

## 32 Financial instruments

### a) Carrying amounts and fair values of financial assets and liabilities

Set out below is a comparison by category of the carrying amounts and fair values of all the Group's financial assets and liabilities as at 31 December 2007:

	31 December 2007		31 December 2006	
	Carrying amount £m	Fair value £m	Carrying amount £m	Fair value £m
<b>Financial assets</b>				
Cash and cash equivalents	1,161	1,161	980	980
<b>Available-for-sale:</b>				
Other investments	13	13	26	26
<b>Loans and receivables:</b>				
Finance lease receivables	1,293	1,226	1,078	1,106
Other long-term receivables	22	22	29	29
Trade receivables	221	221	142	142
Other receivables and accrued income	424	424	157	157
<b>At fair value through profit or loss:</b>				
Assets held for trading	–	–	42	42
Derivative financial assets not designated in a cash flow hedge relationship	236	236	164	164
<b>Designated cash flow hedge relationships:</b>				
Derivative financial assets designated and effective as cash flow hedging instruments	32	32	117	117
<b>Total financial assets</b>	<b>3,402</b>	<b>3,335</b>	<b>2,735</b>	<b>2,763</b>
<b>Financial liabilities</b>				
<b>Financial liabilities at amortised cost:</b>				
Trade payables	184	184	85	85
Other payables (current)	222	222	226	226
Accruals	268	268	206	206
Other payables (non-current)	30	30	40	40
Secured bank loans	4,608	4,608	3,440	3,439
Secured bonds	694	749	687	736
Preferred equity facility	151	151	152	152
Convertible bonds	255	259	237	247
Loans from minority interests	115	115	81	81
Provisions	63	63	43	43
<b>At fair value through profit or loss:</b>				
Derivative financial liabilities not designated in a cash flow hedge relationship	729	729	322	322
<b>Designated cash flow hedge relationships:</b>				
Derivative financial liabilities designated and effective as cash flow hedging instruments	105	105	108	108
<b>Total financial liabilities</b>	<b>7,424</b>	<b>7,483</b>	<b>5,627</b>	<b>5,685</b>

**32 Financial instruments** continued

The methods and assumptions used to estimate fair values of financial assets and liabilities are as follows:

- (i) Other investments comprise minority shareholdings held in privately owned, unquoted companies as well as debt instruments where there is no active market available to value them. Where the fair value of the equity instruments cannot be reliably measured, the fair value shown is recorded at cost. The debt instruments are stated at fair value based on an estimate of the discounted cash flows.
- (ii) The fair value of finance lease receivables and other long-term receivables have been estimated by discounting estimated cash flows. Discount rates in the range of 4% to 10% have been applied.
- (iii) Due to their short maturities, the fair values of trade receivables, other receivables and accrued income have been stated at their book values.
- (iv) Fair values of derivative financial instruments:

Energy derivatives are measured by reference to forward price curves using discounted cash flows and other similar quantification techniques. A forward price curve represents the Group's view as to the prices at which customers would currently contract for delivery or settlement of commodities at future dates. An electricity price curve is derived from published price quotations in an active market, over the short-term horizon period, and from valuation techniques over the more distant horizon period. Discount rates in the range of 7% to 10% have been applied. The prices in the distant horizon period are determined by reference to long-term market price assumptions relating to the prices of commodities such as oil, the cost of constructing and financing the building of new power plants, and the prices at which it would be economic for companies to enter the market and build additional capacity ('new entrant pricing').

Interest rate swaps are measured by reference to both third party bank confirmations and discounted cash flows using the yield curves and spot rates in effect at the balance sheet date.

The fair value of the Group's foreign currency and equity conversion options have also been measured by reference to third party bank confirmations and through calculations using market rates in effect at the balance sheet date.

- (v) The fair value of assets held for trading have been calculated using quoted market prices.
- (vi) Due to their short maturities, the fair values of trade payables, other payables and accruals have been stated at their book values.
- (vii) The fair values of all bank loans, bonds, convertible bonds, the preferred equity facility and loans from minority interests have been calculated using market prices where available or the present value of estimated future cash flows. Discount rates in the range of 4% to 15% have been applied.
- (viii) 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. Consequently the fair value has been presented as book value. Discount rates in the range of 5% to 6% have been applied.

As explained in (iv) above, prices for valuing energy derivatives outside of an active market are derived from long-term assumptions. Changes to these long-term assumptions could have a significant impact on the modelled price. For example, reasonable increases in the assumed cost of construction could increase modelled long-term power prices in the order of 10%, while reasonable variations in the assumed long-term cost of oil could have an impact in the order of 30% on modelled long-term power prices.

Most of our energy derivatives settle within the period covered by an active market and hence these variations in long-term price assumptions have a limited impact on our derivative valuations. We have one long-term derivative contract for power, which was acquired with the Loy Yang B plant in Australia. The contract is open until 2016. Reasonable changes in assumed construction costs could affect the value of this derivative in the order of A\$30 million. Changes in the long-term cost of oil are less significant, since energy prices in Australia are currently not closely linked to world oil prices.

Refer to note 32 f) (i) for sensitivity analysis. Refer to note 39, 'Critical accounting judgements and key sources of estimation uncertainty', for further information on the valuation techniques used and the assumptions applied in determining the fair values of financial assets and liabilities.

## b) Derivative financial instruments

The following table discloses the carrying amount of financial instruments, which are carried at fair value in the balance sheet, that have been valued using a technique based on market observable inputs and those that been valued using non-market observable inputs:

	31 December 2007		31 December 2006	
	Valuation technique – market observable inputs	Valuation technique – non-market observable inputs	Valuation technique – market observable inputs	Valuation technique – non-market observable inputs
Assets held for trading				
Carrying amount (£m)	–	–	42	–
Percentage of total carrying amount	–	–	100%	–
Derivative financial assets				
Carrying amount (£m)	<b>234</b>	<b>34</b>	245	36
Percentage of total carrying amount	<b>87%</b>	<b>13%</b>	87%	13%
Derivative financial liabilities				
Carrying amount (£m)	<b>(681)</b>	<b>(153)</b>	(291)	(139)
Percentage of total carrying amount	<b>82%</b>	<b>18%</b>	68%	32%
	<b>(447)</b>	<b>(119)</b>	(4)	(103)

In the merchant markets of Australia, the US and the UK, market observable inputs are usually defined as published forward curves. Typically observable market data for forward power prices is available in Australia, the US and the UK for between two and three years. For interest rate swaps all forward rates are deemed to be from observable markets.

Non-market observable inputs are typically defined as price forecasts for a particular commodity, which are derived from the Group's in-house modelling. Non-market observable inputs are not published and often form part of a valuation technique when a forward curve is deemed illiquid. A number of modelling techniques exist to generate these forecasts, but a standard approach that the Group follows for valuing forward power sales is to look at the economics of a new-entrant power plant.

When a new-entrant is believed to be required in a particular market, the long-term power price assumed will cover the new-entrant's cost and target return. That is, power prices reflect the 'new-entrant cost' level from this particular point.

As explained on pages 18 to 20 of the business and financial review, the Group's policy is to hedge various exposures.

Energy price risk: We use commodity contracts to fix the prices we achieve for the electrical output from our power stations and the cost of fuel inputs to our power stations. For the purposes of presentation which follows, we group the financial products and commodity contracts used for this purpose, which are classified as derivatives, under the heading 'Energy derivatives'.

Interest rate risk: Principally we use pay-fixed, receive-variable interest rate swaps. We also use options and forward rate agreements. For the purposes of presentation which follows, we group these derivative financial instruments under the heading 'Interest rate swaps'.

Foreign currency risk: For structural and transactional currency exposures and currency exposures on future expected sales we use foreign currency borrowings, forward foreign currency contracts, currency options and swaps. For the purposes of presentation which follows, we group these derivative financial instruments under the heading 'Other derivatives'. This category also encompasses options over equity. The Group owns purchased call options over the equity of various energy related businesses. The Group already has an equity interest in some of these businesses. The Group has convertible bonds which can convert into Ordinary Shares of International Power plc. The conversion feature in the 3.25% convertible euro bond is accounted for as an embedded derivative (refer to note 25).

**32 Financial instruments** continued

The carrying amount of these derivative financial instruments at the reporting date and whether these derivatives are designated in a formal hedging relationship is analysed as follows:

	31 December 2007		31 December 2006	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
<b>Cash flow hedges</b>				
Energy derivatives	8	81	102	100
Interest rate swaps	24	24	15	8
	<b>32</b>	<b>105</b>	117	108
<b>Not designated in a qualifying hedge relationship</b>				
Energy derivatives	200	653	134	262
Interest rate swaps	6	–	–	1
Other derivatives	30	76	30	59
	<b>236</b>	<b>729</b>	164	322
	<b>268</b>	<b>834</b>	281	430
Current	<b>223</b>	<b>508</b>	243	204
Non-current	<b>45</b>	<b>326</b>	38	226
	<b>268</b>	<b>834</b>	281	430

The Group has no financial assets or financial liabilities which have been designated at fair value through profit or loss at initial recognition.

The following table shows the carrying amounts, net gains and losses, cash flows and other movements relating to the Group's derivative financial instruments and where the movements in the income statement are recorded.

	31 December 2007				31 December 2006			
	Energy derivatives £m	Interest rate swaps £m	Other derivatives £m	Total £m	Energy derivatives £m	Interest rate swaps £m	Other derivatives £m	Total £m
At 1 January	(126)	6	(29)	(149)	(394)	(25)	–	(419)
Specific IAS 39 mark to market movements recognised in:								
– revenue	(387)	–	–	(387)	132	–	–	132
– cost of sales	45	–	–	45	(68)	–	–	(68)
– interest	–	1	(17)	(16)	–	2	(28)	(26)
Other movements in the income statement	24	3	–	27	51	6	–	57
Movement in the hedging reserve	(85)	(10)	–	(95)	140	22	–	162
Cash flow	(8)	–	–	(8)	2	–	(1)	1
Acquisitions	40	4	–	44	–	–	–	–
Exchange differences	(29)	2	–	(27)	11	1	–	12
<b>At 31 December</b>	<b>(526)</b>	<b>6</b>	<b>(46)</b>	<b>(566)</b>	(126)	6	(29)	(149)

'Other movements in the income statement' comprise mark to market movements on proprietary trading activities, i.e. on non-asset backed trader, and the amortisation of derivatives acquired with a fair value other than zero. Mark to market movements on asset backed hedges are included within 'specific IAS 39 mark to market movements' (refer to note 1).

**c) Cash flow hedging reserve movements**

The cash flow hedging reserve balance at 31 December 2007 and the periods in which the cash flows are expected to occur are as follows:

	31 December 2007			31 December 2006		
	Energy derivatives £m	Interest rate swaps £m	Total £m	Energy derivatives £m	Interest rate swaps £m	Total £m
Cash flows expected in:						
Less than 12 months	(42)	(2)	(44)	22	(1)	21
1-2 years	(11)	(12)	(23)	(12)	–	(12)
2-5 years	(3)	(11)	(14)	(7)	(2)	(9)
More than 5 years	–	(3)	(3)	–	6	6
<b>Unrecognised (losses)/gains at 31 December</b>	<b>(56)</b>	<b>(28)</b>	<b>(84)</b>	3	3	6

The amounts shown in the preceding table are expected to affect profit or loss in the same period as the cash flows.

The following table identifies the movements in the cash flow hedging reserve during the year, including where gains and losses have been recognised in the income statement.

	31 December 2007			31 December 2006		
	Energy derivatives £m	Interest rate swaps £m	Total £m	Energy derivatives £m	Interest rate swaps £m	Total £m
At 1 January	3	3	6	(103)	(15)	(118)
(Losses) and gains recognised in the hedging reserve during the year	(32)	(35)	(67)	37	15	52
(Losses) and gains arising in previous years that reversed during the year	(22)	1	(21)	67	2	69
Amount removed from hedging reserve and included within the income statement during the year due to settlement of contracts. Recognised in:						
Group revenue	95	–	95	(4)	–	(4)
Share of joint ventures and associates	–	2	2	–	–	–
Net finance costs	–	(3)	(3)	–	–	–
Cash settlement of derivatives during the year	(95)	1	(94)	4	1	5
Ineffectiveness recognised in profit or loss	1	–	1	(1)	–	(1)
Amount removed from hedging reserve and included within a non-financial item during the year	–	–	–	–	(1)	(1)
Exchange differences	(6)	3	(3)	3	1	4
<b>At 31 December</b>	<b>(56)</b>	<b>(28)</b>	<b>(84)</b>	3	3	6

**32 Financial instruments** continued**d) Hedge of a net investment**

An economic foreign currency exposure arises from net investments in Group entities whose functional currency differs from the parent's. An accounting exposure arises from differences between the functional currency of the net investments and the Group's presentation currency. Changes in exchange rates between the functional currency of the net investment and that of its parent will cause the amount of the net investment to vary.

In the absence of hedge accounting, foreign exchange gains and losses on retranslating the net assets of a foreign operation would be taken to reserves, whilst those on the loan would be recognised in the income statement. This creates a mismatch in foreign currency translation. When net investment hedging is applied, this mismatch is eliminated.

The Group, as part of its hedging strategy, has therefore chosen to borrow some debt denominated in foreign currencies in order to hedge the net investments in certain foreign operations within its portfolio. As the hedging instruments are foreign currency borrowings rather than derivatives, no fair values for these instruments are included within the fair value of derivatives disclosed on the balance sheet.

Gains and losses recognised in the translation reserve for hedges of net investments are shown in note 25 and as a separate line item in the Statement of Changes in Equity.

**e) Risk identification and risk management**

There is a continuous process for identifying, evaluating and managing the key risks faced by the Group. Activities are co-ordinated by the Risk Committee, which is chaired by the CFO, and has responsibility, on behalf of the Board, for ensuring the adequacy of systems for identifying and assessing significant risks, that appropriate control systems and other mitigating actions are in place, and that residual exposures are consistent with the Group's strategy and objectives. Assessments are conducted for all material entities.

The Group owns power plants in various locations around the world including merchant markets in the US, Australia and Europe. Plant ownership in the merchant markets exposes the Company to highly volatile and unpredictable commodity prices (including those relating to power and gas) and trading and risk management teams exist in each region to manage the exposure by trading a range of products including physical and financial forwards and futures. A Global Commodities Risk Committee together with the regional risk management teams are responsible for ensuring an adequate risk framework is in place in each region. Local Risk Committees operate in each region and they are responsible for ensuring that the risk framework is applied and that they manage their respective positions in compliance with these Board approved limits.

Treasury policy seeks to ensure that adequate financial resources are available for the management and development of the Group's business whilst managing its market risks and credit risks. The Group's treasury policy is not to engage in speculative transactions. Group treasury acts within clearly defined guidelines that are approved by the Board.

The capital structure of the Group is presented in the balance sheet. Note 30 provides details on equity and note 25 on loans and bonds. Short and medium-term funding requirements are provided by a variety of loan facilities with a range of counterparties and maturities. Longer term funding or funding for a particularly large transaction may be sourced from a combination of these facilities and suitable long-term instruments, such as bonds, or by raising additional equity. Identification of total funding and phasing is achieved via a detailed cash flow forecast which is reviewed and updated on a monthly basis.

Project development activities can, on occasions, require credit support in the normal course of business. This is provided by established funding facilities or via additional bilateral facilities with related project banks. At the individual business level we finance our projects with non-recourse debt in order to insulate the Group from adverse events at the project level, limiting our balance sheet exposure to a given project to the loss of the equity in that project.

Credit exposure to trading and financial counterparties is managed within clearly defined limits, policies and procedures. Financial counterparty risk is restricted to arrangements with relationship banks, money market funds and commercial paper with investment grade ratings. All credit exposures are monitored daily by local regional management and reported to senior management on a monthly basis.

**f) Market risk**

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. The Group is exposed to changes in: commodity prices in the merchant markets in which it operates; interest rates; and foreign currency exchange rates. A significant number of the Group's projects operate without power purchase agreements and are, therefore, vulnerable to market forces which determine the price and amounts of power sold and fuel purchased. In particular, the majority of our plants in the UK within our Europe region, North America, and Australia, operate on a merchant basis.

**(i) Energy trading and market risk**

The Group hedges exposures that arise from the ownership and operation of power plants and related sales of electricity and purchases of fuel by using derivatives to optimise the return achieved from these assets. The Group uses commodity derivative financial instruments to convert floating or indexed electricity and fuel prices to fixed prices. This lessens the Group's vulnerability to reductions in electricity prices for the electricity it generates and to increases in fuel prices for the fuel it consumes in its power plants. Commodity derivative financial instruments also provide a way to meet customers' pricing requirements while achieving a price structure consistent with the Group's overall pricing strategy.

The Group's trading operations are carried out subject to global and local policies and procedures. A similar structure is in place in each region covering monetary, volumetric and term limits. Metrics and limits applied to the trading books include Value-at-Risk (VaR), stop/loss, credit, fuel mismatch, term, volume, approved traders and approved products. Position reports are produced on a regular basis for both the trading and plant books.

The Group accounts for certain derivative financial instruments relating to energy sales and fuel purchases as cash flow hedges where the forecast transaction is highly probable and the hedge is assessed as effective. The Group's coal purchase contracts are typically treated as 'own use' because they are both entered into and continue to be held for the purpose of the Group's electricity production requirements and they are not net settled.

**Sensitivity analysis**

As stated earlier, when hedging the output of our generation assets it is our policy to both forward sell the power and forward buy the corresponding fuel at the same time in order to lock in the 'spread'. The spread is the difference between the cost of fuel to generate a unit of electricity and the price at which that unit of electricity is sold. Spreads are usually expressed in terms of price per MWh. When gas is used as fuel the difference is called 'spark spread' and when coal is used as the fuel it is called 'dark spread'.

From a management perspective, once the spread relating to the future output from a generation asset is forward contracted, the asset is considered hedged. To the extent that future output has not been forward contracted in this manner it is considered unhedged. Management review on an ongoing basis the extent to which generation output is unhedged.

However, in accordance with the requirements of IFRS 7 (Financial Instruments: Disclosures) the following sensitivity analysis shows the impact on the Group's results of changes in market prices as a result of entering into financial instruments including derivatives. Specifically, this sensitivity shows the impact on the Group's results arising from changes in the fair value of forward contracts which are entered into to hedge the future output of our generation assets following a change in forward market prices.

The table below shows the impact on equity and profits of a 20 percent increase in the forward curves for both electricity sales prices and gas purchase prices as if they had occurred on 31 December 2007. This could be viewed as the opportunity cost of our forward contracting if prices had changed in this manner. It should also be noted that if there were to be a 20 per cent decrease in forward prices, the results of the sensitivity analysis would produce an opposite impact on profits and equity to that shown.

The movement of forward price curves by 20 per cent is believed to be a reasonable approximation of how much markets can move, on average, over any given year. In some years markets will be less volatile and in other years they may be more volatile.

The following assumptions have been applied in the performance of these sensitivities:

- All qualifying cash flow hedges at 31 December would continue to be fully effective in achieving cash flow hedge accounting;
- Commodity contracts that qualify for the own use treatment continue to do so, and thus this sensitivity has no impact for these contracts. These typically include coal purchase contracts.

The results are presented net of deferred tax but before minority interests.

	Impact on profit for the year 2007 +/- £m	Impact on total equity 2007 +/- £m	Impact on profit for the year 2006 +/- £m	Impact on total equity 2006 +/- £m
<b>20% increase in forward price curves for electricity</b>	<b>(296)</b>	<b>(357)</b>	(227)	(285)
<b>20% increase in forward price curves for gas</b>	<b>52</b>	<b>52</b>	30	29

This sensitivity analysis highlights that because we hedge the spark spread, i.e. the sales price of electricity and the cost of gas, at the same time, there is little net impact on the fair value of our derivative contracts to changes in the forward price curves to sell electricity and to purchase gas. However, for the dark spread, where the cost of coal is contracted in advance but is accounted for as 'own use', only the electricity sales contracts are exposed to fair value gains and losses arising from changes in the forward curves because these are considered commodity derivative financial instruments. Therefore, from an accounting perspective, forward contracting of dark spread at coal plants potentially gives rise to more volatility in earnings. However, to the extent that fair value gains and losses are recorded in any period within either the income statement or the hedging reserve (when applying cash flow hedge accounting) ultimately they will reverse by the time of delivery.

It should be noted that changes in the fair value of derivatives, which are entered into for economic hedging purposes (refer to basis of preparation in note 1), are recorded in the 'middle column' in the Group's income statement and therefore the fair value gains and losses have no impact on underlying business performance.

To the extent that our power plants are not already contracted, and spreads change as assumed above, it is likely that the future profitability of our coal plants would also improve, because they would contract into the higher dark spreads.

It also means that if plants are unavailable at the point in time at which power should be delivered under the contract, the mark to market position represents the anticipated net cost of purchasing power and selling fuel in the markets to fulfil the contractual obligations and in that instance the unrealised fair value gains and losses would become realised.

## (ii) Interest rate risk

Variability in interest payments can introduce volatility into project returns and corporate funding costs. We mitigate this risk by fixing borrowing rates, principally by using forward rate or interest rate swap agreements. A limited number of our PPAs also have interest rate pass through mechanisms. Significant interest rate management programmes and instruments require the specific approval of the Board.

The Group's policy is fix interest rates for up to 75% of its debt portfolio over the medium to long-term. At individual project company level, it is usually a condition of the non-recourse debt funding that project companies maintain a certain minimum level of fixed rate debt, typically 70%. This complements the Group's policy. The overall level of the Group's fixed rate debt is monitored and reported to senior management on a monthly basis.

### 32 Financial instruments continued

A forward rate agreement is a contract in which one party pays a fixed interest rate and receives a floating interest rate equal to a reference rate specified at the time of entering into the contract. The payments are calculated over a notional amount over a certain period with the differential being settled at the termination date. An interest rate swap is an agreement between two parties to exchange pre-determined interest payments, based on a notional principal amount, over an agreed period of time.

At 31 December 2007, including the impact of 'receive variable: pay fixed' interest rate swaps, £3,587 million (62%) (2006: £3,187 million and 71%) of total debt had fixed interest rates. In 2007 the weighted average interest rate of fixed rate debt, taking into account the effect of 'receive variable: pay fixed' interest rate swaps on floating rate debt, was 7% (2006: 7%). The Group accounts for certain interest rate swaps as cash flow hedges where the forecast transaction is considered highly probable and the hedge is assessed as effective.

The effect of the Group's interest rate swaps effectively replaced £806 million (2006: £796 million) of floating rate Australian dollar borrowings, £759 million (2006: £869 million) of floating rate US dollar borrowings, £297 million (2006: £300 million) of floating rate sterling borrowings, £83 million (2006: £7 million) of floating rate Czech koruna borrowings and £344 million (2006: £35 million) of floating rate euro borrowings with fixed rate borrowings.

The floating rate financial liabilities comprise bank borrowings bearing interest rates fixed in advance for various time periods up to 12 months by reference to official market rates e.g. LIBOR.

When we use project finance in companies with power purchase agreements, our policy is to align the maturity of the debt with the contractual terms of the power purchase agreement.

#### Sensitivity analysis

The sensitivity analysis below shows the impact of a 100 basis point parallel increase in the interest rate yield curve as if it had occurred on 31 December.

The following assumptions have been applied in the performance of this sensitivity:

- The impact of this sensitivity has only been recorded for changes in the fair value of derivative financial instruments, which have their fair value gains and losses recorded within the financial statements; assets available-for-sale; and assets held for trading as the Group does not designate any other financial asset at fair value through profit or loss and these are the only significant financial instruments whose carrying amounts change as a result of changes in interest rates. All other financial instruments are carried at amortised cost and hence no adjustment has been applied;
- No impact is recorded from changes in interest rates on employee benefits (including pensions), provisions and other financial assets and liabilities;
- All qualifying cash flow hedges at 31 December would continue to be fully effective in achieving cash flow hedge accounting;
- Fair value gains and losses on interest rate swaps which do not qualify for hedge accounting as at 31 December are reflected solely in the income statement.

The results are presented net of deferred tax but before minority interests.

	Impact on profit for the year 2007 +/- £m	Impact on total equity 2007 +/- £m	Impact on profit for the year 2006 +/- £m	Impact on total equity 2006 +/- £m
<b>Increase in yield curve by 100 basis point parallel shift</b>	<b>8</b>	<b>49</b>	(3)	33

A second sensitivity analysis calculates the impact on profitability of a 100 basis point increase in interest rates on unhedged interest-bearing loans and bonds, i.e. those which are subject to a floating rate of interest, i.e. where there is no 'receive variable: pay fixed' interest rate swap, and on cash balances on which variable rates of interest are earned. The calculation is performed as follows. The year end cash balance is deducted from the year end unhedged floating rate loans and bonds. The net borrowing is multiplied by 1 percent. In 2007 this equated to £8 million before tax (2006: £3 million).

#### (iii) Foreign currency risk

International Power operates in 20 countries worldwide which exposes it to foreign currency exchange risks. These relate to translation, transaction and economic risks.

Treasury policy is to hedge a reasonable proportion of the Group's translation exposures by borrowing in the same currency as the underlying investment. Any residual translation exposure will result in fluctuating sterling profits and balance sheet asset and liability movements which are not related to underlying business performance. In countries with historically weak currencies we aim to have PPA tariffs denominated in a major international currency. This protects future returns from large and rapid devaluations. Group translation exposure is monitored and reported to senior management on a monthly basis.

For the purposes of preparing the consolidated financial statements, the income statement results of the Group's foreign operations are translated into sterling at the average exchange rates for the period concerned. The balance sheets of foreign operations are translated into sterling at the closing exchange rates.

Currency translation exposures comprise the monetary assets and liabilities of the Group that are not denominated in the functional currency of the operating unit involved, other than borrowings treated as hedges of net investments in overseas operations.

In order to hedge the net assets of foreign operations, borrowings are generally in the same currency as the underlying investment. The Group aims to hedge a reasonable proportion of its non-sterling assets in this way. It is not our policy to hedge currency translation through foreign exchange contracts or currency swaps.

Currency transaction exposure arises where a business unit makes sales and purchases in a currency other than its functional currency. Transaction exposure also arises on the remittance from overseas of dividends or surplus funds. The Group's policy is to match transaction exposure where possible, and hedge remaining transactions as soon as they are committed, by using foreign currency contracts and similar instruments. All external currency instruments used to manage transaction exposure are transacted by Group treasury or under the guidance of Group treasury. Identification of potential transaction exposures is achieved via a detailed cash flow forecast by local currency which is reviewed and updated on a monthly basis.

As noted in 32b), to hedge our foreign exchange risks for transactional currency exposures and currency exposures on future expected sales we use both non-derivative financial instruments, such as foreign currency borrowings, and derivative financial instruments, such as forward foreign currency contracts, currency options and swaps. When we use derivative financial instruments to hedge our exposures to foreign currency risk, the Group may choose to account for these as either fair value hedges or cash flow hedges if they meet the hedge accounting criteria set out in IAS 39.

### Sensitivity analysis

The following sensitivity analysis shows the impact of currency translation exposures arising from monetary assets and liabilities of the Group that are not denominated in the functional currencies of International Power plc or of its subsidiaries. It shows the impact on the Group's consolidated income statement by changing the year end exchange rate of sterling against all other currencies. To the extent that there are monetary assets and liabilities denominated in sterling in subsidiaries with non-sterling functional currencies, the impact of a change in the year end exchange rate is determined. To the extent that there are monetary assets and liabilities denominated in non-sterling currencies in International Power plc or its subsidiaries with sterling functional currencies, the impact of a change in year end exchange rate is determined.

The following assumptions have been applied in the performance of this sensitivity:

- The results of foreign exchange gains and losses on the retranslation of foreign currency denominated loans, that are treated as net investment hedges, are not recorded within the impact on the Group income statement, as these foreign exchange gains and losses are recorded within the translation reserve;
- The exposure on translating the financial statements of subsidiaries into the sterling presentation currency of the consolidated financial statements are not included in the sensitivity analysis;
- No sensitivity has been applied to the results of joint ventures and associates.

The results are presented before tax and minority interests.

	<b>Impact on profit for the year 2007 +/- £m</b>	Impact on profit for the year 2006 +/- £m
<b>10% strengthening of sterling</b>	<b>11</b>	20
<b>10% weakening of sterling</b>	<b>(15)</b>	(26)

### g) Credit risk

We are exposed to credit-related losses in the event that counterparties to traded contracts and financial instruments do not perform according to the terms of the contract or instrument.

The Group's policy is to manage its credit exposure to trading and financial counterparties within clearly defined limits. Energy trading activities are strictly monitored and controlled through delegated authorities and procedures, which include specific criteria for the management of counterparty credit exposures in each of our key regions. Counterparty exposure via customer power purchase agreements (agreements to sell power) is monitored and managed by the local asset team with assistance from Group treasury where appropriate. The impact of an individual PPA default is minimised by the geographical diversity and large number of projects in which the Group is involved. In addition, the non-recourse nature of the funding arrangements, which limits our exposure to our equity commitment in a project, also provides limited credit exposure to the Group.

For the majority of the Group's commodity trading arrangements we have master netting agreements which establish legally enforceable rights of set-off that reduce the credit exposure of the Group in the event of counterparty default. Where possible, the Group will also enter into ISDA (International Swaps and Derivatives Association) master agreements to mitigate its credit exposure to financial instruments.

In the normal course of business there may be occasions when we have a significant concentration of credit risk with one counterparty in order to minimise settlement risk on major transactions. This risk is normally only applicable for a short period of days and is always with an existing relationship bank with a strong investment grade rating.

**32 Financial instruments** continued

Group treasury manages the Group-wide counterparty credit exposure on a consolidated basis for financial counterparties, with the active and close involvement of the global risk manager. Financial counterparty credit exposure is limited to relationship banks and commercial paper with strong investment grade credit ratings.

With regard to financial instruments subject to credit risk, International Power selects counterparties with appropriate ratings for the size, type and duration of the instrument involved. A small proportion of counterparties trading energy are below investment grade. For those energy market transactions with counterparties below investment grade, and which are not supported by appropriate collateral, reserves are carried against the trading risk. Exposures within this band are restricted and closely monitored within narrow limits.

The immediate credit exposure of financial instruments is represented by those financial instruments that have a net positive fair value by counterparty at 31 December 2007.

The Group considers its maximum exposure to credit risk to be:

	<b>31 December 2007 £m</b>	31 December 2006 £m
Cash and cash equivalents <sup>(1)</sup>	<b>1,161</b>	980
Available-for-sale financial assets	<b>13</b>	26
Loans and receivables (refer to note 32a) <sup>(2),(3)</sup>	<b>1,960</b>	1,406
Financial assets at fair value through profit or loss		
– assets held for trading	–	42
– derivative financial assets <sup>(3)</sup>	<b>236</b>	164
Designated cash flow hedge relationships		
– derivative financial assets <sup>(3)</sup>	<b>32</b>	117
<b>Total financial assets</b>	<b>3,402</b>	2,735

(1) The majority of cash balances and short-term deposits are held with strong investment grade banks or financial institutions.

(2) Finance lease receivables are with strong investment grade counterparties including the Portuguese and German governments.

(3) The majority of trade receivables and derivative financial assets relate to merchant trading counterparties for whom we hold collateral in the form of parent company guarantees, letters of credit and cash held as security.

As at 31 December 2007 there were no significant financial guarantees or third party obligations that increase the credit risk of the financial assets set out above.

International Power holds £79 million at 31 December 2007 (31 December 2006: £171 million) in collateral as security for the above financial assets. Collateral held as security includes parent company guarantees (of appropriate credit worthiness), letters of credit issued by investment grade banks and cash margining as set out in the following table:

	<b>31 December 2007 £m</b>	31 December 2006 £m
Parent company guarantee	<b>31</b>	112
Letters of credit	–	1
Cash margining	<b>48</b>	58
	<b>79</b>	171

During 2007 we have not needed to take possession of collateral available to us in order to settle any outstanding debts owed to us.

If the Group was to take possession of collateral or to call on other credit enhancements (e.g. guarantees), and the assets held as security were not readily convertible into cash, we would regularly update our estimates of value and develop a realistic plan for monetisation. We would defend rigorously our right to recoup any outstanding amounts from arrangements which ultimately do not fully settle a liability.

Although we have seen no direct evidence of changes to the credit risk of our counterparties, the current focus on financial liquidity in all international markets has introduced increased financial volatility. We use market knowledge, changes in credit ratings and other techniques to identify significant changes to the financial profile of our counterparties.

**h) Liquidity risk**

Liquidity risk is the risk the Group will encounter difficulty in meeting its obligations associated with its financial liabilities as they fall due. The Group's treasury function is responsible for managing liquidity. The Group's approach to managing liquidity is to ensure that it has sufficient headroom under both normal and abnormal conditions. It manages this through the use of regularly updated cash flow forecasts and a financial headroom analysis which is used to determine funding requirements for a rolling five year period.

The Group holds additional collateral from counterparties in the form of parent company guarantees and letters of credit of £180 million at 31 December 2007 (31 December 2006: £73 million). This collateral only becomes enforceable if existing exposures increase or additional trading with that counterparty is contracted.

### i) Borrowing facilities

The Group has substantial borrowing facilities available to it. The undrawn committed facilities available at 31 December 2007 in respect of which all conditions precedent have been met at that date amount to £586 million (2006: £667 million):

	31 December 2007			31 December 2006		
	Facility £m	Undrawn £m	Available £m	Facility £m	Undrawn £m	Available £m
US dollar Corporate revolving credit facility (October 2010) <sup>(1)</sup>	427	425	425	327	322	322
US dollar ANP Funding 1 revolving credit facility (May 2010) <sup>(2)</sup>	55	42	42	56	40	40
US dollar Tihama term facility (December 2021)	–	–	–	249	–	–
Australian dollar Canunda facility (December 2014)	–	–	–	37	–	–
Sterling Rugeley FGD construction facility (July 2014)	145	57	9	145	129	129
Sterling Rugeley working capital and credit facility (July 2014)	195	97	32	195	100	100
Czech koruna IPO revolving credit facility (May 2012)	138	24	24	24	24	24
Sterling Corporate letter of credit facilities <sup>(3)</sup>	323	–	–	324	11	11
Subsidiary facilities in various currencies	156	54	54	110	41	41
<b>Total</b>	<b>1,439</b>	<b>699</b>	<b>586</b>	1,467	667	667

(1) The drawn element of the US dollar Corporate revolving credit facility relates to letters of credit issued of £2 million (2006: £5 million).

(2) The ANP Funding 1 revolving credit facility includes a US\$50 million supported and US\$60 million unsupported working capital credit facility with capacity to issue letters of credit. At 31 December 2007, £4 million (2006: £4 million) and £9 million (2006: £12 million) of letters of credit had been drawn from each of these facilities respectively.

(3) The Corporate letter of credit facilities can be utilised to issue letters of credit. At 31 December 2007, £323 million of letters of credit had been drawn from these facilities (2006: £324 million) and £173 million of cash and cash equivalents was used as collateral in relation to these facilities (2006: £212 million).

Uncommitted facilities available at 31 December 2007 were:

Facility	31 December 2007			31 December 2006		
	Total £m	Drawn £m	Undrawn £m	Total £m	Drawn £m	Undrawn £m
Bank borrowing and overdraft facilities	50	–	50	35	–	35
Subsidiary facilities in various currencies	44	3	41	11	2	9
	<b>94</b>	<b>3</b>	<b>91</b>	46	2	44

Uncommitted facilities of £94 million (2006: £46 million) include an undrawn and available cash element of £52 million (2006: £37 million). Also included is £39 million (2006: £7 million) of undrawn and available credit lines for the purposes of issuing letters of credit and guarantees in the normal course of business.

Bank borrowing facilities are normally reaffirmed by the banks annually although they can theoretically be withdrawn at any time.

**32 Financial instruments** continued

The following table is an analysis of the contractual undiscounted cash flows relating to financial liabilities at the balance sheet date and a reconciliation from undiscounted cash flows to carrying amounts:

	31 December 2007							
	Due within 1 year	Due between 1 and 2 years	Due between 2 and 5 years	Due after 5 years	Total undiscounted cash flows	Impact of other non-cash items £m	Impact of interest coupons/ discounting £m	Carrying amount
	£m	£m	£m	£m	£m	£m	£m	£m
<b>Non-derivative financial liabilities</b>								
Loans and bonds (note 25)	823	691	2,984	3,567	<b>8,065</b>	(55)	(2,187)	<b>5,823</b>
Other financial liabilities	697	18	23	64	<b>802</b>	–	(35)	<b>767</b>
<b>Derivative financial liabilities</b>								
Net payments								
– Energy derivatives	388	145	129	249	<b>911</b>	–	(177)	<b>734</b>
– Interest rate swaps	7	12	5	1	<b>25</b>	–	(1)	<b>24</b>
– Other derivatives	–	–	–	–	<b>–</b>	76	–	<b>76</b>
<b>Total financial liabilities</b>	<b>1,915</b>	<b>866</b>	<b>3,141</b>	<b>3,881</b>	<b>9,803</b>	<b>21</b>	<b>(2,400)</b>	<b>7,424</b>

	31 December 2006							
	Due within 1 year	Due between 1 and 2 years	Due between 2 and 5 years	Due after 5 years	Total undiscounted cash flows	Impact of other non-cash items £m	Impact of interest coupons/ discounting £m	Carrying amount
	£m	£m	£m	£m	£m	£m	£m	£m
<b>Non-derivative financial liabilities</b>								
Loans and bonds (note 25)	588	766	1,767	3,608	<b>6,729</b>	(59)	(2,073)	<b>4,597</b>
Other financial liabilities	530	19	30	61	<b>640</b>	–	(40)	<b>600</b>
<b>Derivative financial liabilities</b>								
Net payments								
– Energy derivatives	134	61	92	202	<b>489</b>	–	(127)	<b>362</b>
– Interest rate swaps	1	7	2	–	<b>10</b>	–	(1)	<b>9</b>
– Other derivatives	–	–	–	–	<b>–</b>	59	–	<b>59</b>
<b>Total financial liabilities</b>	<b>1,253</b>	<b>853</b>	<b>1,891</b>	<b>3,871</b>	<b>7,868</b>	<b>–</b>	<b>(2,241)</b>	<b>5,627</b>

The net payments relating to interest rate swaps have been calculated based on the yield curves as at 31 December 2007 and 31 December 2006. Net payments under the interest rate swaps represent the projected net settlement amounts under the swaps. The variable interest payments, of the loans to which the swaps relate, are included in the maturity analysis table in note 25 and included in 'loans and bonds' above.

The above tables do not include forecast data for liabilities which may be incurred in the future which are not contracted as at 31 December 2007.

Refer to note 34 for a breakdown of the Group's commitments and to note 35 for a summary of the Group's bonds and guarantees. An assessment of the Group's current liquidity position is given in the 'Business and financial review' section of the *Annual Report* on page 56.

The disclosure of derivatives in the consolidated balance sheet has been made in line with management's view of the Group's operating cycle. This reclassifies certain energy derivative cash flows shown above due after more than one year to being due within one year.