

# **Scottish Hydro Electric Power Distribution plc**

## **Regulatory Accounts for the year ended 31 March 2008**

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## **Scottish Hydro Electric Power Distribution plc**

### **Corporate Report for the year ended 31 March 2008**

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## Scottish Hydro Electric Power Distribution plc

### Corporate Report: Review of the Year to 31 March 2008

Scottish Hydro 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, 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 £810m.

Operating profit for the Company increased by 7.3% to £113.5m. In the Scottish Hydro Electric area, 8.8TWh of electricity were distributed during the year, compared with 8.5TWh distributed in the previous year. There was a 2.1% increase in the number of customers to whom electricity is distributed and this combined with an increase in the price of these units has also contributed to the increase in profitability in the year.

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 were without supply was 72, compared with 77 in the previous year. The number of supply interruptions per 100 customers was 69, 10 less than in the previous year. Performance in respect of both minutes lost and interruptions was ahead of Ofgem's Quality of Service Incentive Scheme (QSI), which gives financial benefits to distribution network operators that deliver good performance for customers QSI targets. This, together with income earned in 2007/08 under other incentive arrangements, is expected to lead to the Company receiving additional revenue of £5.5m in the next two financial years.

#### Electricity Network Investment

The key responsibility of the Company's businesses 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 2007/08. It is now well under way, with capital expenditure of £61.8m during the year, which was 14.2% higher than in 2006/07. In the course of the year, the Company added 233km to the length of its networks, taking the total, to over 46,000km.

Investment at broadly similar levels to 2007/08 will continue during the remainder of the current price control period.

## Scottish Hydro Electric Power Distribution plc

### Corporate Report: Review of the Year to 31 March 2008 (continued)

#### 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 720,000 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 £61.8m 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 Scottish Hydro Electric Power Distribution area, the programme to upgrade and refurbish the network continued during 2007/08, with 2,309km of high voltage overhead lines and 412km of low voltage lines refurbished.

The programme of network automation continued, with another 47 new radio-controlled automated switching units in rural areas, allowing for faster restoration of supply to customers.

## Scottish Hydro Electric Power Distribution plc

### Corporate Report: Review of the Year to 31 March 2008

#### 1 Operational Review (continued)

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

A specific feature of the capital investment programme this year has been the replacement of several submarine cables connecting the mainland electricity network to islands and between islands. The Company's territory features a number of submarine cable links and has the greatest number and longest length of these of any Distribution Network Operator in the United Kingdom. Total expenditure on these cables was over £4m in the year with cables replaced at Kerrera/Mull (8km); Sanday/Stronsay (6km); and Corran Narrows (2km). In addition a new overhead line and submarine cable costing in excess of £2m were installed to provide the island of Mull with a more secure and stable supply of electricity.

Work to enable the maximum Distributed Generation (DG) to connect to the network continues apace. On the Western Isles the company installed a novel device to support the island network at a cost of approximately £2m. The Arnish Generator/Compensator supports the grid voltage at both times of maximum and minimum demand and will assist the optimum volume of DG to connect. The device is integral to plans for a Western Isles Registered Power Zone that aims to increase the DG penetration on the Isles although constraints on the mainland Transmission Grid are the major blockage to this aim as things stand.

The Company continues to ensure that the stewardship of the network is efficient, addresses customer concerns and is robust over the long term. Investment during the year was spread over overhead lines, substations and cables. Network improvements have been driven by targeted investment on automation, refurbishment and replacement. The largest schemes were at Kintore Substation (£587,000), Dornoch Substation (£900,000) and an overhead line at Dunvegan (£687,000).

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

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.

## Scottish Hydro Electric Power Distribution plc

### Corporate Report: Review of the Year to 31 March 2008

#### 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 North of Scotland. 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 was 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.

## Scottish Hydro Electric Power Distribution plc

### Corporate Report: Review of the Year to 31 March 2008

#### 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 Scottish Hydro-Electric Pension Scheme, which, at 31 March 2008, had a surplus included in the Group accounts, net of deferred tax, of £61.8M (2007 - £89.7M).

##### 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 managed as part of the Group's risk policies.

##### 2.3 Taxation

The Company's effective current tax rate was 31.7% compared with 31.3% in the previous year, after prior year adjustments. The headline effective tax rate is 15.5% compared with 26.0% in the previous year.

##### 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 £479.0m (2007 - £475.0m) of which £300m (2007 - £300m) is due to other group companies and £179.0m (2007 - £175.0m) is in the form of loans from the European investment Bank and an index-linked bond. Of the total, interest is paid at fixed or inflation-linked rates on £454.0m (2007 - £450.0m).

As at 31 March 2008, the weighted average interest rate payable was 5.81% (2007 - 5.70%) and the weighted average remaining term was 20.11 years (2007 - 20.88 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 financial statements for the year to 31 March 2008 have been prepared in accordance with EU adopted IFRS.

The accounts of Scottish Hydro Electric Power Distribution plc have been prepared in accordance with applicable UK Generally Accepted Accounting Principles (UK GAAP). A number of the Company's accounting policies were changed in the accounts to 31 March 2007 following the Company re-registering as a Public company and the adoption of a number of new accounting standards issued by the Accounting Standards Board (ASB) as part of the project to converge UK GAAP with adopted IFRS.

