

Scottish Hydro Electric Transmission Limited

Regulatory Accounts for the year ended 31 March 2007

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Scottish Hydro Electric Transmission Limited

Corporate Report for the year ended 31 March 2007

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Scottish Hydro Electric Transmission Limited

Corporate Report: Review of the Year to 31 March 2007

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 during 2006/07 and came into effect on 1 April 2007. As at 31 March 2007, the Company estimates that based on Ofgem's methodology for valuing the assets of the Company's transmission business, the Regulated Asset Value ('RAV') was approximately £300m.

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. These arrangements are working well.

Operating profit increased by 3.9% to £37.2M. The level of revenue increased by 16% during the year, primarily due to an under recovery of regulated revenue in 2005/06 that was collected in 2006/07. The reason for the under recovery was primarily associated with the pre-construction costs associated with the proposed upgrade of the Beauly to Denny Transmission line. These costs were allowed to be recovered via regulated revenue and in 2006/07 there was £5.4M of revenue and costs accounted for associated with this.

The number of transmission system incidents increased to 17, compared with 10 in the previous year. This rise was wholly due to a change in reporting definitions to bring the three UK Transmission Owners onto a consistent reporting basis. On a like for like basis, the figure for 06/07 was down one, to 9 incidents. The level of system availability increased from 96.9% in 2005/06 to 97.9% in 2006/07.

One of the Company's priorities for 2006/07 was to secure a satisfactory outcome from the Transmission Price Control Review for 2007-12, and in December 2006 it decided, on balance, to accept Ofgem's final proposals. While the allowed cost of capital was, and remains, disappointing, the Company concluded, ultimately, that there was within Ofgem's detailed proposals for areas such as capital and operational expenditure sufficient scope and incentive to secure an acceptable level of revenue from its transmission business.

Electricity Network Investment

The level of investment in the transmission network increased to £24.9M, an increase of 30% from 2005/06 levels. This level of investment was within the allowable level of capex agreed with Ofgem in the two year price control period from April 2005 to March 2007.

Electricity Transmission 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 transmission system incidents and availability 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 and the successful completion of the Public Inquiry into the Beauly-Denny transmission line proposal.

Scottish Hydro Electric Transmission Limited

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 transmission network, serving more than 700,000 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 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, Scottish Hydro Electric Transmission Limited is required to ensure there is sufficient network capacity for those seeking to generate electricity from renewable sources. 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 that responsibility. It is likely that the construction of its part of the replacement line will require the Company to invest over £250m, and making progress with this project was another priority during 2006/07. A Public Inquiry into the project began in February 2007, and was still on schedule at the end of July 2007. It is expected that the report of the Inquiry will be submitted to Scottish Ministers for a decision during 2008. The workload and time commitment from the Company to participate in this Inquiry is significant.

In December 2006, SSE published a consultation document on the possible development of a new high voltage transmission line capable of accommodating power from possible renewable energy developments on the Western Isles and connecting this to the existing mainland transmission network at Beauly. The consultation document set out a preferred option for the new connection which would involve the construction of a subsea High Voltage Direct Current (HVDC) cable circuit and an underground HVDC cable. The development on this basis would require investment by the Company broadly estimated at around £375m.

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 £24.9m 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.

One example of the major investments undertaken in the year was the replacement of a number of 275kV air blast circuit breakers. Refurbishment of Grid Substations at Kintore, Fraserburgh, Inverary and Charleston, Dundee was also undertaken. Transmission tower lines were reconducted and refurbished on the Sloy-Killin circuit whilst a new 132kV wood pole line was built between Sloy and Inverary.

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.

Scottish Hydro Electric Transmission Limited

Corporate Report: Review of the Year to 31 March 2007

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 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 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 was agreed during 2006/07 and 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. 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.

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).

Scottish Hydro Electric Transmission Limited

Corporate Report: Review of the Year to 31 March 2007

2. Financial Review (continued)

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 32.1% compared with 32.5% in the previous year, after prior year adjustments. The headline effective tax rate is 29.9% compared with 31.8% 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 £158.1m (2006 – £158.1m) of which £133.1m (2006 - £133.1m) is due to other group companies and £25.0m (2006 - £25.0m) is in the form of loans from the European investment Bank. Of the total, interest is paid at fixed rates on £158.1m (2006 - £158.1m).

As at 31 March 2007, the weighted average interest rate payable was 5.94% (2006 – 5.94%) and the weighted average remaining term was 12.66 years (2006 – 13.66 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 2007 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 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 Transmission Limited (“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 Transmission Limited

Corporate Governance Statement

Scottish Hydro Electric Transmission Limited (“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.

REGISTERED NO.

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