

# **Scottish Hydro Electric Transmission Limited**

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

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## **Scottish Hydro Electric Transmission Limited**

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

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## **Scottish Hydro Electric Transmission Limited**

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

Scottish Hydro Electric Transmission Limited (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 the electricity network, encouraging companies to operate the networks as efficiently as possible and ensuring that prices for customers are no higher than they need to be. A new five-year Transmission Price Control was agreed in December 2006 and this financial year has been the first year of this price control. As at 31 March 2008, the Company estimates that based on Ofgem's methodology for valuing the assets of the Company's transmission business (the Regulated Asset Value or 'RAV') was approximately £330m.

Since the introduction of British Electricity Trading and Transmission Arrangements (BETTA) in April 2005, National Grid has been Great Britain System Operator, responsible for balancing the supply and demand of electricity across Great Britain. Scottish Hydro Electric Transmission Limited remains responsible for operating, maintaining and investing in the transmission network in its area, which serves around 70% of the landmass of Scotland.

The year to 31 March 2008 resulted in a decrease in operating profit of £5.3M (14.2%) to £31.9M. The level of revenue decreased by 11.8% during the year, primarily due to the collection in 2006/07 of an under-recovery of regulated revenue in 2005/06 and the impact of the reduction in regulated revenue following the introduction of the new price control. There have also been costs incurred during the year associated with the Beaulieu Denny Public Inquiry and other Beaulieu Denny pre construction costs which have not yet been recovered via regulated revenue. Discussions are ongoing with Ofgem to obtain permission to recover these costs under the Transmission Licence condition covering this project.

The number of transmission system incidents that resulted in a loss of supplies to customers increased to 18, compared with 17 in the previous year. However, the level of system availability increased from 95.7% in 2006/07 to 97.7% in 2007/08.

#### **Electricity Network Investment**

The level of investment in the Transmission network increased significantly to £44.2M, an increase of more than 75% from 2006/07 levels. As a result of the new price control the level of capital investment in the Transmission network was forecast to increase significantly and this has happened during 2007/08. This level of investment was within the allowable level of capital expenditure agreed with Ofgem at the price control.

#### **Electricity Transmission Priorities in 2008/09**

During 2008/09, 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 transmission system incidents and availability will continue to be critical. This 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.

During 2008/09, important questions will be asked about the reliability of the UK's electricity networks and their fitness for purpose in the context of the need to accommodate output from renewable energy schemes. Key priorities for the Company during the year will include the efficient delivery of the next phase of the major programme of investment in the network. This will be targeted at upgrading the network so as to benefit the greatest number of customers. It will also undertake work in advance of what is hoped to be a successful outcome from the Public Inquiry into the Beaulieu-Denny transmission line proposal.

## **Scottish Hydro Electric Transmission Limited**

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

#### **1 Operational Review**

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

The Company is responsible for managing an electricity transmission network, serving more than 720,000 customers. Transmission of electricity within specified areas is a monopoly activity and the income earned by charging electricity customers for the use of the system is closely regulated by Ofgem, as is the level of investment which is made.

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.

As the licensed transmission company for the north of Scotland, the Company is required to ensure there is sufficient network capacity for those seeking to generate electricity from renewable sources. In January 2008, the Scottish Government designated electricity network reinforcement to support renewable energy development as one of nine proposed 'National Developments' in the draft second National Planning Framework. Designation as National Developments in the Framework establishes these projects as being in the national interest.

The Company believes the project to replace the electricity transmission line connecting Beauly in the Highlands with Denny in the Central Belt of Scotland is in line with its responsibilities as a licensed transmission company and is also in the national interest. A year-long Public Inquiry into the project was completed in February 2008. The Scottish Minister for Enterprise, Energy and Tourism stated in the Scottish Parliament in September 2007 that Ministers do not expect to receive the report of the Inquiry until late 2008 and that a determination is unlikely before early 2009. It is now likely that the construction of the Company's share of the replacement line will require investment in excess of £300m.

As the UK Business Council for Sustainable Energy said in its paper on implementing the EU renewable energy target in the UK, the consenting and completion of the Beauly-Denny rebuild is essential to releasing the upgrade potential of the existing Scottish transmission system. By rebuilding the weakest part of a north of Scotland transmission ring, it will allow the other elements to that ring to be re-conducted and re-insulated (avoiding any need for new overhead line routes) to increase the capability for renewable energy capacity in the north of Scotland to over 6GW, compared with around 2.2GW currently connected.

The Company has undertaken a public consultation exercise on its draft proposals for the possible development of a new high voltage electricity transmission cable capable of accommodating power from wind farms on Shetland and connecting it to the existing mainland transmission network at Blackhillock in Moray.

The Scottish Government is exploring subsea electricity network options through two offshore transmission studies: the Irish Scottish Links on Energy Study and the North Sea Energy Grid. The Company is well-placed to contribute to the development of new grid options and will continue to work on them with Scottish Ministers and officials and other stakeholders.

In September 2007, the European Commission published its third package of proposals to further liberalise the EU's energy market. The package includes options for electricity and gas transmission networks: the full ownership unbundling of transmission from production and supply in both electricity and gas; or the designation of an independent system operator (ISO) that would operate, maintain and develop the networks, which would make it possible for existing vertically-integrated companies to retain network ownership. The Group believes that the ISO model in Great Britain has worked well and could be successfully replicated elsewhere in the EU. Discussions on this issue are continuing, with a view to EU governments reaching agreement on a way forward later this year.

## Scottish Hydro Electric Transmission Limited

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

#### 1 Operational Review (continued)

##### 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 £44.2m was invested in the transmission 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.

The most significant electricity transmission project on which work is actually getting under way is the Inveraman substation. Planning consent for this project was obtained in December 2007 and work has now commenced. This project will provide 200MW additional export capacity for electricity generated from renewable sources in Argyll. This is a joint project with Scottish Power Transmission. The Company's investment is around £12m.

##### 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.

##### 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.

## Scottish Hydro Electric Transmission Limited

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

#### 1 Operational Review (continued)

##### 1.5 Principal risks and uncertainties

As noted, the Company is responsible for managing a regulated electricity transmission 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. A new five-year Transmission Price Control came into effect on 1 April 2007. 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.

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 the impact of this review will not impact on the Company until the next Transmission Price Control review in 2012.

#### 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 31.4% compared with 32.1% in the previous year, after prior year adjustments. The headline effective tax rate is 20.2% compared with 29.9% 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 Transmission Limited**

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

#### **2. Financial Review (continued)**

##### **2.5 Borrowings and Facilities**

The Company has loans of £158.1m (2007 – £158.1m) of which £133.1m (2007 - £133.1m) is due to other group companies and £25.0m (2007 - £25.0m) is in the form of loans from the European investment Bank. Of the total, interest is paid at fixed or inflation-linked interest rates on £158.1m (2007 - £158.1m).

As at 31 March 2008, the weighted average interest rate payable was 5.94% (2007 – 5.94%) and the weighted average remaining term was 11.66 years (2007 – 12.66 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 Transmission Limited have been prepared in accordance with applicable UK Generally Accepted Accounting Principles (UK GAAP).

## **Scottish Hydro Electric Transmission Limited**

### **Corporate Governance Statement**

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

The Board is accountable to the Group’s shareholders for the good conduct of the Group’s affairs. Throughout the year the Group monitors developments in corporate governance best practice. Due regard is also given to the policy guidelines of organisations representing major institutional investors. In addition, internal procedures are regularly reviewed and updated by the Board and the various Board committees.

The Board continues to be committed to ensuring that the highest standards of corporate governance are maintained. The Group’s core purpose is to provide the energy people need in a reliable and sustainable way while abiding by its core values: safety; service; efficiency; sustainability; excellence; and teamwork.

The Board continues to be committed to ensuring that the highest standards of corporate governance are maintained and the Board confirms that throughout the year, the Group complied with all provisions set out in Section 1 of the Code.

The Board consists of a non-Executive Chairman, four Executive Directors and five independent non-Executive Directors. This gives the Board an appropriate balance of independence and experience, ensuring that no one individual or group of individuals has undue influence over the Board’s decision-making. The composition of the Board and its committees is regularly reviewed to ensure that this balance and mix of skills and experience is maintained.

#### **Scottish Hydro Electric Transmission Limited (“The Company”)**

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

The Board consists of four 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.

