

Southern Electric Power Distribution plc

Regulatory Accounts for the year ended 31 March 2008

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Corporate Report for the year ended 31 March 2008

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Southern Electric Power Distribution plc

Corporate Report: Review of the year to 31 March 2008

Southern Electric Power Distribution plc (the Company) is a wholly owned subsidiary of Scottish and Southern Energy plc (the Group). The Company's first responsibility is to maintain safe and reliable supplies of electricity and to restore supplies as quickly as possible in the event of interruptions. In line with this it is encouraging that our performance across a range of measures continues to be good. This performance has been achieved while maintaining close control over the operating cost base and confirms that the electricity networks managed by the Group are among the most efficient in the world.

The Company is the subject of incentive-based regulation by the Office of Gas and Electricity Markets (Ofgem), which sets for periods of five years the prices that can be charged for the use of the electricity network, the capital expenditure and the allowed operating expenditure. In broad terms, Ofgem seeks to strike the right balance between attracting investment in electricity networks, encouraging companies to operate the networks as efficiently as possible and ensuring that prices for customers are no higher than they need to be. As at 31 March 2008, the Company estimates that, based on Ofgem's methodology for valuing the assets of the Company's distribution business (the Regulated Asset Value or 'RAV') was approximately £1,570m.

During 2007/08, the Company's operating profit increased by 18.4% to £210.5m. One of the principal reasons for this was the reduction in the charge related to pension deficit contributions made to the Southern Electric Pension Scheme (SEPS). Under the current price control arrangements with Ofgem, 76% of the total pension deficit repair contributions made to the SEPS are allowed to be recovered by the Company. The charge to the Company in 2007/08 was £27.0M, which is 76% of the total deficit payment to SEPS for this year. This compares with a charge to the Company of £49.0M in 2006/07. The charge in 2006/07 represented two years contribution for 2006/07 & 2005/06. Adjusting for the pension deficit charge the underlying performance of the Company saw an increase in the operating profit of £10.7M (4.7%) from the previous year.

During the year, the Company distributed 34.2TWh of electricity, compared with 33.9TWh in the previous year. There was a 1.1% increase in the number of customers to whom electricity is distributed. This combined with an increase in the price of these units has also contributed to the increase in profitability in the year. In addition to this increase in underlying operating profit were gains on disposal of assets of £8.9M which included £8.2M in relation to the sale of a 132kv overhead line at Marchwood in Hampshire.

Ensuring the reliability of the electricity networks it owns and operates is one of the Company's main priorities and the key measures of reliability are customer minutes lost and customer interruptions. The average number of minutes that customers in the Southern Electric Power Distribution area were without supply was 67, this was 5 fewer than in the previous year; and the number of supply interruptions per 100 customers was 66, compared with 75 in the previous year. Performance in respect of both minutes lost and interruptions was ahead of the targets set by Ofgem under its Quality of Service Incentive Scheme (QSIS), which gives financial benefits to distribution network operators that deliver good performance for customers. This, together with income earned in 2007/08 under other incentive arrangements is expected to lead to the Company receiving additional revenue totalling £10.5m during the next two financial years.

Electricity Network Investment

The key responsibility of the Company's business is to maintain safe and reliable supplies of electricity and to restore supplies as quickly as possible in the event of interruptions. The Distribution Price Control Review for 2005-10 resulted in substantially increased allowances for capital expenditure to maintain and improve the networks' performance. This will enable the Company to increase its revenue from its networks, and delivery of this enhanced investment programme was one of the Company's priorities for the year. 2007/08 was Year 3 of the current Distribution Price Control Review and the level of capital expenditure increased significantly in the year with the commencement of a number of significant schemes and an increase in refurbishment programmes. Capital expenditure was £170.3m during the year, which was 24.6% higher than in 2006/07. In the course of the year, the Company added just over 915km to the length of its networks, taking the total to over 75,500km. 2008/09 will see a further increase in capital expenditure .

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Electricity Distribution Priorities in 2008/09

During 2008/09, the Company's first objective will be to maintain safe and reliable supplies of power. In addition a key objective is to ensure that the network operations are managed as efficiently as possible, including maintaining tight controls over operational expenditure and delivering efficient capital expenditure, so that the number and duration of power cuts experienced by customers is kept to a minimum. The Company seeks to earn additional incentive-based revenue under the various Ofgem-sponsored schemes. Over time, the objective is to grow the RAV of the network business and secure increased revenue from it.

These objectives will be supported by delivery of continuous improvement initiatives, following the implementation of a review of internal processes and customer-facing operations that took place during 2007/08. Ofgem has already stated that encouraging electricity distribution companies to be 'more responsive to the needs of customers' will be amongst its key priorities for the forthcoming Distribution Price Control Review for 2010-15.

Over the next year, detailed work will begin on the Review, where Ofgem's other key priorities include giving companies 'strong incentives to help tackle climate change' and 'delivering good value for consumers by ensuring that companies provide secure and more sustainable networks'. Ofgem also pointed out that it is likely that there will be growth in renewable and small-scale 'distributed' generation, which could see much more generation connecting directly to the distribution, as opposed to the transmission network.

The Company believe that constructive engagement with Ofgem during the Review process is important and this will be a major objective during 2008/09.

1 Operational Review

1.1 Factors affecting the Business

The Company is responsible for managing an electricity distribution network, serving more than 2,850,000 customers. Distribution of electricity within specified areas is a monopoly activity and the income earned by charging electricity customers for the use of the wires is closely regulated by Ofgem, as is the level of investment which is made in electricity networks. The Company has completed the third year of the price controls set for the period up to 31 March 2010.

Against this background, the Company's objective is to manage the consequences of the growth in demand for electricity and ensure the network has the minimum number of faults and the maximum robustness in the face of severe weather and other supply interruption risks. It is also important to automate networks so that when supply is interrupted, it can be restored as soon as possible. The programme of investment is designed with these goals in mind.

1.2 Use of Resources and Status of Significant Projects

In line with the policies in place to achieve the objectives highlighted at 1.1, a total of £170.3m was invested in the electricity network. The investment undertaken upgrades the electricity network and reinforces the value of the RAV which, in turn, supports the ongoing value of the business.

In the Southern Electric Power Distribution area, the programme to upgrade and refurbish the network continued during 2007/08, with 1,347km of high voltage overhead lines and 800km of low voltage lines refurbished.

The substantial programme of network automation continued, with another 105 urban substations completed, together with 70 new radio-controlled automated switching units in rural areas, allowing for faster restoration of supply to customers. There has also been significant investment in the underground network, with 70km of high voltage cable replaced.

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1 Operational Review (continued)

1.2 Use of Resources and Status of Significant Projects (continued)

The most significant electricity distribution project being undertaken by the Company is the construction of two new underground cable 132kV circuits from Bramley to Basingstoke in Hampshire, designed to ensure the electricity network can meet maximum demand for 650,000 customers served by the Bramley and Fleet grid supply points. The 10km route includes 4km of urban roads, directional drills under rural water courses and large open cut crossings through the main railway line in Basingstoke. It also requires development work at two substations. The total cost of the project is over £16m and it is on course for completion before the end of 2008.

The increased capital spend spans the breadth of the network aimed at improving customers quality of supply as well as replacing worn out assets. In our largest substations we have continued to invest appropriate amounts to meet both load growth and replace end of life assets. The Cippenham/Chalvey project to replace life expired transformers and switchgear cost £5m this year and features the most modern gas insulated switchgear situated indoors to meet tight space requirements.

At Henley, the Company replaced 5.5km of old fluid filled 33kV cable at a cost of £1.6m. This was a challenging project through the centre of a busy town and was delivered to time and budget despite the many issues faced. Load growth is still evident all over our Licence area with much of our investment focussed here. At Hedge End, a new primary substation was built at a cost of over £1m to meet load growth in the Southampton area.

Legislative changes and environmental pressures have required investment in a number of large schemes. Recent modifications to the Electricity, Safety, Quality and Continuity Regulations require us to increase our tree cutting and modify overhead lines to achieve revised clearance requirements. We have, wherever possible, undertaken this work along with our established programmes to minimise costs and ensure we take advantage of duplicate work sites. The total spend on overhead lines was approximately £24m in the year.

1.3 Employees

Employees are encouraged to participate in the businesses of the Group in a variety of ways. In support of the Board's commitment to providing opportunities for employees to become shareholders, the Group offers a Share Incentive Plan and a Sharesave Scheme which is open to all eligible employees. Employee participation in these schemes, over the Group, is around 38% and 37% respectively. The company recognises that its continuing success is closely linked to the performance, skills and individual commitment of its employees. As part of a 2007 employee award, all eligible employees were awarded 20 free shares. The company places a strong emphasis on employee communication and involvement. An employee newspaper is published and distributed to employees. Participation and engagement is encouraged through team meetings, briefings and the intranet where employees are informed of the latest company news from recent media coverage and about developments within the business.

The Group Chief Executive regularly communicates with employees through his blog and receives feedback, in addition to live on-screen question and answer style 'webchats'. During the year, the senior management held a series of roadshows around the Group to present and discuss the Group's vision, values and strategy. The Company has in place an extensive range of policies to safeguard the interests of its employees and potential employees. In particular, its equal opportunities policy aims to ensure that all employees and job applicants are no less fairly treated due to age, gender, sexual orientation, race, disability or other reasons not justified in law or relevant to performing their job. The Company also aims to ensure that employees have the right skills to deliver the high standards of performance that are necessary to achieve its objectives. Detailed information about the Group's approach to these and related matters is set out in its Corporate Responsibility Report 2008.

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1 Operational Review (continued)

1.4 Safety

The Group believes that all work can be done in such a way that no-one, whether an employee, contractor, customer or member of the community, suffers from its operations. It believes that all injuries are preventable and it aims to provide staff with training, work methods and equipment to achieve that goal.

'Being safe' is a core value in the business. In line with this, the Group's Health, Safety and Environment Manual, which has the status of a work instruction, emphasises that safety will not be compromised for business interest or operational pressures and all injuries, plant damage and near misses will be reported and investigated. The Health, Safety and Environmental Advisory Committee, together with the Audit Committee and management, ensures that health, safety and environmental policy statements are being adhered to; sets health, safety and environmental targets for the Group; and monitors the performance of the Group against these targets. The Director with lead responsibility for Health and Safety is Colin Hood, who chairs the Safety and Health leadership team.

As a result of this commitment to safety, Scottish and Southern Energy plc continues to be at the forefront of Britain's electricity industry in relation to safety.

1.5 Principal risks and uncertainties

As noted, the Company is responsible for managing a regulated electricity distribution network, based in the South of England. One of the major risks arises from the quinquennial price review, when the future income that the Company may collect from the users of the electricity network is set. The current price control period runs from 1 April 2005 to 31 March 2010 and discussions on the next price control have now started. The year to 31 March 2008 is the third year of the current price review period. In arriving at the allowed income Ofgem assess the revenue and capital expenditure plans of the business and determine an efficient level of that expenditure. In addition they assess the quality of service requirements for the network and determine a cost of capital sufficient to encourage the required investment in the network. Given the importance of the outcome of the price control review process, the establishment of allowable income for the following years, the Company invests considerable management time to ensure that the correct price control is set.

In March 2008, Ofgem announced plans to review the 20-year old regime governing the regulation of electricity and gas networks. The review will examine whether the 'current approach will continue to deliver customers reliable, well-run networks with good service at reasonable prices amid growing investment challenges faced by the energy networks in the future'. Ofgem has stated that the range of possible recommendations emerging from the review runs from no change to substantial change, and that where change is recommended, there will be full consultation. Because the review will not report until 2010, and because any proposed changes will be subject to consultation, work on the Distribution Price Control Review for 2010-15 is expected to be unaffected.

The key responsibility of the Company is to maintain safe and reliable supplies of electricity and to restore supplies as quickly as possible in the event of interruptions. In the long term this is done by ensuring the correct level of investment in the network. In the short term the electricity network can be subject to damage, and potentially major disruption, by the weather. Storms caused by winter weather fronts, winter snow fall and lightning storms at any time of year can damage the electricity distribution network and result in customers' supply of electricity being interrupted. To mitigate the effects of these events, weather forecasts are closely monitored and staff deployed in advance of foreseeable major weather events. Arrangements are in place to use resources from contractors and other electricity distribution network operators in the event of major interruptions and contracts are in place with suppliers of materials and services which can be brought into action at short notice in the event of severe weather.

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1 Operational Review (continued)

1.5 Principal risks and uncertainties (continued)

The Directors acknowledge that they have responsibility for the Company's systems of internal control and risk management and for monitoring their effectiveness. The purposes of these systems are to manage, rather than eliminate, the risk of failure to achieve business objectives, to provide reasonable assurance as to the quality of management information and to maintain proper control over the income, expenditure, assets and liabilities of the Company.

No system of control can, however, provide absolute assurance against material misstatement or loss. Accordingly, the Directors have regard to what controls, in their judgement, are appropriate to the Company's business and to the relative costs and benefits of implementing specific controls.

2. Financial Review

2.1 Balance Sheet

The Group and Company both continue to maintain one of the strongest balance sheets in the global utility sector. This gives the Company significant competitive advantage in terms of cost of funding and supporting new developments.

The majority of employees of the Company are members of the Southern Electric Pension Scheme, which, at 31 March 2008, had a deficit included in the Group accounts, net of deferred tax, of £97.1M (2007 - £154.0M).

2.2 Financial Risk Management

The Company's financial risk is managed as part of the wider group risk management policy.

The Company's operations are financed by a combination of retained profits, bank borrowings, long term debt issuance and inter company loan stocks.

The main financial risks affecting the Group include exposures to fluctuations or changes in interest rates, foreign exchange rates, liquidity, commodity prices and volumes and counterparty creditworthiness. The Group's Risk Committee, which reports to the Board, reviews and agrees policies for addressing each of these risks. At 31 March 2008, 65.7% of the Group's borrowings were at fixed or inflation-linked interest rates, after taking account of interest rate swaps. The Company's main risk area is in relation to interest rates and, as noted, this is controlled as part of the Group's risk management policies.

2.3 Taxation

The Company's effective current tax rate was 33.1% compared with 35.4% in the previous year after prior year adjustments. The headline effective tax rate is 16.5% compared with 29.1% in the previous year.

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2. Financial Review (continued)

2.4 Dividend

The Company's dividend policy was to distribute up to 50% of surplus cash flow as a dividend for both years.

2.5 Borrowings and Facilities

The Company has loans of £784.2m (2007 – £877.1m) of which £25.0m (2007 - £25.0m) is due to other group companies and £85.4m (2007 - £116.8m) is in the form of loans from the European Investment Bank. Of the total, interest is paid at fixed rates on £759.2m (2007 - £852.1m). As part of the adoption of the fair value hedge accounting requirements of FRS 25 and FRS 26, the Company's loans are stated as being £784.2m (2007 - £866.5m).

As at 31 March 2008, the weighted average interest rate payable was 5.20% (2007 – 5.41%) and the weighted average remaining term was 23.46 years (2007 – 21.91 years).

2.6 International Financial Reporting Standards

The application of International Financial Reporting Standards (IFRS) is required for listed companies for accounting periods commencing on or after 1 January 2005. As a result, the Group's Accounts for the year to 31 March 2008 have been prepared in accordance with EU adopted IFRS.

The accounts of Southern Electric Power Distribution plc have been prepared in accordance with applicable UK Generally Accepted Accounting Principles (UK GAAP).

