on or before 30 December 2005). The directors consider it prudent to seek consent for these steps now since they comprise part of the Reorganisation Steps and this avoids the need for having to seek further consents for these steps later in the year.

The Rationale

2.5 The following benefits are expected to result from the Reorganisation Steps:

2.5.1 Drax Holdings has already received £25 million of TXU Proceeds (the "**£25 million Sum**") (in addition, Drax Holdings received payment of VAT thereon, albeit this VAT is not taken into account for the purposes of this definition) in consideration of Drax Holdings procuring the compromise of the non-compete claims in respect of the Primary Hedge Guarantee and certain other claims. This amount should constitute a capital receipt in the hands of Drax Holdings.

In addition following Drax Power's agreement to assign the Excess Proceeds to Drax Electric on 25 November 2004 and following consent to such assignment being obtained on 30 December 2004, Drax Electric acquired the rights to the Excess Proceeds from Drax Power for £8 million which sum is left outstanding on an intercompany account. To the extent that they exceed this sum, the gain will be subject to corporation tax on chargeable gains (whether in the hands of Drax Electric or, following the transfer at 2.4.6 above, Drax Holdings).

In terms of the likely quantum of the Excess Proceeds this remains uncertain. However, on 30 March 2005, the supervisors of the company voluntary arrangements for TXU EET and TXU EG paid £189,234,904 to Drax Power and the £25 million Sum to Drax Holdings. In the financial statements for Drax Holdings for the period ended 30 December 2004, the directors' expectations were that further distributions totalling approximately £134 million would be received from TXU EET and/or TXU EG by around April 2006, although this is not certain.

The result of the Reorganisation Steps is that uncrystallised capital losses inherent within the Group will become available to Drax Holdings to the extent necessary to shelter from corporation tax on chargeable gains any gain arising in respect of either the Excess Proceeds or the £25 million Sum.

2.5.2 The intra-group balances will be consolidated within Drax Holdings and the up-streaming of cash to the debt holders will be facilitated. The consolidation of the Group balances will simplify the Group's UK to UK transfer pricing position.

2.5.3 It will provide the ongoing benefit of having current and future cash receipts closer to the current Drax Bondholders and will simplify the Group structure.

2.5.4 It will streamline the Group corporate structure to a "core" set of companies, while leaving the opportunity in the future to crystallise a proportion of the inherent capital losses with respect to shareholdings in Drax Electric, Drax Ouse and Drax Limited in excess of the amounts needed to shield the Excess Proceeds and the £25 million Sum from corporation tax.

2.6 The Company does not consider that the proposed steps will have any adverse impact on the ability of Drax Holdings to pay amounts due on the Drax Eurobonds as the intra-group distributions will be subject to the existing security package as set out in the Drax Intercreditor and Security Trust Deed and no payments will be made outside the Group. Indeed the proposed steps will improve the Group's Available Cash position from what it would be were the steps not to be taken.

2.7 As part of the arrangements, it is proposed that Drax Ouse re-registers as an unlimited company. Drax Ouse will continue to be solely held by Drax Limited (a limited company with no material assets and liabilities following these transactions) until the step set out in paragraph 2.4.7 occurs. Drax Ouse has not traded since December 2003 when the agreement to transfer its assets and liabilities to Drax Power was completed.

2.8 Although there may be certain obligations for which Drax Ouse remains liable, Drax Power has provided Drax Ouse with a full indemnity under the terms of the Drax Sale and Purchase Agreement in respect of any remaining liabilities relative to the business, assets and employees of the Power Station. The directors are satisfied that any liabilities for which Drax Ouse may remain liable are liabilities which will be capable of being funded by the indemnity provided by Drax Power. Accordingly, if Drax Ouse does become an unlimited company, the directors are satisfied that the full amount of the distributable reserve will be available for distribution.

2.9 The directors anticipate that a similar result could be achieved if Drax Ouse was not re-registered as an unlimited company and an application was instead made to the Court for the share capital of Drax Ouse to be reduced. The Court does have a discretion, in Court-sanctioned reductions of share capital, as to what to award and in certain cases can require either bank guarantees in respect of certain obligations or restrict the payment of distributions until certain liabilities have been met. As it is important that the full amount of the distributable reserve is available for distribution, the directors therefore believe it is in the Group's interests to proceed with the re-registration of Drax Ouse as an unlimited company since it provides greater certainty that the necessary distributions can be made.

2.10 The Company does not believe that there will be any material adverse impact on the security arrangements of any Drax Eurobond Finance Party. Newco and GCo will accede to the Drax Third English Debenture and the Drax Intercreditor and Security Trust Deed and the shares of these companies will be subject to the existing security arrangements, with the shares in GCo being subject to a fixed charge rather than a legal mortgage.

2.11 Drax Ouse was formerly the operating company which owned the Power Station. On 22 December 2003, the business and assets of Drax Ouse (including the Power Station and TXU Claim) were transferred to Drax Power. It is possible that certain contractual and other rights associated with the Power Station may not have been capable of being transferred by this sale and these would remain with Drax Ouse (which makes them available to Drax Power).

2.12 The Drax Security Trustee (or its nominee) cannot remain as legal mortgagee (and therefore registered owner of the shares in Drax Ouse) if Drax Ouse becomes an unlimited liability company (as the registered shareholders and certain past shareholders would be liable for the debts of such a company in the event of its insolvent winding-up). Accordingly, in order to avoid this unlimited liability, the legal ownership of the shares in Drax Ouse will be transferred by Chase Nominees Limited, as the nominee of the Drax Security Trustee, back to Drax Limited prior to Drax Ouse's re-registration as an unlimited company (accordingly, the shares in Drax Ouse will no longer be subject to a legal mortgage although fixed charge security will be retained over such shares). Once Drax Ouse becomes an unlimited company, any sale of this company on an enforcement of the security (which may be desirable if Drax Power was being sold, for the reasons set out in paragraph 2.11 above (albeit that with the passage of time it becomes less likely that such rights remain vested in Drax Ouse)) would have to be conducted other than by the Drax Security Trustee, or its nominee, as legal owner of the shares. However, such a sale could still occur and the directors consider that any prejudice to the rights of Lenders or their Security Interests is very much theoretical rather than practical. Absent a breach of the terms of the Security Documents, the priority of the security could not be affected.

2.13 In respect of Drax Electric, it is not possible to re-register a Cayman Islands company as an unlimited company and so the Court-sanctioned route is unavoidable. Since Drax Electric has never traded, this is likely to be a relatively straightforward process.

Consents

2.14 The Company therefore requests your consent to the implementation of the Reorganisation Steps, as summarised in Schedule 1 (*Group reorganisation and capital losses planning*) to this letter.

3 FRS 25 PLANNING

3.1 In 1999, InPower and Drax Holdings entered into the Preference Share Subscription Agreement (which InPower subsequently novated to BondPower Limited) pursuant to which preference shares are to be issued by Drax Holdings.

3.2 It is proposed that, as a result of the compulsory implementation of FRS 25, the rights attaching to the preference shares be amended to provide for redemption of the preference shares at par, or at more than par, in accordance with the terms of the Preference Share Subscription Agreement (as amended) (the "**Preference Share Rights Amendment**").

The Rationale

3.3 If the Preference Share Rights Amendment is not implemented, changes to UK GAAP resulting from the adoption of FRS 25 (which has to be adopted by Drax Holdings in its accounting period commencing 31 December 2005) are likely to result in certain changes to the accounting treatment of the original Eurobonds and Preference Share Subscription Agreement which could potentially result in a very material and unexpected adverse tax impact on the Group.

3.4 The Company expects that, following the implementation of the proposed Preference Share Rights Amendment, there will be no change to the Group's current tax treatment resulting from the issue of the original Eurobonds. However, your attention is drawn to the information set out in Schedule 2 (*Preference Share Rights Amendment*) to this letter. You should also be aware of the fact that future changes to accounting practice and standards and legislation could result in adverse and unexpected consequences.

3.5 Further details regarding the Preference Share Rights Amendment are set out in Schedule 2 (*Preference Share Rights Amendment*) to this letter. Deloitte & Touche LLP, the Group's Auditors, have confirmed that the accounting treatment under FRS 25 following the proposed amendments will be as set out in Schedule 2 (Preference Share Rights Amendment) to this letter.

Consents

3.6 The Company therefore requests your consent to the Preference Share Rights Amendment.

4 DRAX SHAREHOLDER DOCUMENTS

4.1 The Reorganisation Steps and the Preference Share Rights Amendment (each a "**Proposal**" and together the "**Proposals**") will result in, or may give rise to, events which, if they occur, will require consent or waiver under, or amendment to, the Shareholders Agreement (clauses 9.1(a), 9.1(c), 9.1(e) and 9.1(h)) and the Articles (Articles 69(1)(a), 69(1)(c), 69(1)(e) and 69(1)(h)).

5 REQUEST FOR CONSENT

5.1 We hereby request your consent to each Proposal.

5.2 If you are in favour of a Proposal, it is important that you vote in favour of the Proposal as failure actively to give your approval will register as a vote against the Proposal. This is because the approval level needed requires the positive approval of more than 50% of the shares in issue and not simply more than 50% of the votes cast.

6 ACTION TO BE TAKEN

6.1 You will find a form headed "Shareholder Consent" provided with this letter (also the "**Consent Form**"). Please complete, sign and return the enclosed Consent Form provided to you as soon as possible to the address and/or fax number indicated on the Consent Form.

6.2 Shareholders who are also holders of A2 Loans or A2 Notes will be receiving separate consent requests in the usual way requesting their consent to the Group taking certain actions related to the subject matter of this consent request. Shareholders may also have holdings of A1 Loans or A1 Notes and B Loans and B Notes. Holders of these securities are also being asked for related consents. It is important that you respond to each consent request you receive relating to your holdings of these securities in the form requested of you pertinent to that security.

6.3 Please note that the consent of the shareholders to the Proposals is required by not later than **5.00 p.m. (London Time)** on **Friday 12 August 2005**.

6.4 You are also reminded that if you are in favour of a Proposal yet fail to submit a Consent Form giving your approval your vote will effectively be registered as a vote against the Proposal.

7 RECOMMENDATION

Your Directors unanimously believe that the Proposals described in this letter are in the best interests of the Company and its shareholders as a whole. They therefore recommend shareholders to approve and give their consent to all the matters proposed herein.

Yours faithfully,

Gordon Horsfield
Chairman
Drax Group Limited

Schedule 1

Group reorganisation and capital losses planning

Background

The market value of the operating business transferred from Drax Ouse to Drax Power on 22 December, 2003 was materially less than the acquisition cost of Drax Ouse in 1999. Consequently, the Holding Companies in the Group used to acquire Drax Ouse have substantial unrealised capital losses. These latent capital losses can be realised to offset any capital gain arising in respect of the £25 million Sum and the Excess Proceeds (which would otherwise be subject to corporation tax on chargeable gains). However, these losses would be exempt under the substantial shareholdings legislation in Schedule 7AC Taxation of Chargeable Gains Act 1992 (and not therefore available to shelter any other capital gains) if realised now. The unrealised capital losses will cease to be exempt under the substantial shareholdings legislation on 23 December 2005 and after this date, capital losses can be realised to offset any capital gain as set out above.

The debt owed to Drax Ouse by Drax Power is valued by Drax Ouse at par, and accordingly the accounting fair value of Drax Ouse is currently considered to be approximately £1,385 million at 31 March 2005. Drax Limited and Drax Electric also value the debts owed to them at par. On this basis, capital losses of about £584 million, £420 million and £262 million could be crystallised on the disposal of Drax Ouse, Drax Limited and Drax Electric respectively.

Drax Investments was incorporated as a wholly-owned Subsidiary of Drax Holdings on 29 November 2004 with an authorised share capital of £1,000 divided into 1,000 ordinary shares of £1 each. The consent of the Instructing Group ratifying the incorporation of this new Subsidiary was granted on 30 December 2004. Drax Investments was brought into charge to corporation tax on 23 December 2004 by the acquisition of gilts. If any capital gains had been deemed to have arisen from the receipt of the £25 million Sum or the Excess Proceeds in the year ended 30 December 2004, such gains could have been elected into Drax Investments and sheltered from corporation tax. Drax Investments is now intended to be used in the period to 30 December 2005 to facilitate the crystallisation of the latent capital loss in respect of shares in Drax Ouse being crystallised. The resulting loss will be elected to Drax Holdings to shelter any gain arising on the £25 million Sum and the Excess Proceeds.

Reorganisation steps

The following detailed steps will be required to effect the proposed reorganisation. These are also reflected in diagrammatic form at the end of this schedule (in respect of which, please note that the numbers are estimates, are shown for illustrative purposes and will be subject to revision).

Step 1 - inter-company balances

Summary

First, it will be helpful to reorganise the inter-company balances owed between Drax Holdings and/or its Subsidiaries so as to ensure, as far as possible, that Drax Holdings is a counter-party in respect of such balances.

Process steps

The intercompany balances as shown in the management accounts at 31 March 2005 are as follows:

Debtor		Creditor	Estimated amount (£m)
1	Drax Electric	Drax Holdings	1,031
2	Drax Holdings	Drax Ouse	145
3	Drax Holdings	Drax Power	183
4	Drax Electric	Drax Power	8
5	Drax Electric	Drax Ouse	200
6	Drax Ouse	Drax Limited	89
7	Drax Power	Drax Ouse	1,129

Please note these figures are stated as at 31 March 2005, are shown for illustrative purposes only and will be revised at the time that the reorganisation of the intercompany balances actually occurs.

Drax Holdings is already a party to the loans numbered 1-3 above. Drax Holdings will assume the obligation to pay the creditor under the loans numbered 4-6 above, and as a result the debtors under those loans will owe the same amount to Drax Holdings. The debt numbered 7 is equal to the price for the business transfer in 2003 (plus accrued interest), and the parties are not changed until the debt is distributed (which is part of Step 2 below).

After the reorganisation of the inter-company balances, the intercompany debts (based upon the 31 March 2005 balances which are shown for illustrative purposes only) will be as follows:

Debtor		Creditor	Estimated amount (£m)
1	Drax Holdings	Drax Ouse	256[1]
2	Drax Holdings	Drax Electric	0
3	Drax Holdings	Drax Limited	89[2]
4	Drax Holdings	Drax Power	191[3]
5	Drax Ouse	Drax Holdings	0
6	Drax Limited	Drax Holdings	0
7	Drax Electric	Drax Holdings	1,239[4]
8	Drax Power	Drax Ouse	1,129

[1] This figure arises from (1) the existing debt of £145m owed by Drax Holdings to Drax Ouse; (2) the assumption by Drax Holdings of the £200m liability owed by Drax Electric to Drax Ouse, which causes the debt owed by Drax Holdings to Drax Ouse to increase by £200m; (3) the assumption by Drax Holdings of the £89m liability owed by Drax Ouse to Drax Limited, which causes the debt owed by Drax Holdings to Drax Ouse to decrease by £89m.

[2] This figure arises from the assumption by Drax Holdings of the £89m liability owed by Drax Ouse to Drax Limited.

[3] This figure arises from (1) the existing debt of £183m owed by Drax Holdings to Drax Power; (2) the assumption by Drax Holdings of the £8m liability owed by Drax Electric to Drax Power.

[4] This figure arises from (1) the existing debt of £1,031m owed by Drax Electric to Drax Holdings; (2) the assumption by Drax Holdings of the £200m liability owed by Drax Electric to Drax Ouse, which causes the debt owed by Drax Electric to Drax Holdings to increase by £200m; (3) the assumption by Drax Holdings of the £8m liability owed by Drax Electric to Drax Power, which causes the debt owed by Drax Electric to Drax Holdings to increase by £8m.

Rationale

Rationalising the Group's debts will consolidate assets and liabilities, improve cashflow streams, expedite the reorganisation and reduce the number of assignments required of Group debts.

Step 2 - capital reductions and distribution of assets

Summary

In order to allow all assets in the Drax Electric sub-group to be transferred to Drax Holdings, it is proposed that such assets are distributed in turn by each of Drax Ouse, Drax Limited and Drax Electric. In order to create distributable reserves in each of Drax Ouse and Drax Electric, it will be necessary to carry out reductions of share capital. It is proposed that Drax Ouse will be re-registered as an unlimited company prior to its reduction of share capital and will not therefore require the sanction of the English High Court. The reduction of share capital in respect of Drax Electric will require Cayman Court approval.

Drax Ouse has an issued share capital of £1,000,001 divided into 1,000,001 ordinary shares of £1 each and share premium of approximately £1,205 million. It has other reserves of approximately £105 million. It has a positive balance on its profit and loss account of approximately £75 million. It is proposed that Drax Ouse will re-register as an unlimited company, and then reduce its share capital and share premium accounts, so as to create the necessary distributable reserves. The intra-group receivables due to Drax Ouse will then be distributed up to its immediate Holding Company, Drax Limited.

Drax Limited has an issued share capital of £1,896 comprising £191 of ordinary share capital (divided into 191 ordinary shares of £1 each) and £1,705 of preference share capital (divided into 1,705 preference shares of £1 each) and share premium of approximately £1,894 million. It has no reserves. Following the transaction described above, it will have a negative balance on its profit and loss account of approximately £420 million. Under Cayman law, a company's share premium is treated as distributable profits. Accordingly, the share premium will be used to create sufficient distributable reserves to permit their proposed distribution. The intra-group receivables due to Drax Limited will then be distributed up to its immediate Holding Company, Drax Electric.

Drax Electric has a share capital of £505,000,002 divided into 505,000,002 ordinary shares of £1 each and no share premium. It has no other reserves. Following the transaction described above, it will have a negative balance on its profit and loss account of approximately £262 million. It is proposed that a Court-sanctioned capital reduction is carried out so as to create realised profits available for distribution. The intra-group receivables due to Drax Electric will then be transferred by way of repayment of intercompany debt, or distributed, to its immediate Holding Company, Drax Holdings.

Process Steps

The figures set out below have been rounded for ease of reference and are shown for illustrative purposes only. They are based on 31 March 2005 figures and there will have to be some adjustment to these figures to take account of the final position as at the date of the actual distributions.

1. Chase Nominees Limited, as nominee for the Drax Security Trustee, will re-transfer legal title to 1,000,001 ordinary shares of £1 each held by it in Drax Ouse to Drax Limited such that the shares will be registered in the name of Drax Limited. 1 ordinary share of £1 held by Drax Limited will then be transferred to Drax Electric to be held as nominee for Drax Limited. These shares will remain subject to the Security Interests held by the Drax Security Trustee.

2. Drax Ouse will then be re-registered as an unlimited company and will reduce its share capital and share premium to create a reserve to fund the dividend in specie. At the time of re-registration, the Memorandum and Articles of Drax Ouse will be amended to reflect its unlimited status.

3. Drax Ouse will prepare unaudited accounts as at the date immediately following re-registration.

4. Drax Ouse will distribute to Drax Limited, by way of dividend in specie, the receivables due from Drax Power (approximately £1,129 million) and Drax Holdings (approximately £256 million).

5. Drax Limited will credit the dividend in specie received from Drax Ouse to profit and simultaneously impair the cost of investment in Drax Ouse (approximately £1,278 million), taking the excess to the profit and loss account.

6. Drax Limited will prepare unaudited accounts as at the time immediately following the receipt of the distribution.

7. Drax Limited will distribute to Drax Electric, by way of dividend in specie, the receivables due from Drax Power (approximately £1,129 million) and Drax Holdings (approximately £345 million[5]).

8. Drax Electric will credit the dividend in specie from Drax Limited to profit and simultaneously impair the cost of investment in Drax Limited (approximately £1,289 million) taking the loss to the profit and loss account.

9. Drax Electric will undertake a Cayman Islands Court-sanctioned capital reduction to convert share capital into distributable reserves.

10. Drax Electric will prepare unaudited accounts as at the time immediately following the receipt of the distribution.

11. Drax Electric will distribute to Drax Holdings, by way of dividend in specie, part of the receivables due from Drax Power (approximately £235 million) and the right to the Excess Proceeds (£8 million) (carried in Drax Electric at the £8 million cost paid to Drax Power for this right to receive the Excess Proceeds).

12. Drax Electric will offset the debts due to and receivables due by Drax Holdings and will transfer (by way of repayment of the net debt due to Drax Holdings) the receivable due from Drax Power (received from Drax Limited) in the amount of approximately £894 million.

13. Drax Holdings and Drax Power will offset the debts between them and leave a net balance due from Drax Power to Drax Holdings of approximately £938 million.

In order to implement certain of the steps outlined above, the Drax Security Trustee and/or Chase Nominees Limited (as a nominee of the Drax Security Trustee) will be required to consent to the passing of shareholder resolutions in accordance with the terms of the relevant Security Documents.

Rationale

The purpose of this step is to:

- provide distributable reserves to distribute the receivables due from Drax Power and Drax Holdings from Drax Ouse to Drax Holdings (via Drax Limited and Drax Electric). Following these steps the balance sheets of Drax Ouse, Drax Electric and Drax Limited will be simplified;
- have any capital gain arising on realisation of the £25 million Sum and the Excess Proceeds in Drax Holdings;
- rationalise group balances and enable cash to flow up from Drax Power to Drax Holdings to service the Drax Eurobonds.

[5] This figure comprises the £256 million received from Drax Ouse and the existing £89 million owed by Drax Holdings to Drax Limited

Step 3 - incorporation of a new company limited by shares and transfer of shares in Drax Ouse

Summary

A new UK incorporated Subsidiary of Drax Holdings will be established to assist in retaining control of Drax Ouse if Drax Electric and its Subsidiaries were subsequently to leave the Group.

Process steps

1. A UK company ("**Newco**") is formed by Drax Holdings with an authorised share capital of £1,000. Drax Holdings will subscribe cash for shares of £1,000 and Newco will deposit such amount in an interest-bearing account, with such account not to be used for any purpose other than for holding this deposit.

2. On 28 December 2005, Drax Limited (on behalf of and as nominee and bare trustee for Newco, Newco having agreed to fund any such subscription) will subscribe for 9,000 £1 ordinary shares (or the equivalent amount in reduced nominal share capital) in Drax Ouse with the subscription money left outstanding. The beneficial interest in these shares will at all times be vested in Newco. Drax Limited's legal interest in these shares will be immediately transferred to Newco.

3. A certain number (likely 50%) of the ordinary shares in Drax Ouse will be transferred from Drax Limited to Drax Investments. The consideration for the transfer will be satisfied in cash and the transfer will take place at market value (which by this stage should be minimal). The inherent capital loss on the ordinary shares transferred will, when triggered, be sufficient to cover the capital gain on the £25 million Sum and the Excess Proceeds. For illustration purposes (in the diagram), 5% of the shares in Drax Ouse will be transferred to Drax Investments.

Rationale

The purpose of this step is to:

- create an intra-group transfer on a "no gain/no loss" basis under TCGA 1992 s171. This will enable a de-grouping charge under TCGA 1992 s179 to be triggered in the future when Drax Investments leaves the capital gains group and thus crystallise the latent capital loss;

- establish a structure to enable a future disposal of the Drax Electric sub-group to a third party;

- ensure that in the event of a future disposal of the Drax Electric sub-group, the Drax Group will retain control over Drax Ouse for commercial reasons (concerning unascertained liabilities and residual rights, if any) (which disposal would be subject to a further consent request).

Step 4 - incorporation of a new company limited by guarantee

Summary

A company limited by guarantee will be incorporated by Drax Holdings to facilitate triggering the de-grouping charge referred to in Step 3 above.

Process steps

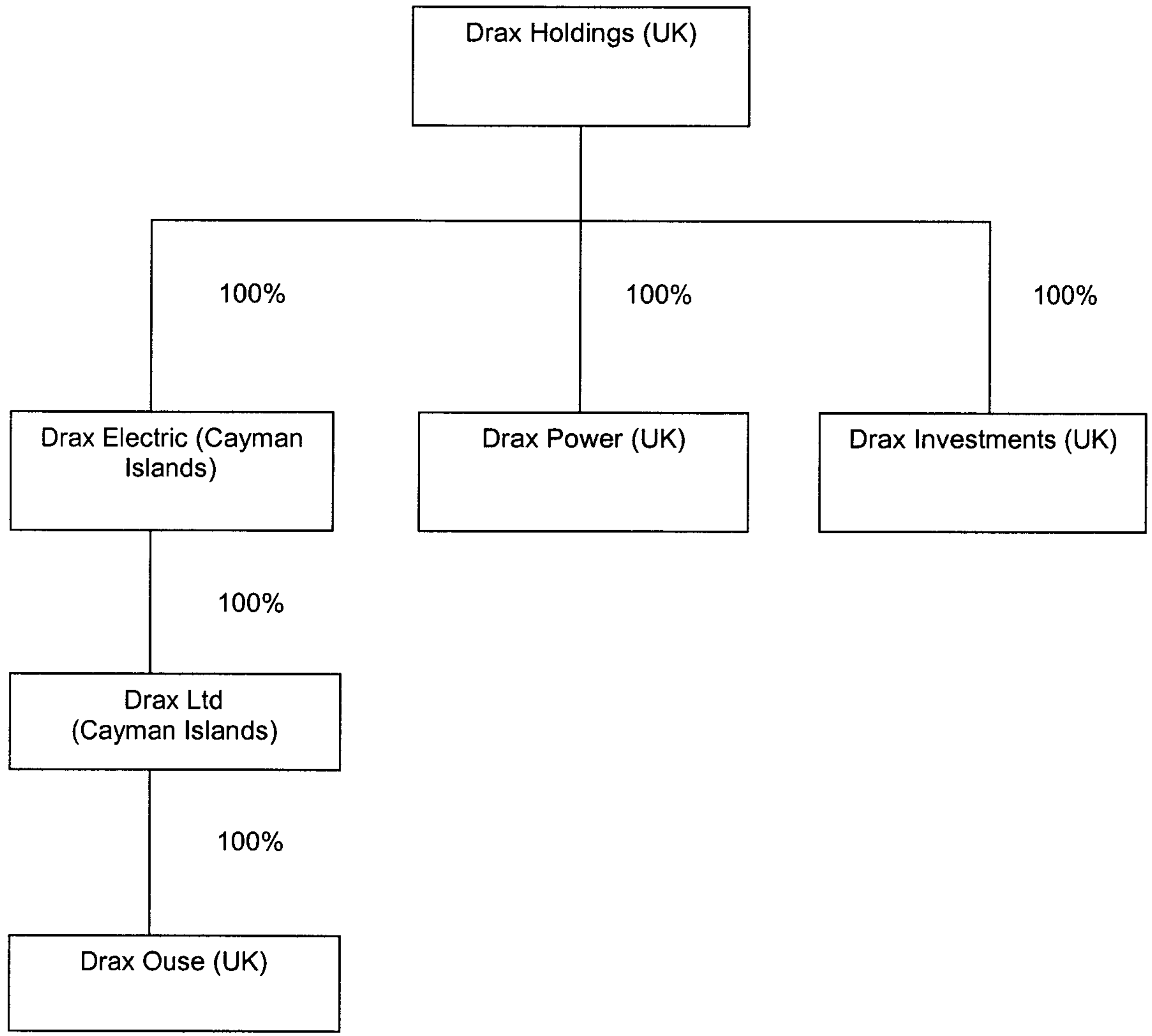
1. A company limited by guarantee ("**GCo**") is to be incorporated by Drax Holdings. It should be funded by an interest bearing loan from Drax Holdings (of not more than £2,000) of which £1,000 will be used to purchase shares in Drax Investments (see below) and £1,000 will be held on deposit in an interest bearing account, with such account not to be used for any purpose other than for holding this deposit.

2. On 30 December 2005, Drax Investments will issue £1,000 of ordinary shares to Drax Holdings. Such right, title and interest as Drax Holdings has in these shares will be immediately transferred to GCo with the consideration left outstanding. This will leave the ownership of Drax Investments split 50% with Drax Holdings and 50% with GCo. The reason for specifying 30 December, 2005 as the proposed action date in this respect is to avoid any potential uncertainty regarding the precise date of the commencement of the corporation tax accounting period of Drax Investments.

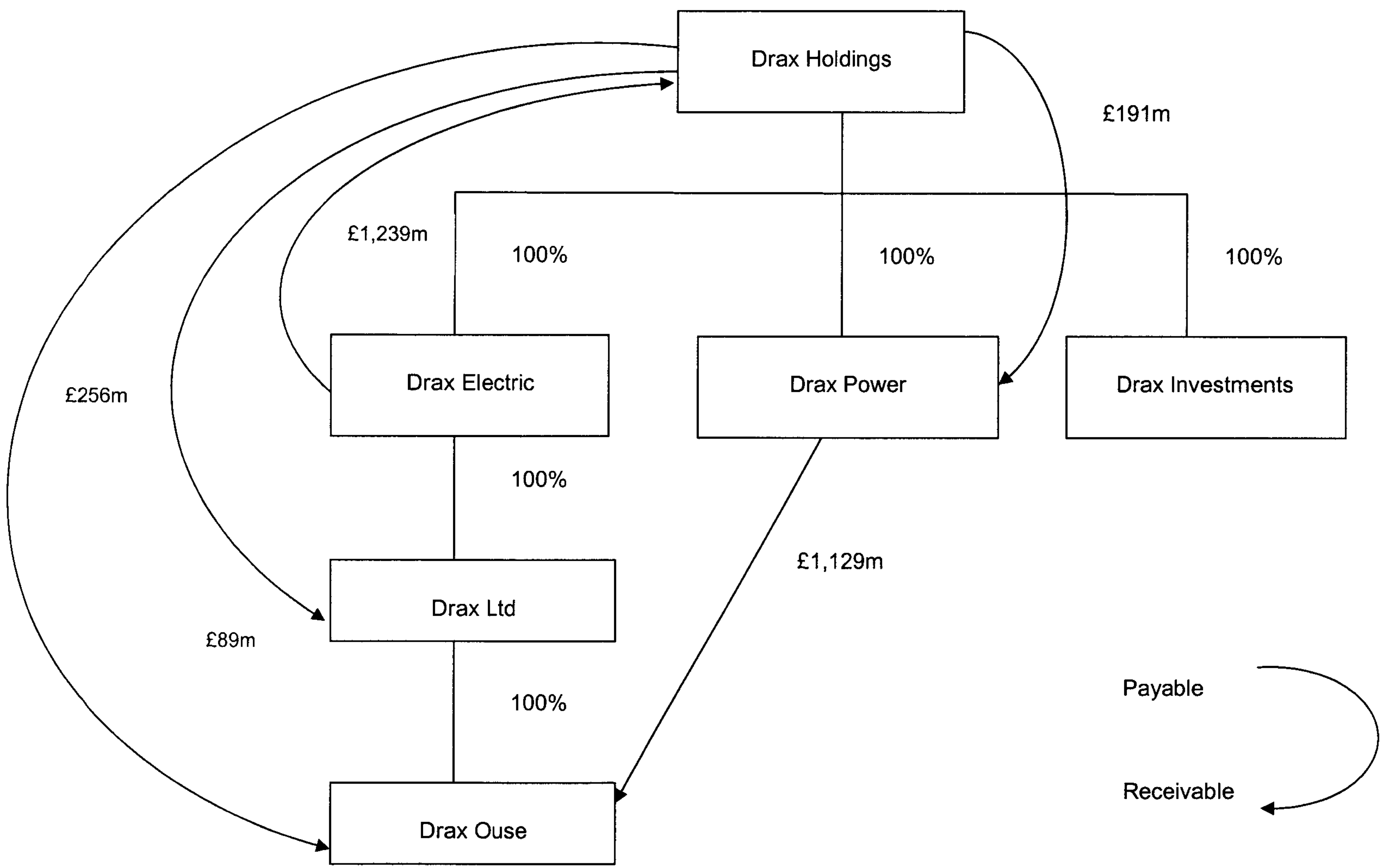
Rationale

The issue of the shares on 30 December 2005 will degroup Drax Investments from the Drax Holdings capital gains tax group so that a capital loss is triggered on the previous no gain/no loss transfer to Drax Investments of shares in Drax Ouse. In due course, appropriate elections will be made to enable the capital loss to be set against any capital gains arising in Drax Holdings on the £25 million Sum and the Excess Proceeds.

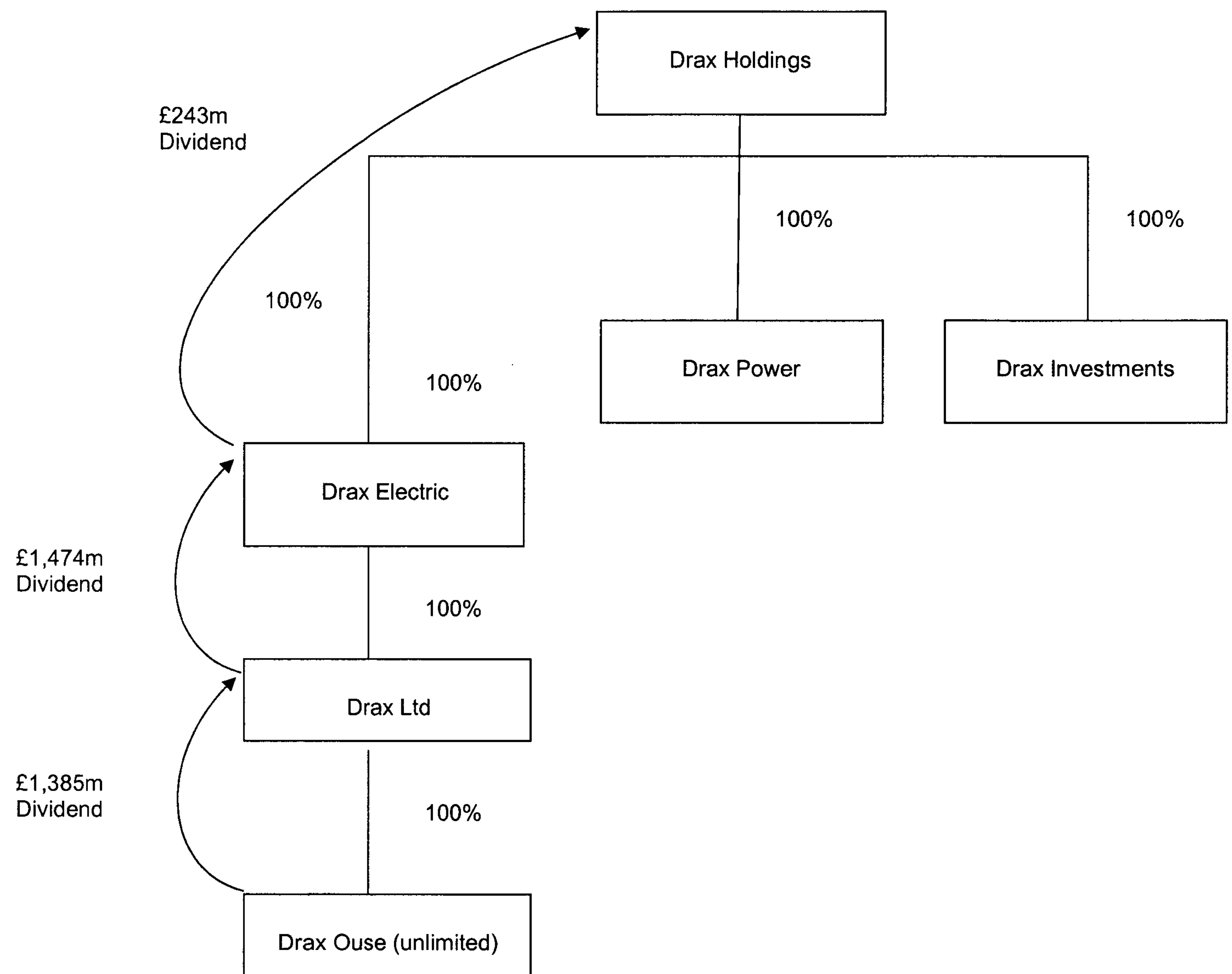
Current Structure



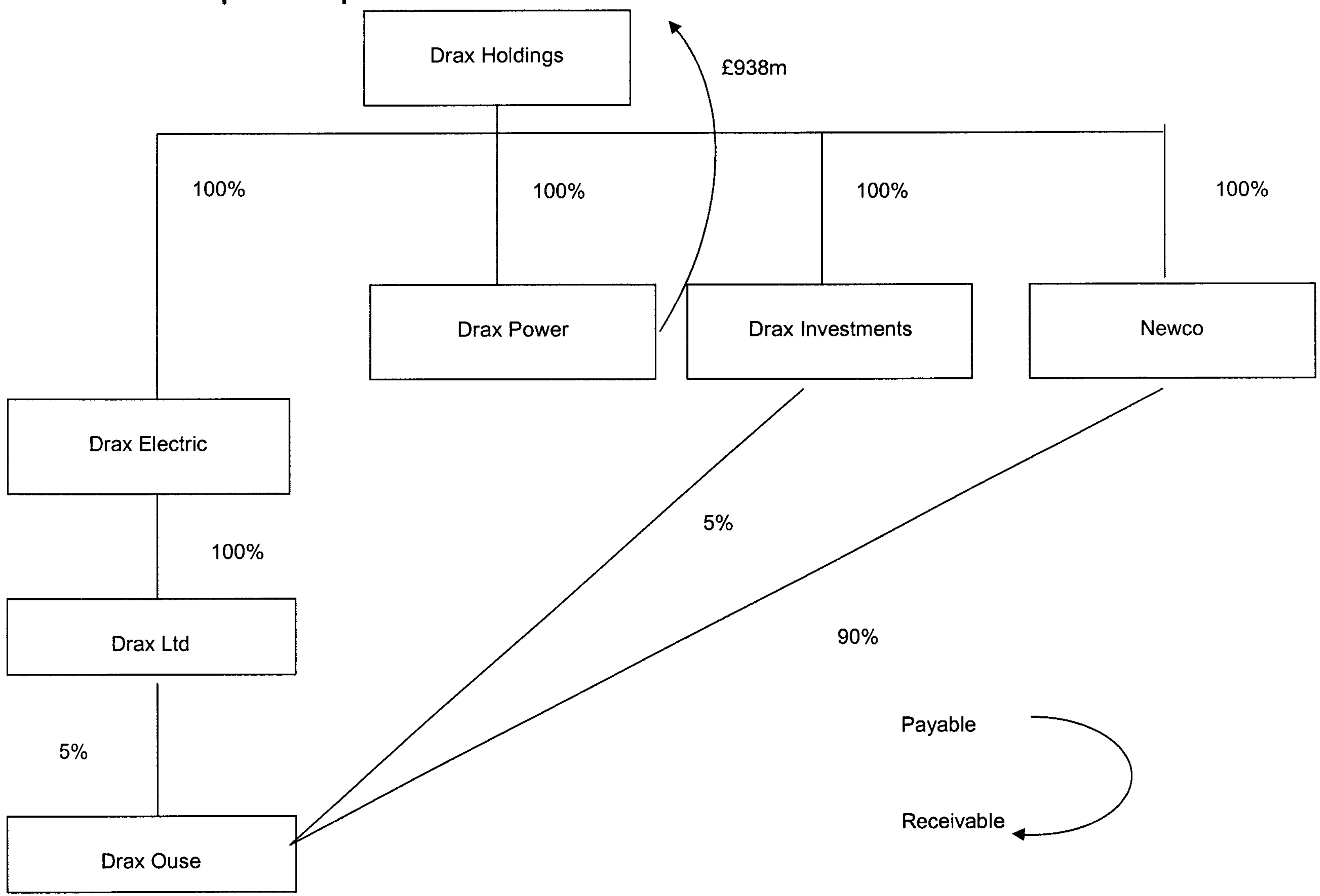
Step 1 - group debts after making Drax Holdings the counter-party



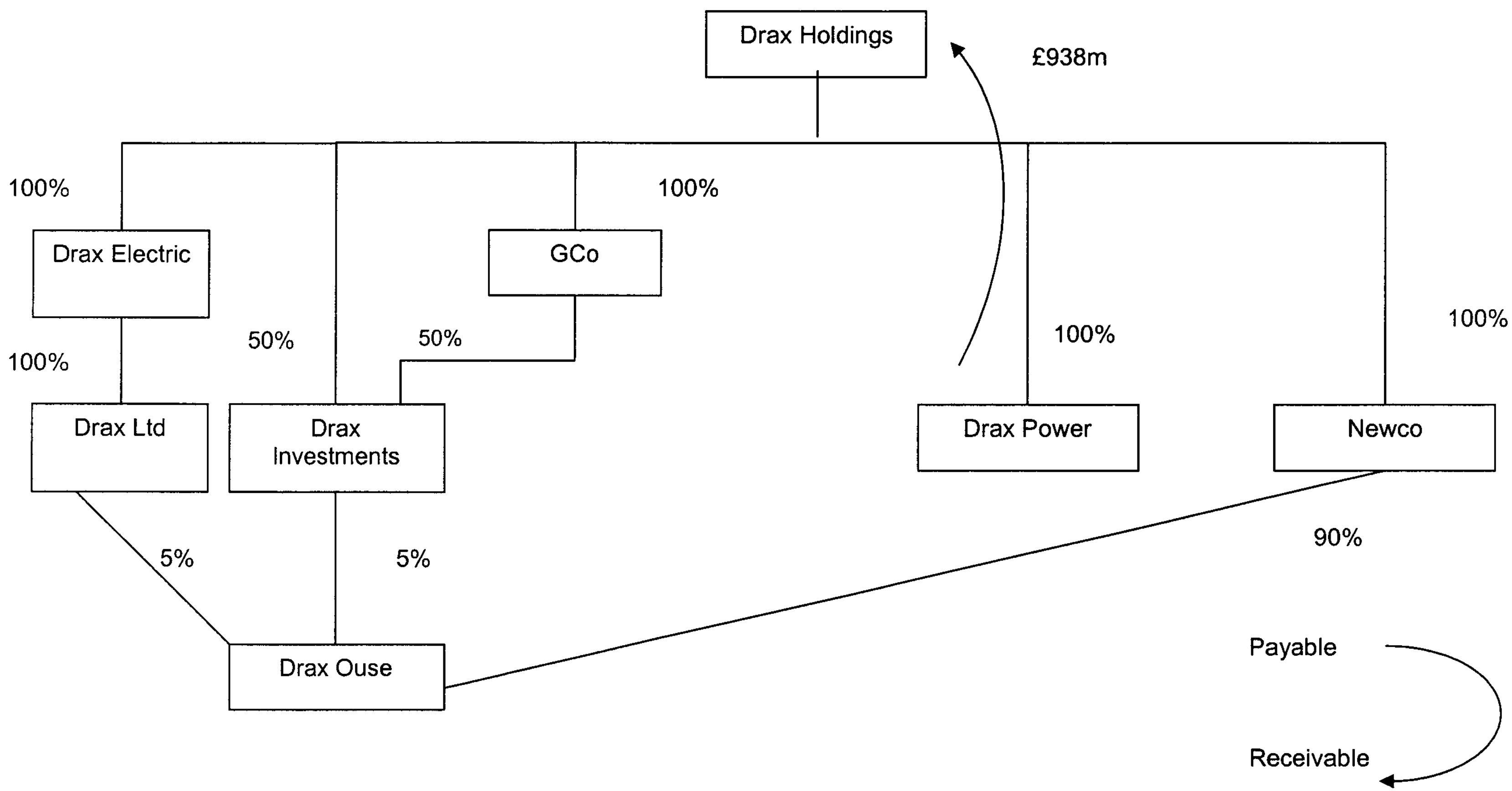
Step 2 - capital reductions and distributions



Step 3 - incorporation of a Newco and transfer of shares in Drax Ouse



Step 4 - incorporation of a Newco limited by guarantee



Only group companies relevant to Step 4 are shown in the above diagram

Schedule 2

Preference Share Rights Amendment

Background

Under current UK corporation tax law, profits and losses (including interest payments) of a company from its loan relationships are taxed and relieved in accordance with the figures shown in its accounts, provided they are drawn up in accordance with UK GAAP. As a result, the tax position of the Group's financing structure is sensitive to changes in UK GAAP. Frequently such changes will have no consequences, but the sophisticated nature of the arrangements in place in relation to the £1,725 million Eurobond issued in 1999 by Drax Holdings (the "**Original Eurobond**") means that any changes to UK GAAP need to be carefully monitored for their impact on the Group.

In summary, the terms of the Original Eurobond are such that no repayments of the principal amount borrowed (the "**Bond Principal**") are made during the term of the Original Eurobond. Instead, the Bond Principal is repayable in whole 15 years after the issue of the Original Eurobond. The Original Eurobond carries interest at a fixed rate, payable 6-monthly. The company entitled to repayment of the Bond Principal, BondPower Limited, is also obliged (under a separate agreement, the Preference Share Subscription Agreement) to subscribe an amount equal to the Bond Principal for preference shares in Drax Holdings. Drax Holdings is irrevocably authorised to apply the Bond Principal in satisfaction of the subscription obligation. The right to receive the preference shares has been assigned to Drax Intermediate Holdings Limited as part of the 2003 restructuring. Originally Drax Acquisition paid £425 million for the right to receive these preference shares.

FRS 25

The introduction of Financial Reporting Standard 25 (*Accounting for Investments*) ("**FRS 25**") may have an effect on the accounting (and consequently tax) treatment of the Group financing structure, and as a result, amendments to certain aspects of the structure are required to retain the existing accounting (and tax) treatment. FRS 25 was issued in December 2004 as part of the convergence project of UK GAAP to IFRS whereby IFRS (IAS 32) was brought into UK GAAP and its presentation requirements apply to all companies (both listed and unlisted). It is applicable for periods commencing on or after 1 January 2005 (thus impacting UK GAAP entity and consolidated financial statements of Group companies).

FRS 25 Para 18 states that the substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. The key issue in the Drax structure is whether the Original Eurobond currently recorded as a liability in Drax Holdings is "linked" to the preference share subscription agreement entered into at the same time as the issue of the Original Eurobond, and thus whether the two instruments are, from an accounting perspective, considered to be one financial instrument. In the absence of any amendments to the preference share rights it is possible that under FRS 25, the rights of the preference shares[6] represent a small financial liability, with the majority being classified as "equity" and as such the arrangement may be viewed as being mandatorily convertible into equity shares.

Accounting Treatment

Two alternative accounting views of the instruments under FRS 25 may be formed:

(i) that the Original Eurobond and Preference Share Subscription Agreement are two separate financial instruments to be accounted for in accordance with the substance of each instrument,

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[6] The £1,725,000,000 perpetual cumulative preference share rights include the following: annual dividend payable at a dividend rate of 0.0001 per cent per annum; no other stated obligation to pay cash other than on a return of capital or liquidation. With the very low dividend rate and no redemption of the principal, the liability portion of the preference shares would be insignificant on
bifurcation as required under FRS 25.

being a “debt” in relation to the Original Eurobond and an “equity forward” in relation to the Preference Share Subscription Agreement; and

(ii) that the two instruments should be treated as one financial instrument and accounted for as a mandatorily convertible debt instrument, in which instance under FRS 25 the accounting treatment would be as follows:

- record a liability equal to the present value (“**PV**”) of the cash obligation (the coupons to be paid on the debt and dividends on the preference shares); and

- record in equity the difference between the cash proceeds (£1,725 million) and the amount recorded as a liability.

The previous UK GAAP accounting treatment stated that conversion of such instruments was not to be anticipated and thus amounts were shown as liabilities (FRS 4 Para 25).

As noted above, the terms of the Preference Share Subscription Agreement require that the subscription obligation is satisfied out of the proceeds of repayment of the Bond Principal. Accordingly it is arguable that, based on consideration of the Preference Share Subscription Agreement, the Original Eurobond and the Preference Share Subscription Agreement should be viewed as linked and therefore treated together as a mandatorily convertible debt instrument.

The right to receive the preference shares was sold for £425 million and, as a result of the December 2003 restructuring, Drax Intermediate Holdings is now due to receive these shares in 2015. The accounting would therefore be that in Drax Holdings entity and consolidated accounts:

- a liability would be recorded equal to the PV of the Original Eurobond coupons; and

- the difference between the cash received (£1,725 million) and the PV of the Original Eurobond coupons would be recorded as equity. If the interest rate was assumed to be market rate at the date of issue then this difference would be represented by the payment of £425 million by Drax Holdings’ then parent to acquire the right to receive the preference shares (which, following the December 2003 restructuring, would be received by Drax Intermediate Holdings Limited in 2015).

The new accounting treatment would be similar to the US GAAP treatment presented in the consolidated accounts of Drax Holdings shown in the Form 20-Fs in prior years.

Taxation consequences

Tax legislation does not cope with the deemed amalgamation of the two instruments and it is likely that HM Revenue and Customs would consider that a single loan relationship continued to exist. Under specific rules, where a company changes its accounting policy and there is a difference between the accounting value of a loan relationship at the end of a period and the accounting value at the beginning of the next accounting period, the difference (either a debit or a credit) is relieved or taxed in the second accounting period.

The accounting value at 31 December 2004 would be £1,490 million (net of coupon prepayments), and at 1 January 2005 would be £858 million resulting in a difference of £632 million. The corresponding credits would be taken either to profit and loss reserves or to another component of equity, with all these credits being taxed.

To the extent the adjustment to the profit and loss reserves would result in a timing difference under FRS 19 the resulting deferred tax liability would be offset against the opening profit and loss reserve movement. This deferred tax liability would then be released to the profit and loss account in the current year as the current tax liability on this amount crystallises.

To the extent the equity adjustment is a permanent difference under FRS 19, the related tax charge will be taken in the current year profit and loss account.

Solution

To avoid the tax implications that arise as a result of the mandatory implementation of FRS 25, one of the following two approaches can be adopted:

(i) changing the nature of the equity instruments such that they continue to be treated as liabilities. In particular, this would be the case where the Preference Share Subscription Agreement terms were amended so that the rights attaching to the shares provided for the preference shares to be redeemed at par, or at more than par, in accordance with the terms of the Preference Share Subscription Agreement (as amended);

(ii) breaking the link between the two instruments as would be the case if the Preference Share Subscription Agreement was varied to require subscription of the Bond Principal for a variable number of preference shares at a price equal to their fair value at the time (rather than £1 per share). This would require a valuation of the preference shares at maturity of the Original Eurobond.

After due consideration, Drax regards option (i) as the preferred route to follow as it avoids the need for the valuation. As Drax Intermediate Holdings will be the only holder of these preference shares, the timing of redemption can also be determined within the Group.

Deloitte & Touche LLP have confirmed that on the basis of FRS 25 as currently in force, if the changes to the Preference Share Subscription Agreement are made, as set out in approach (i) above, the accounting treatment will be preserved, with no consequent adjustment to the valuation of the Original Eurobond liability being required.

The Group has consulted with leading tax counsel on the proposed changes to the Preference Share Subscription Agreement. Counsel has confirmed the tax treatment would follow the accounting analysis and that he is of the view that the proposed changes would not result in any adverse tax consequences.

If there are any subsequent changes to FRS 25 or IAS 32 these will need to be reviewed as there can be no certainty that the existing accounting (and tax) treatment would continue to prevail.