31 NET DEBT

Analysis of net debt

	31 December 2004 £m	On adoption of IAS 32 and IAS 39 £m	1 January 2005 £m	Exchange differences £m	Other non-cash movements £m	Cash flow £m	31 December 2005 £m
Cash and cash equivalents	565	–	565	18	–	37	**620**
Assets held for trading	47	–	47	2	3	–	**52**
	612	–	612	20	3	37	**672**
Debt financing							
Loans due within one year	(71)	–	(71)	–	(73)	(43)	**(187)**
Loans due after more than one year	(2,525)	22	(2,503)	(145)	63	(136)	**(2,721)**
Preferred equity facility	(154)	–	(154)	(18)	(1)	–	**(173)**
Convertible bonds	(158)	22	(136)	(17)	(3)	31	**(125)**
Secured bonds	(449)	–	(449)	–	4	–	**(445)**
Total debt financing	(3,357)	44	(3,313)	(180)	(10)	(148)	**(3,651)**
Net debt	(2,745)	44	(2,701)	(160)	(7)	(111)	**(2,979)**

	1 January 2004 £m	Exchange differences £m	On acquisition of subsidiaries (excluding cash) £m	Other non-cash movements £m	Cash flow £m	31 December 2004 £m
Cash and cash equivalents	696	(10)	–	–	(121)	565
Assets held for trading	47	–	–	–	–	47
	743	(10)	–	–	(121)	612
Debt financing						
Loans due within one year	(531)	34	(39)	466	(1)	(71)
Loans due after more than one year	(704)	(5)	(887)	(437)	(492)	(2,525)
Preferred equity facility	–	–	–	–	(154)	(154)
Convertible bonds	(200)	13	–	(1)	30	(158)
Secured bonds	–	–	(449)	–	–	(449)
Total debt financing	(1,435)	42	(1,375)	28	(617)	(3,357)
Net debt	(692)	32	(1,375)	28	(738)	(2,745)

32 FINANCIAL INSTRUMENTS – 2005

In accordance with IFRS 1, the Group has taken the exemption from the requirement to restate comparative information for IAS 32 and IAS 39. Accordingly the financial instruments disclosure presented in this note on the basis of IAS 32 and IAS 39 is only for 2005. The UK GAAP FRS 13 disclosures for 2004 are shown in note 33.

a) Treasury policy

Treasury policy seeks to ensure that adequate financial resources are available for the development of the Group's business whilst managing its currency, interest rate and counterparty 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.

b) Risk identification and 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.

c) Interest rate risk and hedge accounting

The Group's policy is to fix interest rates for a significant portion of the debt, 61% as at 31 December 2005 using forward rate or interest rate swap agreements. Significant interest rate management programmes and instruments require the specific approval of the Board. The weighted average interest rate of fixed rate debt was 7%. Where project finance is utilised, our policy is to align the maturity of the debt with the contractual terms of the customer offtake agreement. The Group accounts for interest rate swaps as cash flow hedges where the forecast transaction is highly probable and the hedge is assessed as effective.

Effective interest rates and repricing analysis

The following is a table illustrating the effective interest rates of interest earning financial assets and interest bearing financial liabilities at 31 December 2005 and the period in which they reprice:

	31 December 2005							
	Effective interest rate	Total £m	Less than 12 months £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m
Financial assets								
Finance lease receivable:								
Euro	7.9%	460	12	12	14	15	16	391
Assets held for trading:								
Australian dollars	5.5%	52	52	–	–	–	–	–
Cash and cash equivalents:								
Australian dollars	5.4%	109	109	–	–	–	–	–
Czech koruna	1.9%	4	4	–	–	–	–	–
Euro	2.4%	55	55	–	–	–	–	–
Sterling	4.5%	331	331	–	–	–	–	–
US dollars	4.3%	109	109	–	–	–	–	–
Other currencies	3.2%	12	12	–	–	–	–	–
Total financial assets		**1,132**	**684**	**12**	**14**	**15**	**16**	**391**
Financial liabilities								
Secured bank loans:								
Australian dollars	6.7%	1,108	40	41	80	71	46	830
Effect of interest rate swap	*0.7%*	*(701)*	*(17)*	*(160)*	*(169)*	*(71)*	*(266)*	*(18)*
Czech koruna	2.8%	55	8	47	–	–	–	–
Effect of interest rate swap	*0.8%*	*(40)*	–	*(40)*	–	–	–	–
Euro	4.8%	371	21	22	24	23	27	254
Effect of interest rate swap	*0.4%*	*(43)*	*(5)*	*(5)*	*(8)*	*(21)*	*(4)*	–
Sterling	6.8%	335	85	17	15	22	17	179
Effect of interest rate swap	*(0.3)%*	*(192)*	*(19)*	*(12)*	*(10)*	*(15)*	*(136)*	–
US dollars	7.2%	1,013	31	33	37	31	540	341
Effect of interest rate swap	*0.2%*	*(440)*	*56*	*(23)*	*(24)*	*(200)*	*(17)*	*(232)*
Other currencies	7.7%	26	2	2	2	3	3	14
Sub total secured bank loans	6.6%	2,908	187	162	158	150	633	1,618
Sub total of effect of interest rate swaps	*0.4%*	*(1,416)*	*15*	*(240)*	*(211)*	*(307)*	*(423)*	*(250)*
Preferred equity:								
US dollars	7.2%	173	–	–	173	–	–	–
Convertible bond[1]:								
US dollars	7.4%	125	–	–	–	–	–	125
Secured bonds:								
Sterling	8.3%	445	–	–	–	–	–	445
Loans from minority interests:								
US dollars	8.0%	81	–	21	–	–	60	–
Total financial liabilities		**3,732**	**187**	**183**	**331**	**150**	**693**	**2,188**

(1) The effective interest rate for the convertible bond represents the liability element and the equity component (refer to note 24 for further details).

The effect of interest rate swaps refers to the annual movements in the principal amount of the interest rate swap, and are included in the above table to identify to which financial liability they relate. They are not included within total financial liabilities shown above as they are recognised as derivative financial instruments in the balance sheet.

The effect of the Group interest rate swaps effectively replaced £701 million of floating rate Australian dollar borrowings, £440 million of floating rate US dollar borrowings, £192 million of floating rate sterling borrowings, £40 million of floating rate Czech koruna borrowings and £43 million of floating rate euro borrowings with fixed rate borrowings.

Management estimates that a one percentage point increase in interest rates would have the effect of decreasing the Group's profit before tax by approximately £8 million.

32 FINANCIAL INSTRUMENTS – 2005 continued

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 LIBOR for that time period.

d) Energy trading risk, energy market risk and hedge accounting

The Group hedges exposures that arise from the ownership and operation of power plants and related sales of electricity and purchases of natural gas, and utilises derivatives to optimise the return achieved from these assets. The Group enters into derivative commodity financial instruments to convert floating or indexed electricity and gas prices to fixed prices in order to lessen its vulnerability to reductions in electricity prices for the electricity it generates and to increases in gas 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.

Energy market risk on our asset and proprietary portfolios is measured using various techniques including Value-at-Risk (VaR). VaR is used where appropriate and provides a fair estimate of the net losses or gains which could be recognised on our portfolios over a certain period and given a certain probability; it does not provide an indication of actual results. Scenario analyses are used to estimate the economic impact of sudden market movements on the value of our portfolios. This supplements the other techniques and methodologies and captures additional market risks.

The Group accounts for certain energy sales and fuel purchases as cash flow hedges where the forecast transaction is highly probable and the hedge is assessed as effective.

e) Currency exposures

Currency translation exposure
The 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. 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 our policy not to hedge currency translation through foreign exchange contracts or currency swaps.

Currency transaction exposure
This 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.

Currency 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 certain non-sterling borrowings treated as hedges of net investments in overseas operations.

Management estimates that a one percentage point weakening of sterling against all currencies would reduce the Group's profit before tax by approximately £3 million.

f) Borrowing facilities

The Group has substantial borrowing facilities available to it. The undrawn committed facilities available at 31 December 2005 in respect of which all conditions precedent have been met at that date amount to £441 million.

	31 December 2005		
	Facility £m	Undrawn £m	Available £m
US$640 million Corporate revolving credit facility (June 2008)[1]	373	142	142
US$110 million ANP Funding 1 revolving credit facility (May 2010)[2]	64	34	34
US$488 million Tihama term facility (December 2021)	284	72	72
A$92 million Canunda facility (December 2014)	39	12	12
CZK1,000 million IPO revolving credit facility (May 2007)	24	20	20
£60 million Corporate working capital facility (January 2006)[3]	60	60	60
£94 million Corporate letter of credit facilities[4]	94	1	1
£153 million Subsidiary facilities in various currencies	153	100	100
Total	**1,091**	**441**	**441**

(1) The drawn element of the US$640 million Corporate revolving credit facility relates to letters of credit issued of £181 million and £50 million of cash drawings.

(2) This 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 2005, £8 million and £22 million of letters of credit had been drawn from each of these facilities respectively.

(3) This facility could have been utilised to draw cash and issue letters of credit in relation to merchant trading support. It was not renewed when it expired in January 2006.

(4) These facilities can be utilised to issue letters of credit. At 31 December 2005, £93 million of letters of credit had been drawn from these facilities and £28 million of cash and cash equivalents was used as collateral in relation to these facilities.

Uncommitted facilities available at 31 December 2005 were:

	31 December 2005		
	Total £m	Drawn £m	Undrawn £m
Facility			
Bank borrowing and overdraft facilities	36	18	18
£11 million Subsidiary facilities in various currencies	11	2	9
	47	**20**	**27**

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

g) 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 2005:

	31 December 2005	
	Carrying amount £m	Fair value £m
Financial assets		
Other investments	4	4
Finance lease receivables	460	460
Other long-term receivables from joint ventures and associates	30	30
Trade receivables (current)	163	163
Other receivables (current)	108	108
Derivative financial instruments	268	268
Assets held for trading	52	52
Cash and cash equivalents	620	620
Total financial assets	**1,705**	**1,705**
Financial liabilities		
Trade payables (current)	118	118
Other payables (current)	153	153
Derivative financial instruments	687	687
Secured bank loans	2,908	2,928
Preferred equity facility	173	173
Convertible bonds	125	125
Secured bonds	445	480
Loans from minority interests	81	81
Total financial liabilities	**4,690**	**4,745**

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

(i) Other investments comprise equity held in privately owned, unquoted companies and therefore fair value cannot be reliably measured. The fair value has thus been based on the cost amount.

(ii) The fair value of finance lease receivables and other long-term receivables have been estimated by discounting estimated cash flows.

(iii) Trade and other receivables (current) and trade and other payables (current) are stated at fair value, set equal to book value, because of their short maturity.

(iv) Assets held for trading have been estimated using quoted market prices and discounted cash flows.

(v) The fair value of the Group's forward exchange contracts, foreign currency swaps and foreign currency options have been calculated using market rates in effect at the balance sheet dates.

(vi) The fair value of energy derivatives is measured using discounted cash flows and other similar quantification techniques. Where there is no active market, fair value is determined using valuation techniques. These include using recent arm's length market transactions, reference to the current market value of another instrument which is substantially the same, discounted cash flow analysis and pricing models.

(vii) All loans and bonds have been calculated using market prices where available or the net present value of future cash flows arising.

h) Hedges

As explained on pages 38 and 39 of the business and financial review, the Group's policy is to hedge the following exposures:

(i) Interest rate risk – using interest rate swaps, options and forward rate agreements.

(ii) Structural and transactional currency exposures – using currency borrowings, forward foreign currency contracts, currency options and swaps.

32 FINANCIAL INSTRUMENTS – 2005 continued

(iii) Currency exposures on future expected sales – using currency swaps, forward foreign currency contracts, currency options and swaps.

(iv) Energy price fluctuations – using physical hedges through the operation of energy supply and trading activities together with financial products.

The hedging of structural currency exposures associated with foreign currency net investments is recognised in the consolidated balance sheet.

i) Cash flow hedging reserve movements

The following shows the cash flow hedging reserve balance at 31 December 2005 and the periods in which the cash flows are expected to occur:

	Interest rate swaps £m	Energy derivatives £m	Total £m
Unrecognised losses at 31 December 2005	(15)	(103)	**(118)**
Cash flows expected during			
2006	(2)	(67)	**(69)**
2007	(1)	(27)	**(28)**
2008	(1)	(10)	**(11)**
2009	(1)	1	**–**
2010 onwards	(10)	–	**(10)**
	(15)	(103)	**(118)**

Gains and losses recognised in the hedging reserves during the year were as follows:

	Interest rate swaps £m	Energy derivatives £m	Total £m
Gains and (losses) recognised in the hedging reserve on adoption of IAS 32 and IAS 39 at 1 January 2005	(20)	8	**(12)**
Gains and (losses) arising in previous years that were recognised during the year	(2)	(7)	**(9)**
Amount removed from equity and included with a non-financial item	5	–	**5**
Amount recognised in equity	2	(104)	**(102)**
	(15)	(103)	**(118)**

j) Hedge of a net investment

A foreign currency exposure arises from net investments in Group entities whose functional currency differs from the Group's presentation currency. The risk is defined as the risk of fluctuation in spot rates between the functional currency of the net investments and the Group's presentation currency. This will cause the amount of the net investment to vary.

In the absence of hedge accounting the foreign exchange gains and losses on retranslating the net assets of the 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 assets within its portfolio. As the hedging instrument is foreign currency borrowings rather than a derivative, no fair value for this instrument is included within the fair value of derivatives disclosed on the balance sheet.

k) Counterparty credit risk

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 offtake agreements is monitored and managed by the local asset team with assistance from Group treasury where appropriate. In addition, 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.

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. This is mitigated by the fact that for the majority of the Group's commodity trading arrangements there is a legally enforceable right of set-off that reduces the credit exposure of the Group in the event of counterparty default.

Where possible the Group will also enter into master netting agreements that further serve to mitigate its credit exposure.

With regard to financial instruments subject to credit risk, we select 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. We do not expect any significant credit loss to result from non-performance of instruments or traded contracts.

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 2005. At 31 December 2005, the exposures for interest rate swaps, currency swaps and forward exchange contracts were not considered to be material. Contracts for differences also involve a degree of credit risk. This risk is controlled by appropriate authorisation and monitoring procedures.