

Scottish Hydro Electric Transmission Limited

Regulatory Accounts for the year ended 31 March 2009

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Scottish Hydro Electric Transmission Limited

Corporate Report for the year ended 31 March 2009

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Scottish Hydro Electric Transmission Limited

Corporate Report: Review of the Year to 31 March 2009

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 five-year Transmission Price Control came into effect on 1st April 2007 and this financial year has been the second year of this price control. As at 31 March 2009, 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 £375m.

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 2009 resulted in an increase in operating profit of £9.5M (29.8%) to £41.4M. The level of revenue increased by 11.9% during the year, primarily due to the collection of the under recovery of regulated income of £2.9M from 2007/08. This under recovery was due to the delayed recovery of costs incurred in the Beaulieu Denny public inquiry as formal Ofgem approval was required. In addition as a result of the completion of the public inquiry the operating costs of the Company reduced during 2008/09.

The number of transmission system incidents that resulted in a loss of supplies to customers decreased to 14, compared with 18 in the previous year. However, the level of system availability also decreased from 97.7% in 2007/08 to 96.7% in 2008/09.

Electricity Network Investment

The level of investment in the Transmission network increased significantly to £60.7M, an increase of more than 37% from 2007/08 levels. This was as a result of a large number of reinforcement and refurbishment projects approved as part of the price control which have continued and commenced during the year. In addition expenditure commenced on the Inverarnan substation project which is a project under the Transmission Investment for Renewable Generation (TIRG) licence condition.

Electricity Transmission Priorities in 2009/10

During 2009/10, 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.

Key priorities for the Company during the year will include the continued efficient delivery 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. In addition the Company would hope to secure Scottish Government Ministers' consent to upgrade the Beaulieu-Denny transmission network following the Public Inquiry that was completed in early 2008.

Scottish Hydro Electric Transmission Limited

Corporate Report: Review of the Year to 31 March 2009

1 Operational Review

1.1 Factors affecting the Business

The Company is responsible for managing an electricity transmission network, serving more than 735,000 customers. Transmission of electricity within specified areas is a monopoly activity and the income earned by charging 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.

As the licensed transmission company for the north of Scotland the Company is responsible for operating, maintaining and investing in the transmission network in its area, which serves around 70% of the land mass of Scotland. The Company 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 Beaully in the Highlands and Denny in the Central Belt of Scotland follows on from the Company's licence responsibilities. The Beaully-Denny Public Inquiry, the largest in Scotland since devolution, was completed in February 2008. Scottish Ministers received the report of the Inquiry in February 2009, and the Scottish Government said they will 'take a final decision on the proposal later this year'. It is likely that the Company's share of the replacement line (200km of the total distance of 220km) will require investment in excess of £300m.

The TIRG mechanism provides funding for transmission companies which are required to undertake work in connection with renewable energy that was not forecast at the time the relevant price controls were set. In May 2008, Ofgem announced it would allow an increase in the Company's income to take account of costs incurred in respect of the Beaully-Denny public inquiry. In doing so, it noted that: 'We are convinced that SHETL diverting its own internal resources to the Public Inquiry (above and beyond what could reasonably be expected) has resulted in material cost savings that would otherwise have been funded by consumers'.

In December 2008, the Scottish government included future electricity network reinforcement to support renewable energy development as one of 12 'National Developments' in the second National Planning Framework. Designation as National Developments in the Framework establishes the need for these projects in the national interest. The Renewable Energy Directive includes a binding commitment on EU Member States to ensure their electricity networks 'accommodate the further development of electricity production from renewable energy sources'. Against this background, in March 2009, the Electricity Networks Strategy Group, co-chaired by Ofgem and the UK Department of Energy and Climate Change, and on which the Company is represented, published *Our Electricity Transmission Network: A Vision for 2020*. It set out a series of proposed reinforcements to the Great Britain transmission network, with a total value of £4.7bn, of which over £1bn would be required in the Company's area, in two stages. The reinforcements would accommodate, amongst other things, the large amount of onshore and offshore wind farms that will be required to meet the UK's legally-binding renewable energy targets for 2020.

The report said: 'The proposed Beaully-Denny rebuild is an important step in developing a transmission system in the north of Scotland of sufficient capacity to accommodate renewable development proposals. With this upgrade in place, further reinforcement of the north of Scotland transmission system can be achieved by the strengthening of the other elements of the system.'

In other words, the consenting and completion of the Beaully-Denny upgrade would allow other elements of the north of Scotland transmission ring to be re-conducted and re-insulated while avoiding any need for new overhead line routes. This would increase the capability for renewable energy capacity in the north of Scotland to over 6GW, well over double that currently connected.

SSE's proposal for an electricity transmission connection between the Western Isles and the north west of Scotland is consistent with this featuring, for the mainland section, an underground cable between the west coast of Sutherland and the Beaully substation near Inverness. The Company submitted to Scottish Ministers an application for consent to construct the connection in October 2008.

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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

In line with the policies in place to achieve the objectives highlighted at 1.1, a total of £60.7m 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 underway during 2008/09 was the TIRG project at Inveranan substation. Planning consent for this project was obtained in December 2007 and work started in early 2008. This project will provide 200MW additional export capacity for electricity generated from renewable sources in Argyll. The Company's investment in 2008/09 was £8.3m and the total project is expected to cost around £12m.

In addition major investment has been made on projects replacing and refurbishing Tealing substation 132kv Circuit Breakers and other substation equipment at a cost of £5.1M in the year and a major infrastructure reinforcement project at St Fergus, Peterhead where £4.1M was spent in the year. This project includes the construction of a new auto transformer and associated substation switchgear and cabling. Both of these projects are ongoing but will be completed during 2009/10.

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 Energy 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).

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 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 continues to be at the forefront of Britain's electricity industry in relation to safety.

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Corporate Report: Review of the Year to 31 March 2009

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 2009, based on an IAS 19 accounting basis, had a surplus included in the Group accounts, net of deferred tax, of £nil (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 and Trading 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 17.3% compared with 31.4% in the previous year, after prior year adjustments. The headline effective tax rate is 22.1% compared with 20.2% in the previous year.

2.4 Dividend

The Company's dividend policy is to distribute up to 50% of surplus cash flow as a dividend for both years.

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2. Financial Review (continued)

2.5 Borrowings and Facilities

The Company has loans of £158.1m (2008 – £158.1m) of which £133.1m (2008 - £133.1m) is due to other group companies and £25.0m (2008 - £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 (2008 - £158.1m).

As at 31 March 2009, the weighted average interest rate payable was 5.94% (2008 – 5.94%) and the weighted average remaining term was 10.66 years (2008 – 11.66 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 2009 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. Company Board Meetings are held on 8 occasions during the course of the year. The Group has an Audit Committee, a Remuneration Committee, an Executive Committee, a Risk and Trading Committee, a Health, Safety and Environmental Advisory Committee and a Nomination Committee and details of the appointees and the work undertaken are included in the published Corporate Governance Statement of the Group (see www.scottish-southern.co.uk). The Company, as a subsidiary entity, has no such Committees but the Group arrangements cover the operations of the Company.

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

