

32. Financial risk management

A discussion of the Group's treasury objectives and policies and the use of financial instruments can be found in the Directors' report. Financial instruments comprise net debt (note 29) together with other financial assets and other financial liabilities (note 17) and other instruments deemed to be financial instruments under IAS 32 including non-current receivables, non-current payables and non-current provisions.

Hedging instruments

The notional, or contracted, amounts of derivative financial instruments are shown below, analysed between foreign exchange contracts and interest rate contracts, classified by year of maturity.

	31 December 2007				31 December 2006			
	Not exceeding one year	Between one year and five years	More than five years	Total	Not exceeding one year	Between one year and five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Foreign exchange contracts								
Net forward (sales)/purchase contracts								
US dollar	(2,366)	141	(12)	(2,237)	(1,498)	25	(38)	(1,511)
Euro	1,277	425	(1)	1,701	643	10	3	656
Other	131	3	-	134	36	2	-	38
	(958)	569	(13)	(402)	(819)	37	(35)	(817)

	31 December 2007				31 December 2006			
	Not exceeding one year	Between one year and five years	More than five years	Total	Not exceeding one year	Between one year and five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate contracts								
Interest rate swap contracts								
US dollar	-	654	-	654	128	664	-	792
Sterling	30	120	31	181	26	99	53	178
	30	774	31	835	154	763	53	970

	31 December 2007				31 December 2006			
	Not exceeding one year	Between one year and five years	More than five years	Total	Not exceeding one year	Between one year and five years	More than five years	Total
	£m	£m	£m	£m	£m	£m	£m	£m
Cross-currency swap contracts								
Net forward (sales)/purchase contracts								
US dollar	38	176	339	553	143	252	301	696
Swedish krona	(143)	-	-	(143)	-	(137)	-	(137)
	(105)	176	339	410	143	115	301	559

Fair value of financial instruments

The fair value of a financial instrument is the price at which one party would assume the rights and/or duties of another party.

The fair values of financial instruments have been determined based on available market information at the balance sheet date, and the valuation methodologies listed below:

- the fair value of forward foreign exchange contracts are calculated by discounting the contracted forward values and translating at the appropriate balance sheet rates;
- the fair value of both interest rate and cross-currency swaps are calculated by discounting expected future principal and interest cash flows and translating at the appropriate balance sheet rates;
- the fair value of loans and overdrafts has been estimated by discounting the future cash flows to net present values using appropriate market-based interest rates prevailing at 31 December.

Due to the variability of the valuation factors, the fair values presented at the balance sheet date may not be indicative of the amounts the Group would expect to realise in a current market environment.

Notes to the Group accounts (continued)

32. Financial risk management (continued)

The following table compares the estimated fair values of certain financial assets and liabilities to their carrying values at the balance sheet date¹.

	Net carrying amount 2007 £m	Estimated fair value 2007 £m	Net carrying amount 2006 £m	Estimated fair value 2006 £m
Assets				
Non-current				
Other investments	-	-	4	4
Other receivables ²	265	265	569	569
Other financial assets	48	48	51	51
Current				
Other investments	164	164	503	503
Other financial assets	101	101	50	50
Cash and cash equivalents	3,062	3,062	3,100	3,100
Liabilities				
Non-current				
Loans	(2,197)	(2,399)	(2,776)	(2,964)
Other financial liabilities	(26)	(26)	(45)	(45)
Current				
Loans and overdrafts	(299)	(308)	(334)	(339)
Other financial liabilities	(71)	(71)	(50)	(50)

1 the estimated fair values of the remaining financial assets and liabilities are consistent with their carrying values at the balance sheet date

2 net carrying amount approximates to estimated fair value as there is no active market

Interest rate risk

Based on contracted maturities and/or repricing dates, the following amounts are exposed to interest rate risk over the future as shown below:

	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	Beyond 2012 £m
Assets						
Non-current						
Other receivables	109	-	-	-	-	-
Current						
Other investments	164	-	-	-	-	-
Cash and cash equivalents	3,062	-	-	-	-	-
Liabilities						
Non-current						
Loans	(577)	(577)	(545)	(263)	(127)	(94)
Current						
Loans and overdrafts	(41)	-	-	-	-	-

Collateral

As shown above, the Group has entered into a number of financial derivative contracts to hedge certain long-term foreign currency and interest rate exposures. Cash collateral payments can be required to be made periodically to the counterparty dependent on the market value of these financial derivatives. Cash deposited in this way is treated as a non-current receivable and at 31 December 2007 totalled £109m (2006 £115m).

Committed undrawn borrowing facilities

At 31 December 2007 the Group had a committed Revolving Credit Facility (RCF) of £1.5bn, which expires in more than two years but less than five years (2006 £1.5bn which expires in more than two years but less than five years). The RCF was originally contracted for five years until 2010. However, it has been extended by the agreement of two one-year extensions until 2012, although the available amount for the final year has been reduced from £1.5bn to £1.3bn. The RCF remained undrawn throughout the year.

32. Financial risk management (continued)

Interest rate fluctuations

The objective of interest rate risk management is to reduce the exposure to interest rate fluctuations on borrowings and deposits. This is achieved through varying the proportion of fixed rate debt relative to floating rate debt over the forward time horizon by utilising derivative instruments, mainly interest rate swaps. The Group's current interest rate management policy is that a minimum of 25% (2006 25%) and a maximum of 75% (2006 75%) of debt is maintained at fixed interest rates. At 31 December 2007, the Group had 75% (2006 72%) of fixed rate debt and 25% (2006 28%) of floating rate debt based on a gross debt of £2.5bn (2006 £3.1bn).

The floating rate debt has been predominantly achieved by entering into interest rate swaps which swap the fixed rate US dollar interest payable on debt into either floating rate sterling or US dollars. At the end of 2007, the Group had a total of \$1.3bn (2006 \$1.6bn) of this type of swap outstanding with a weighted average duration of 3.2 years (2006 3.6 years). In respect of the fixed rate debt the weighted average period in respect of which interest is fixed was seven years (2006 six years).

Given the level of short-term interest rates during the year, the average cost of the floating rate debt was 6.7%, with 6.3% on US dollars and 7.3% on sterling (2006 both 5.8%). The cost of the fixed rate debt was 7.1% (2006 7.0%). A change of 100 basis points in short-term rates applied to the average fixed/floating mix and level of borrowings would vary the interest cost to the Group by £7m (2006 £11m).

In respect of cash deposits, given the fluctuation in the Group's working capital requirements, cash is generally invested for short-term periods based at floating interest rates. A change of 100 basis points in the average interest rates during the year applied to the average cash deposits would vary the interest receivable by £23m (2006 £15m).

Credit risk on cash and cash equivalents

The Group is exposed to credit risk on its cash and cash equivalents to the extent of non-performance by its counterparties in respect of financial instruments. However, the Group has policies in place to ensure credit risk is limited by placing concentration limits. BAE Systems has a credit limit system to manage actively its exposure to treasury counterparties. The cash and cash equivalents balance at 31 December 2007 of £3,062m (2006 £3,100m) was invested with 26 (2006 45) financial institutions. The system assigns a maximum exposure based on the counterparty's size, FT composite rating and Credit Default Swap price. These limits are regularly monitored and updated. The Group has material receivables due from the UK, US and Saudi Arabian governments where credit risk is not considered to be an issue. For the remaining trade receivables no one counterparty constitutes more than 3% of the balance (2006 4%).

The cash and cash equivalents of the Group are invested in non-speculative financial instruments which are usually highly liquid such as short-term deposits. The Group, therefore, believes it has negligible exposure to price risk.

Currency risk

In order to protect itself against currency fluctuations, the Group's policy is to hedge all material firm transactional exposures. Further explanation is set out in the Risk management and principal risks section of the Directors' report on page 50.