

Scottish Hydro Electric Power Distribution plc

Regulatory Accounts for the year ended 31 March 2009

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Scottish Hydro Electric Power Distribution plc

Corporate Report for the year ended 31 March 2009

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Scottish Hydro Electric Power Distribution plc

Corporate Report: Review of the Year to 31 March 2009

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 increasing the level of investment in the network.

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, within a framework known as the Price Control. 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. Ofgem also places specific incentives on companies to improve their efficiency and quality of service.

During 2008/09, the Company's operating profit increased by 5.0% to £119.2m. During the year, the Company distributed 8.5 TWh of electricity, compared with 8.6TWh in the previous year a reduction of 1.2% reflecting the current economic climate. There was a 1% increase in the number of customers to whom electricity is distributed. This combined with an increase in the price of these units and a continued focus on cost control 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 in the Scottish Hydro Electric Power Distribution area were without supply was 75 (2008: 72), and the number of supply interruptions per 100 customers was 76, compared with 69 in the previous year. The increase in the number of supply interruptions reflects the fact that snow, accompanied by strong winds, was a feature of the weather over an extended period during the winter and resulted in more faults to the network.

Under the current distribution price control arrangements the company has an incentive to earn additional performance based income. Performance-based income covers a number of areas, including the quality of service provided to customers, reducing electrical losses and innovation. As noted above quality of supply performance in respect of both customer minutes lost and customer interruptions was ahead of the targets set by Ofgem under its Quality of Service Incentive Scheme (QSIS). During 2008/09 the company has earned £7.6m in additional performance based income which it will receive over the next 2 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. Investment is geared to renewing the company's network, which were largely built in the 1950s and 1960s, and thereby reducing the number and duration of power supply interruptions. It is also geared to providing the infrastructure to accommodate customers' demand for power. 2008/09 was Year 4 of the current Distribution Price Control Review and the level of capital expenditure increased significantly in the year with the continuation of a number of significant schemes and an increase in refurbishment programmes. Capital expenditure was £68.3m during the year, which was 10.5% higher than in 2007/08. In the course of the year, the Company added just over 208km to the length of its networks, taking the total to over 46,000km.

As at 31 March 2009, 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 £840m.

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Corporate Report: Review of the Year to 31 March 2009 (continued)

Electricity Distribution Priorities in 2008/09

During 2009/10, the Company's first objective will continue to 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.

Key to this objective is an acceptable outcome to the Distribution Price Control for the 2010 to 2015 period. This means being able to earn a reasonable return on the RAV through: a fair allowed return (currently 4.8% post-tax real) which reflects the current economic and financial environment; and scope for out-performance from the various incentive mechanisms.

Detailed work on the Price Control has been ongoing during 2008/09 and we continue to engage constructively with Ofgem on this project. Ofgem's key priorities include encouraging electricity distribution companies to be more responsive to the needs of customers and ensuring that companies provide secure and more sustainable networks. The Company therefore expects that annual capital expenditure during the next Price Control will be maintained at broadly the 2008/09 level. Having published its third consultation document about the Review for 2010-15 in May 2009, Ofgem will publish its Initial Proposals on each electricity distribution company's revenue requirements in early August 2009 with the final proposals due by December 2009.

It is clear that encouraging electricity companies to be more responsive to the needs of customers will be amongst Ofgem's key priorities for 2010-15, and the Company has in place a programme of continuous improvement initiatives in anticipation of this. The Company is also looking to the longer-term issues, such as the possible impact on its distribution networks of the deployment of a large number of electric vehicles and the development of 'intelligent' networks.

1 Operational Review

1.1 Factors affecting the Business

The Company is responsible for managing an electricity distribution network, serving more than 735,000 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 fourth 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 £68.3m 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 2008/09, with 1,987km of high voltage overhead lines and 218km 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.

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Corporate Report: Review of the Year to 31 March 2009

1 Operational Review (continued)

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

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 included the completion of an additional overhead line and submarine cable costing £1.7m were installed to provide the island of Mull with a more secure and stable supply of electricity. In addition reinforcement works at Skene substation to accommodate new demand at a cost of £1.5m and Redmoss reinforcement work at a cost of £1.0m were undertaken.

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 £18m 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 31% respectively. The company recognises that progress is made due to the professionalism, commitment and teamwork of its employees. For that reason, and to mark the tenth anniversary of the Scottish and Southern Group, of which the Company is part, all eligible employees received a special award comprising an offer, free of charge, of 10 shares in SSE plc; an online voucher worth £200 for Scottish and Southern Energy's retail business, and an additional day's holiday. The company places a strong emphasis on employee communication and involvement. An employee newspaper is 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 is also committed to the continuing employment of, and the arranging of appropriate training for, any employees who become disabled during the course of employment. The Company 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 2009 (refer www.scottish-southern.co.uk).

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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 Group 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 Group 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 and the Company continue 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 ends on 31 March 2010 and discussions on the price control arrangements that will be in place from 2010 to 2015 are well underway. Given the importance of the outcome of the price control review process to the establishment of allowable income for the following years, the Company invests considerable management time in constructively engaging with Ofgem 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. This review is considering whether the current approach will continue to deliver customers reliable, well-run networks with good service at reasonable prices, amid the growing investment challenges faced by the energy networks in the future. This review will not be concluded until 2010. Any changes arising from it will be the subject of consultation and so work on the Distribution Price Control Review for 2010-15 is expected to be largely 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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Corporate Report: Review of the Year to 31 March 2009

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 2009 on an IAS 19 basis had a surplus of £nil included in the Group accounts, net of deferred tax, (2008 - £61.8m).

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 2009, 84.8% 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 33.5% compared with 31.7% in the previous year, after prior year adjustments. The headline effective tax rate is 26.8% compared with 15.5% 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 £484.0m (2008 - £479.0m) of which £300.0m (2008 - £300.0m) is due to other group companies and £184.0m (2008 - £179.0m) 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 £459.0m (2008 - £454.0m).

As at 31 March 2009, the weighted average interest rate payable was 4.75% (2008 - 5.81%) and the weighted average remaining term was 19.41 years (2008 - 20.11 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 2009 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).

