

**Southern Electric Power Distribution plc**

**Regulatory Accounts for the year ended 31 March 2007**

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## **Southern Electric Power Distribution plc**

### **Corporate Report for the year ended 31 March 2007**

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## **Southern Electric Power Distribution plc**

### **Corporate Report: Review of the year to 31 March 2007**

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 2007, the Company estimates that, based on Ofgem's methodology for valuing the assets of the Company's distribution business, the Regulated Asset Value ('RAV') was approximately £1,515m.

During 2006/07, the Company's operating profit fell by 21.9% to £177.8m. The principal reason for this was a charge of £49.0M from another group company, SSE Services plc, in connection with pension deficit payments made to the Southern Electric Pension Scheme (SEPS). Under the current price control arrangements with Ofgem 76% of total payments made in respect of pension deficit to SEPS are allowed to be recovered by the company. The initial payment to SEPS was made by SSE Services plc and the charge to the Company in current year represented 76% of the total deficit payments to SEPS in 2005/06 & 2006/07. During the year, the Company distributed 33.9TWh of electricity, compared with 34.9TWh in the previous year, despite a growth in the number of customers to whom electricity is distributed. This reduction in the number of units distributed was, however, partially offset by changes in their price.

Ensuring the reliability of the electricity networks it owns and operates is one of SSE'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 72, one more than in the previous year; and the number of supply interruptions per 100 customers was 76, compared with 78 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 (QSI), which gives financial benefits to distribution network operators that deliver good performance for customers. This, together with income earned in 2006/07 under other incentive arrangements is expected to lead to the Company receiving additional revenue totalling £9m during the next two financial years.

In January 2007, the Southern Electric Power Distribution area was affected by a storm which the Meteorological Office said was the most severe in its scale and impact for 17 years. This led to additional costs of around £2m being incurred. It resulted in almost 200,000 customers having their electricity supply interrupted. Power was restored to around 180,000 customers within a day and to almost all of the affected customers within 36 hours. Over 1,000 people in SSE, from across the country, were involved in dealing with the consequences of the storm, from engineers out in the field to customer service advisers who spoke to over 50,000 affected customers who called in. It was an exercise in which first class teamwork was key. Following the event, SSE undertook a comprehensive review to ensure that it is as well prepared as possible for storms in the future.

### **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 2006/07. It is now well under way, with capital expenditure of £136.7m during the year, which was 17.8% higher than in 2005/06. In the course of the year, the Company added just over 800km to the length of its networks, taking the total to over 77,500km. 2007/08 will see a further increase in capital expenditure.

## **Southern Electric Power Distribution plc**

### **Corporate Report: Review of the year to 31 March 2007**

#### **Electricity Distribution Priorities in 2007/08**

During 2007/08, the Company's first objective will be to maintain safe and reliable supplies of power and to restore supplies as quickly as possible in the event of interruptions, so performance in terms of customer minutes lost and customer interruptions will continue to be critical. This will be supported by delivery of continuous improvement initiatives, following a fundamental review of internal processes and customer-facing operations that is now under way. Other key priorities will be the efficient delivery of the next phase of the major programme of investment in the networks, targeted at upgrading them so as to benefit the greatest number of customers.

### **1 Operational Review**

#### **1.1 Factors affecting the Business**

The Company is responsible for managing an electricity distribution network, serving more than 2,800,000 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 second 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 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 £136.7m was invested in the electricity network. Investment of this kind 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 2006/07, with 1,280km of high voltage overhead lines and 770km of low voltage lines refurbished.

The substantial programme of network automation continued, with another 112 urban substations completed, together with 96 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 55km of high voltage cable replaced.

An example of the type of project in which investment is being made is the installation of a 15km overhead 'BLX' line and 2.5km underground cable, which will improve the security of supply to customers at Marchington on the Dorset/Wiltshire border. The cable is being laid using directional drill techniques which avoid the need for large open trenches under sensitive woodland to comply with requests from English Nature and the National Trust.

Rising demand for electricity in north Hampshire and south Berkshire has created the need for a reinforcement of the local electricity network. In line with this, SSE has begun preliminary work on the installation of two 10km underground 132kV cables that will carry power from National Grid's substation at Bramley to the SEPD substation in Basingstoke.

## **Southern Electric Power Distribution plc**

### **Corporate Report: Review of the Year to 31 March 2007**

#### **1 Operational Review (continued)**

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

The Company continues to implement a number of initiatives to improve further the resilience of the electricity network for the future. For example, falling trees or clashing branches are a major source of supply interruptions during windy weather conditions. To improve performance in this area, for the past number of years, the Group has employed directly most of the people involved in tree cutting. This is also in line with the Group's general approach that operations and services are best managed and delivered by people who are directly employed by the Company.

##### **1.3 Employees**

Enabling employees to derive the maximum possible benefit from their employment with the Group is one of the principles which has been adopted. The Board believes that this can be achieved through active encouragement of share ownership, participation in the Group's affairs, and the maintenance of effective policies on issues such as equal opportunities.

Participation in the Group's affairs is encouraged through team meetings, briefing documents and an internal magazine. During the year, employees were invited to attend business development and financial results briefings. Policies on such matters as Equal Opportunities and Health and Safety are regularly communicated to staff.

It is Group policy, where possible, to provide employment opportunities for disabled people. Staff who become disabled are supported in continuing employment through identification of suitable jobs and the provision of any necessary re-training.

##### **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 Director with lead responsibility for Health and Safety is Colin Hood.

The net result of this commitment to safety is that Scottish and Southern Energy plc continues to lead Britain's electricity industry in 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 will formally start in 2008. The year to 31 March 2007 is the second 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.

## **Southern Electric Power Distribution plc**

### **Corporate Report: Review of the Year to 31 March 2007**

#### **1 Operational Review (continued)**

##### **1.5 Principal risks and uncertainties (continued)**

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.

#### **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 2007, had a deficit included in the Group accounts, net of deferred tax, of £154.0M (2006 - £198.8M).

##### **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 2007, 82.6% of the Group's borrowings were at fixed 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 35.4% compared with 30.4% in the previous year after prior year adjustments. The headline effective tax rate is 29.1% compared with 29.8% in the previous year.

## **Southern Electric Power Distribution plc**

### **Corporate Report: Review of the Year to 31 March 2007**

#### **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 £877.1m (2006 – £882.8m) of which £25.0m (2006 - £25.0m) is due to other group companies and £116.8m (2006 - £122.8m) is in the form of loans from the European Investment Bank. Of the total, interest is paid at fixed rates on £852.1m (2006 - £857.8m). 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 £866.5m (2006 - £880.3m).

As at 31 March 2007, the weighted average interest rate payable was 5.41% (2006 – 5.42%) and the weighted average remaining term was 21.91 years (2006 – 22.76 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 2007 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).

## **Southern Electric Power Distribution plc**

### **Corporate Governance Statement**

#### **Scottish and Southern Energy plc Group (“The Group”)**

The Board continues to commit to the highest standards of corporate governance, and has due regard to the continuing developments in this field. The Group seeks to run its entire business and maximise profits in a way which is responsible, safe, customer focused and commercially aware. These are the four core values which underlie everything the Group does. Moreover, the Group aims to conduct its business in an ethical manner that maintains an appropriate balance between social, economic and environmental issues.

In keeping with this, the Group has continued its commitment to high standards of corporate governance.

Throughout the year, the company has complied with all the provisions set out in Section 1 of the Combined Code and the Board therefore considers that the company has satisfied its obligations under the Combined Code.

The Board comprises a non-Executive Chairman, four Executive Directors and six independent non-Executive Directors, which complies with the Combined Code provisions in this regard.

The Board acknowledges its responsibility for ensuring that an adequate system of internal control exists which accords with the requirements of the Turnbull Committee guidance.

#### **Southern Electric Power Distribution plc (“The Company”)**

##### **Board of Directors**

The Board consists of three Directors, two of whom are Directors of the Group. None of the Directors are Directors of Group Companies involved in Supply or Generation activities. The Group has an Audit Committee, a Remuneration Committee, an Executive Committee, a Risk Committee, a Health, Safety and Environmental Advisory Committee and a Nomination Committee and details of the appointees are included in the published Corporate Governance Statement of the Group. The Company, as a subsidiary entity, has no such Committees.

##### **Internal Control**

The Directors acknowledge that they have responsibility for the Company’s systems of internal control and risk management and for monitoring their effectiveness. The purpose of these systems are to manage, rather than eliminate, the risk of failure to achieve business objectives, and 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, to the materiality of the risks inherent in the business, and to the relative costs and benefits of implementing specific controls. This process is regularly reviewed by the Board and has been in place for the whole year.

Control is maintained through an organisation structure with clearly defined responsibilities, authority levels and lines of reporting; the appointment of suitably qualified staff in specialised business areas; and continuing investment in high quality information systems. These methods of control are subject to periodic review as to their implementation and continued suitability.

There are established procedures in place for regular budgeting and reporting of financial information. The Company’s performance is reviewed by the Board and the Executive Committee. Reports include variance analysis and projected forecasts of the year compared to approved budgets and non-financial performance indicators.

There are policies in place covering a wide range of issues and risks such as financial authorisations, IT procedures, health, safety and environmental risks, crisis management, and a policy on ethical principles. The business risks associated with the Company’s operations are regularly assessed by the Directors

The effectiveness of the systems of internal control is monitored by the internal audit department. Their reports, which include where appropriate relevant action plans, are distributed to senior managers and Directors.

## **Southern Electric Power Distribution plc**

### **Corporate Governance Statement (continued)**

#### **Southern Electric Power Distribution plc (“The Company”) continued**

##### **Environment**

The Group manages a wide range of environmental issues. Operating the power systems network is recognised as a priority area and formal environmental management systems have been developed across the Group. The systems have five main elements, based on the established management cycle of (1) setting policy, (2) planning, (3) implementing and operating, (4) checking and correcting and (5) reviewing.

The system exists to enable managers to deliver the Group’s environmental policies through procedures and work instructions. It reflects an integrated, Group-wide health and safety and environmental management system.

##### **Going Concern**

The Directors consider that the Company has adequate resources to continue in operational existence for the foreseeable future. The accounts are therefore prepared on a going concern basis.

**Southern Electric Power Distribution plc**

**Regulatory Accounts for the year ended 31 March 2007**

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