

Scottish Hydro Electric Power Distribution plc

Regulatory Accounts for the year ended 31 March 2007

CONTENTS	Section
Corporate Report	1
Regulatory Accounts	2

Scottish Hydro Electric Power Distribution plc

Corporate Report for the year ended 31 March 2007

CONTENTS	Section 1 Page No.
Review of the Year	1 - 5
Corporate Governance Statement	6 - 7

Scottish Hydro Electric Power Distribution plc

Corporate Report: Review of the Year to 31 March 2007

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 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 £795m.

Operating profit for the Company increased by 2.6% to £105.8m. In the Scottish Hydro Electric area, 8.5TWh of electricity were distributed during the year, compared with 8.9TWh distributed in the previous year. This reduction in the number of units distributed was, however, offset by changes in their price.

The average number of minutes that customers were without supply was 77, compared with 65 in the previous year (which was the best performance in the area since records began) and 82 in 2004/05. This followed an increase of almost 25% in the number of weather-related faults experienced on the 33kV network during January and February of 2007. The number of supply interruptions per 100 customers was 79, one more than in the previous year. Performance in respect of both minutes lost and interruptions was, however, ahead of Ofgem's QGIS targets. This, together with income earned in 2006/07 under other incentive arrangements, is expected to lead to the Company receiving additional revenue of just under £4m during 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 2006/07. It is now well under way, with capital expenditure of £54.1m during the year, which was 26.1% higher than in 2005/06. In the course of the year, the Company added just over 300km to the length of its networks, taking the total, to nearly 46,000km.

Investment at similar levels to 2006/07 will continue during the remainder of the current price control period.

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.

Scottish Hydro Electric Power Distribution plc

Corporate Report: Review of the Year to 31 March 2007

1 Operational Review

1.1 Factors affecting the Business

The Company is responsible for managing an electricity distribution network, serving more than 700,000 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 £54.1m 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 2006/07, with 1,784km of high voltage overhead lines and 350km of low voltage lines refurbished.

The programme of network automation continued, with another 81 new radio-controlled automated switching units in rural areas, allowing for faster restoration of supply to customers.

During 2006/07 work took place to refurbish major substations at Ballindalloch, Burghmuir, St Cyrus and at a number of locations in Shetland. Replacement of transformers, switchgear and ancillary equipment has brought these sites to an 'as new' condition. In addition, a major 33kV Distribution overhead line between Torr Achilty and Garve was refurbished and partially rebuilt. Work on replacing a specific type of circuit breaker that is known to be prone to early failure has continued to attract significant expenditure.

2007/08 will be marked by the replacement of no fewer than four subsea cables, reinforcing the electricity supply to islands off the north and west coasts.

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.

Scottish Hydro Electric Power Distribution plc

Corporate Report: Review of the Year to 31 March 2007

1 Operational Review (continued)

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 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 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 five years, the Company invests considerable management time to ensure that the correct price control is set.

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 2007

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 2007, had a surplus included in the Group accounts, net of deferred tax, of £89.7M (2006 - £63.1M).

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 managed as part of the Group's risk policies.

2.3 Taxation

The Company's effective current tax rate was 31.3% compared with 35.2% in the previous year, after prior year adjustments. The headline effective tax rate is 26.0% compared with 34.4% 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.

Scottish Hydro Electric Power Distribution plc

Corporate Report: Review of the Year to 31 March 2007

2. Financial Review (continued)

2.5 Borrowings and Facilities

The Company has loans of £475.0m (2006 – £375.0m) of which £300m (2006 - £300m) is due to other group companies and £175.0m (2006 - £75.0m) is in the form of loans from the European investment Bank and a new index-linked bond. Of the total, interest is paid at fixed rates on £450.0m (2006 - £350.0m).

As at 31 March 2007, the weighted average interest rate payable was 5.70% (2006 – 5.86%) and the weighted average remaining term was 20.88 years (2006 – 14.22 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 2007 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. A fuller explanation of the changes in the Company's accounting policies is included in Notes 1 and 2 to the Accounts.

Scottish Hydro 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.

Scottish Hydro 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.

Scottish Hydro Electric Power Distribution plc

Corporate Governance Statement

Scottish Hydro 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.

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Scottish Hydro Electric Power Distribution plc

Regulatory Accounts for the year ended 31 March 2007

CONTENTS	Section 2 Page No.
Report of the Directors	1 – 4
Statement of directors' responsibilities in respect of the Directors' Report and the Regulatory Accounts and Compliance with Standard Licence Condition 42	5
Profit and Loss Account	6
Balance Sheet	7
Statement of Total Recognised Gains and Losses and Reconciliation of Movements in Shareholders' Funds	8
Notes on the Accounts	9 - 24
Additional disclosures	25 – 28
Independent auditors' report to the Scottish Hydro Electric Power Distribution plc and to the Gas and Electricity Markets Authority ("The Regulator")	29 – 30

