POWERFUL OPPORTUNITIES

Scottish and Southern Energy plc
Annual Report 2006

Scottish and Southern Energy

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Directors

Sir Robert Smith
Chairman
Ian Marchant
Chief Executive
Gregor Alexander
Finance Director
Colin Hood
Chief Operating Officer
René Médori
Non-Executive Director
David Payne
Deputy Chairman
Alistair Phillips-Davies
Energy Supply Director
Susan Rice CBE
Non-Executive Director
Kevin Smith CBE
Non-Executive Director

Financial Calendar

Annual General Meeting
27 July 2006
Ex dividend date
23 August 2006
Record date
25 August 2006
Final dividend payable
22 September 2006
Interim announcement
15 November 2006*

* Provisional date

POWERFUL COMMITMENT

Sir Robert Smith
Chairman

Scottish and Southern Energy's first responsibility to its shareholders is to deliver sustained real growth in the dividend. I am, therefore, pleased to report that the Board is recommending a final dividend of 32.7p per share, making a full-year dividend of 46.5p – an increase of 9.4%. I am also pleased to report that we are on course to deliver at least 4% real growth in the dividend in 2007 and 2008, with sustained real growth thereafter. As the company approaches the eighth anniversary of its formation, at the end of 2006, a decade of sustained real growth in the dividend is coming within sight.

Focus
This has been possible as a result of SSE's consistent and continuing focus on the four areas in which we can enhance and create value for shareholders: maintaining and investing in our energy networks; adding to our leading-edge generation portfolio; growing our energy supply business; and developing our presence in businesses such as contracting, connections, gas storage and telecoms. We have, as a result, delivered another very good financial performance, with adjusted profit before tax now £858.2m.

Customers
This consistent focus is not simply financial: as a utility and provider of services on which our customers depend, everyone in SSE believes it is essential to strive for excellence in everything we do. I am, therefore, particularly pleased that we have secured another reduction in the number of power cuts experienced by our electricity network customers and another reduction in the number of complaints sent by our energy supply customers for resolution to energywatch. It is also encouraging that this customer-focused approach is being extended to Scotia Gas Networks (SGN), in which we invested during 2005, where the number of customer complaints is also improving.

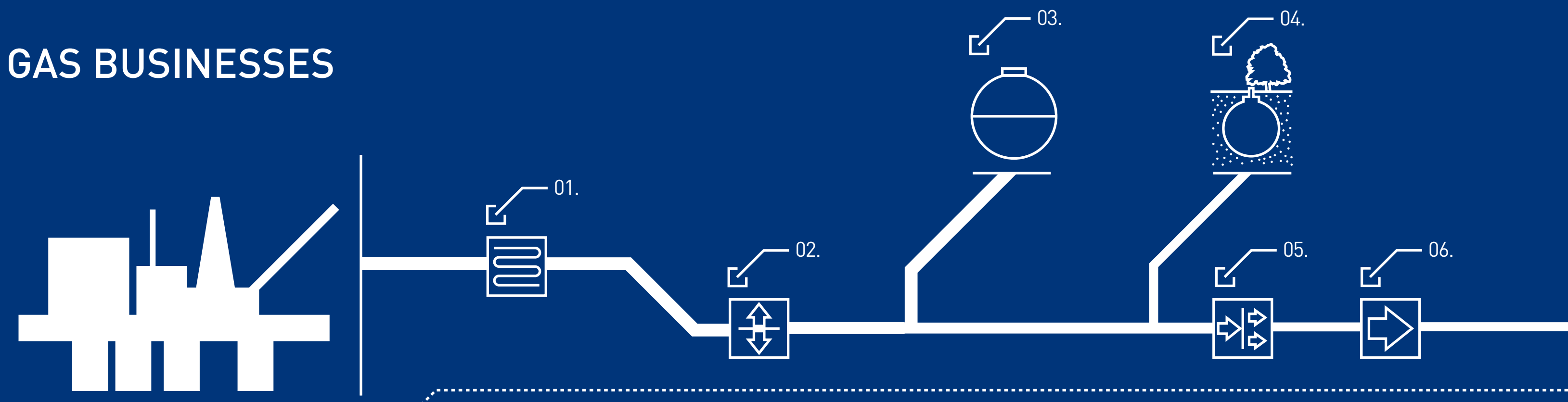
Opportunities
The investment in SGN confirmed SSE as the second largest distributor of electricity and gas in the UK. We are also the largest non-nuclear generator of electricity and the largest generator from renewable sources in the UK – as well as being the third largest supplier of electricity and gas. At Hornsea, we have the biggest onshore gas storage facility in the UK and we have one of the country's most successful electrical contracting business. This gives us an excellent platform from which to expand further in the second half of this decade, and we have the financial strength and the investment opportunities to do so.

Investment
Over the next few years, we expect to enhance value by investing in assets in our energy networks, electricity generation and gas storage businesses. During 2005/06 we took important decisions to invest in fitting flue gas desulphurisation equipment at our coal-fired power stations and in building Scotland's first large-scale conventional hydro electric station for 50 years. These and other investments will build on our existing energy and infrastructure-related businesses in the UK and confirm our position as the broadest-based UK energy company, with involvement in electricity generation, gas storage and gas and electricity distribution, contracting and supply.

Commitment
In each of these activities, we depend on the people throughout SSE whose enthusiasm and skill is hugely impressive. I've heard a member of our customer service team sum it up very well: "There's a culture of passion, promises and commitments." That's an excellent and deserved tribute to the hard work done by people throughout the organisation, which I endorse wholeheartedly.

That culture is at the heart of everything that SSE aims to do. The commitment is to colleagues, customers and shareholders. It means that we have great strengths to draw on as we continue to work towards our core objective: the delivery of sustained real growth in the dividend.

GAS BUSINESSES



Suppliers
Gas is supplied from offshore fields, onshore fields and an interconnector with mainland Europe.

01. Terminal
Gas is delivered to the NationalTransmission System through six beach terminals and is transported at pressures up to 85 bar gauge (barg)

02. Compressor
Maintains pressure and propels gas through the system

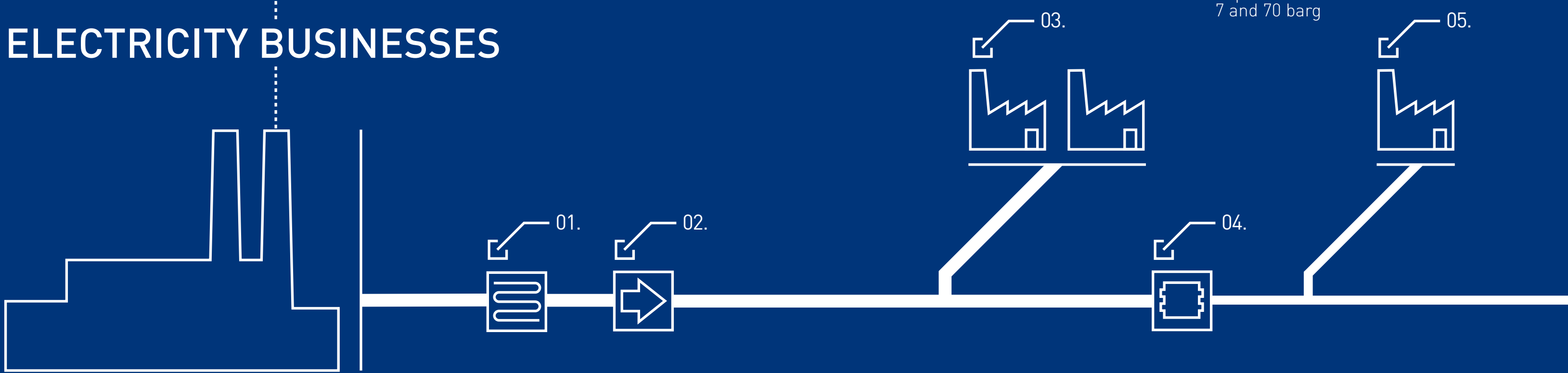
03. Liquefied Natural Gas Storage
Gas is cooled and stored as liquefied natural gas

04. Gas Storage
Gas is stored in underground caverns

05. Offtake
The point where gas is delivered to the distribution system operator

06. High Pressure System
Transports gas in steel pipes over large distances at pressures between 7 and 70 barg

ELECTRICITY BUSINESSES



Power Station
Electricity is generated from nuclear, gas, electricity, coal, oil, hydro and wind power

01. Grid Entry Point
The voltage is increased to 275kV or 400kV and the transmission company takes responsibility for transmitting the electricity

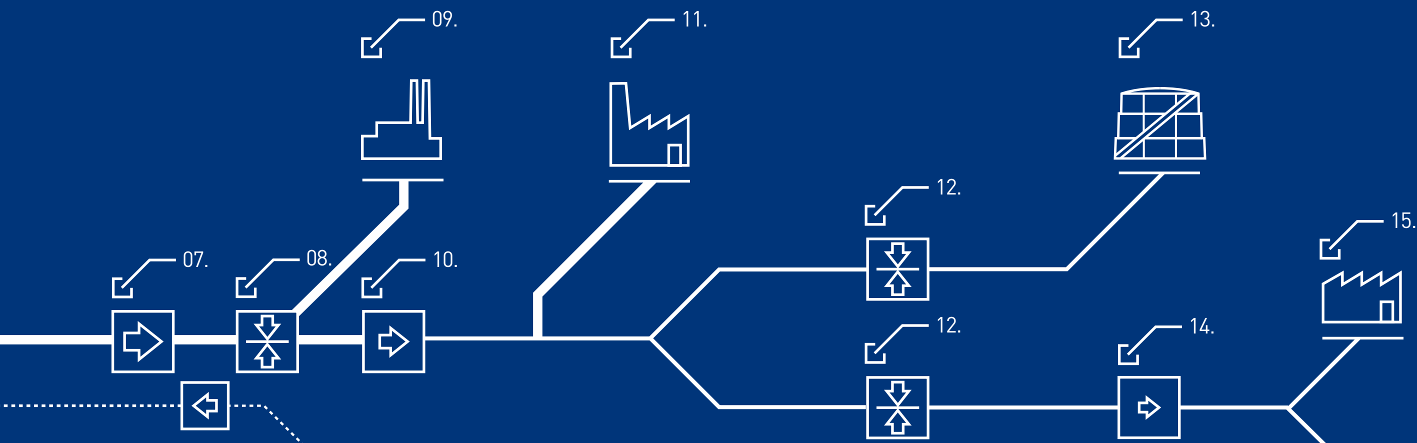
02. Transmission System
The electricity is transmitted over large distances at 400kV or 275kV (also 132kV in Scotland)

03. Very Large Industrial Customers
Very large customers such as steel producers take their electricity direct from the transmission system at voltages up to 400kV

04. Grid Supply Point
The voltage is reduced to 132kV and responsibility for distribution of the electricity is handed onto the regional distribution companies

05. Large Industrial Customers
Large industrial customers connected to the distribution system at 132kV

MORE THAN AN ELECTRICITY COMPANY



07. Intermediate Pressure System
Transports gas in steel or high density polyethylene (PE) pipes between towns and villages at pressures between 2 and 7 barg

08. Pressure Reduction
Gas is reduced in pressure to between 75 mbarg and 2 barg

09. Industrial Customers
Industrial customers such as power stations are connected to the IP system

10. Medium Pressure System
Transports gas into towns and villages through PE, iron or steel pipes

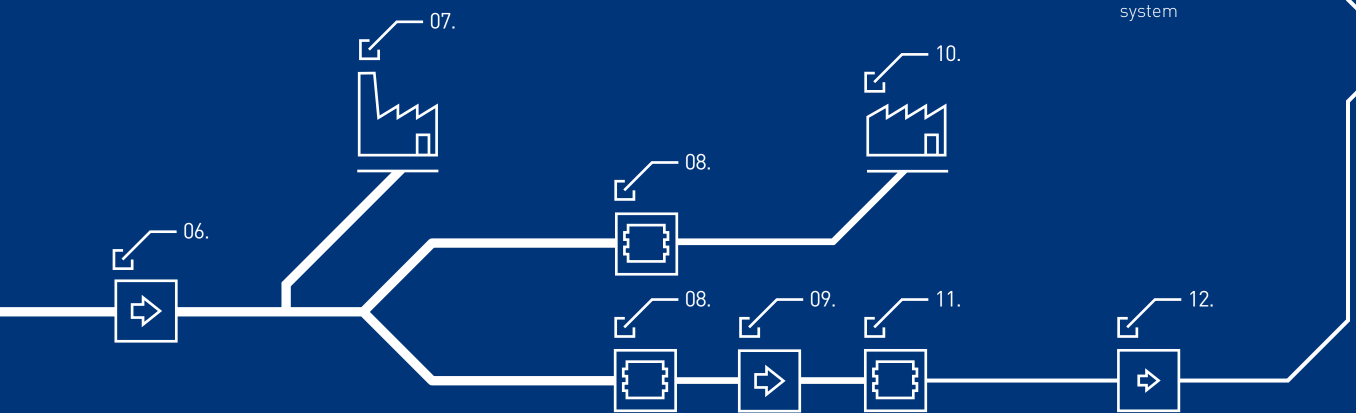
11. Industrial Customers
Industrial customers are connected to the MP system

12. Pressure Reduction
Gas is further reduced in pressure, to up to 75 mbarg

13. Gas Storage
Gas is stored in large holders

14. Low Pressure System
Carries gas in populated areas in PE, iron or steel pipes

15. Commercial Customers
Commercial customers connected to the LP system



06. Extra High Voltage Distribution System
Electricity is carried between towns and villages on overhead lines (mostly on wooden poles) and underground cables at 66kV or 33kV

07. Industrial Customers
Industrial customers connected to the network at 66kV or 33kV

08. Primary Distribution Substations
The electricity is reduced to 33kV or 11kV

09. High Voltage Distribution System
Electricity is carried locally at 11kV

10. Industrial and Commercial Customers
Connected to the distribution system at 66kV, 33kV or 11kV

11. Secondary Distribution Substation
The Electricity is reduced to 230V

12. Low Voltage Distribution System
Electricity is carried locally on overhead lines and underground cables at 230V

16/13. Residential and Commercial Customers
Connected to the LP gas system at pressures of up to 75 mbarg and to the electricity network at 230V

16/13. Beyond the Meter
Including contracting, micro generation, appliance retailing and energy efficiency services

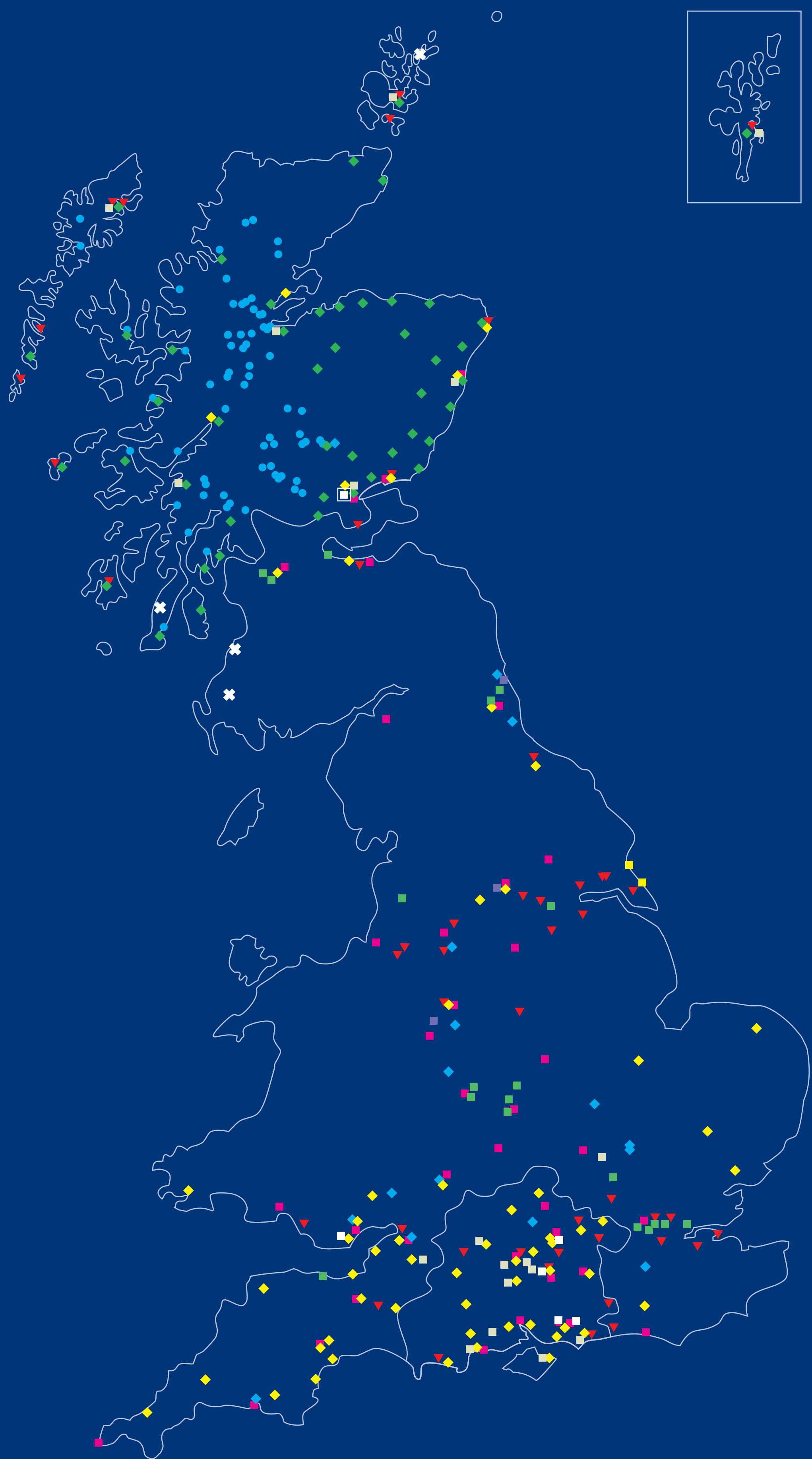
Scottish and Southern Energy is more than just Scottish and Southern.

It serves customers from more than 150 sites across the country.

The map shows the locations of the main power stations, depots, customer service centres and shops.

- **Headquarters** – Perth
- **Customer Service Centres** – including Perth, Basingstoke, Cardiff, Havant, Portsmouth, Reading
- **Hydro Generation** – power stations throughout the north of Scotland
- **Wind Farms** – four operational
- **Thermal Generation** – main, wholly-owned power stations at Fife, Ferrybridge, Fiddler's Ferry, Keadby, Medway, Peterhead
- **Gas Storage** – Hornsea operational and Aldbrough under construction
- **Energy Networks** – distributing electricity to 3.5 million customers and gas to 5.6 million customers
- **Embedded Distribution Networks** – 19 electricity networks outside its electricity distribution areas
- **Telecoms** – managing 7,500km of telecoms network
- **Direct Sales** – teams of direct sales staff operating in locations across the country
- **Shops** – serving local communities in northern Scotland
- **Contracting Group** – operating from 48 regional offices nationwide
- **Public Lighting PFIs** – Leeds, Newcastle and North Tyneside, and Stoke-on-Trent

MORE THAN JUST SCOTTISH AND SOUTHERN



Key Performance Indicators

FINANCIAL OVERVIEW

	2006	2005	
Adjusted profit before tax* – £m	858.2	719.7	+19.2%
Adjusted earnings per share* – pence	72.9	62.8	+16.1%
Dividend per share – pence	46.5	42.5	+9.4%
Capital expenditure – £m	502.1	383.5	+30.9%
Net debt – £m	2,166.4	1,430.0	+51.5%
Underlying interest cover – times	9.2	9.0	+2.2%
Dividend cover – times	1.6	1.5	+6.7%

ENERGY SYSTEMS

	2006	2005	
Power Systems operating profit* – £m	367.9	336.8	+9.2%
Southern Electric Power Distribution operating profit – £m	226.1	201.6	+12.2%
Scottish Hydro Electric Power Distribution and Transmission operating profit – £m	141.8	135.2	+4.9%
Electricity distributed – TWh	43.8	42.9	+2.1%
Southern Electric Power Distribution – customer minutes lost	71	84	-15.5%
Southern Electric Power Distribution customer interruptions – number per 100 customers	78	98	-20.4%
Scottish Hydro Electric Power Distribution – customer minutes lost	65	86	-24.4%
Scottish Hydro Electric Power Distribution customer interruptions – number per 100 customers	79	89	-11.2%
Power systems capital expenditure – £m	172.1	171.5	+0.3%
Scotia Gas Networks – number of complaints to energywatch	166	346	-52.0%
Southern Gas Networks level of customer satisfaction – scale of 1 to 5 (5 = very satisfied)	4.00	N/A	N/A
Scotland Gas Networks level of customer satisfaction – scale of 1 to 5 (5 = very satisfied)	4.04	N/A	N/A

CONTRACTING, CONNECTIONS AND METERING

	2006	2005	
Contracting, Connections and Metering operating profit* – £m	50.4	47.9	+5.2%
New electrical connections – 000s	42.9	42.0	+2.1%
New gas connections – 000s	7.9	7.0	+12.9%
Managed networks	19	16	+18.8%

GENERATION AND SUPPLY

Generation and Supply operating profit* – £m		
2006	444.8	+14.5%
2005	388.6	

Electricity generation capacity – MW		
2006	10,015	+2.3%
2005	9,794	

Electricity generation capacity qualifying for ROCs (hydro and wind) – MW		
2006	566	+43.3%
2005	395	

Electricity generated – TWh		
2006	41.1	+5.9%
2005	38.8	

Electricity generated qualifying for ROCs (biomass) – GWh		
2006	795	+38.7%
2005**	573	

Electricity generated qualifying for ROCs (hydro and wind) – GWh		
2006	1,555	+4.3%
2005	1,490	

Power station availability – gas %		
2006	87	-7.5%
2005	94	

Power station availability – coal and biomass %		
2006	92	+4.5%
2005	88	

Power station availability – hydro output GWh		
2006	3,054	-2.1%
30-year average	3,118	

** from 1 August 2004

Electricity supplied – TWh		
2006	49.9	+4.6%
2005	47.7	

Supply customers – millions		
2006	6.7	+9.8%
2005	6.1	

Complaints to energywatch direct selling – number per 1,000 transfers		
2006	0.85	-60.6%
2005	2.16	

Complaints to energywatch transfers – number per 1,000 transfers		
2006	2.57	-38.1%
2005	4.15	

Complaints to energywatch account and billing – number per 1,000 customers		
2006	0.147	-2.6%
2005	0.151	

Total complaints to energywatch		
2006	1,692	-14.6%
2005	1,981	

GAS STORAGE

Gas storage operating profit* – £m		
2006	27.3	+43.7%
2005	19.0	

Customer nominations met – %		
2006	100	+0%
2005	100	

TELECOMS

Telecoms operating profit* – £m		
2006	13.2	+22.1%
2005	10.8	

SAFETY

Lost time and reportable accidents		
2006	17	+0%
2005	17	

Lost time and reportable accidents – number per 1,000 employees		
2006	1.38	-10.4%
2005	1.54	

Serious, or potentially serious, road traffic accidents		
2006	17	-29.2%
2005	24	

Serious, or potentially serious, road traffic accidents – number per 100 vehicles		
2006	0.28	-33.3%
2005	0.42	

SGN lost time accidents		
2006	20	-33.3%
2005	30	

POWERFUL RESULTS

Ian Marchant
Chief Executive

During 2005/06 Scottish and Southern Energy continued its focus on delivering a strong operational performance and on securing value from its investment in new assets. This has enabled the company to deliver another set of very sound financial results and add to its well-established track record of sustained real growth in the dividend. In summary:

- The full-year dividend will increase by 9.4% to 46.5p per share, including the recommended final dividend of 32.7p per share.
- Adjusted profit before tax* grew by 19.2%, from £719.7m to £858.2m.
- Adjusted earnings per share* increased by 16.1%, from 62.8p to 72.9p.
- There are exceptional items totalling £127.4m, comprising distributions from the administration of TXU businesses and profit from the sale of Thermal Transfer.
- The integration of the Scotland and the Southern gas networks is on schedule, following their acquisition by Scotia Gas Networks, in which SSE has a 50% stake, in June 2005.
- SSE's energy supply business has grown to over 6.7 million customers at the end of March 2006 – a net gain of 600,000 during the year and of 2.2 million since 2002.
- SSE decisions to delay price rises have saved a typical gas and electricity customer around £100 since the start of 2004, compared with what they would have paid had SSE increased prices at the same time as the UK's largest energy supplier. Prices will be held at their current levels until at least the start of 2007.
- SSE has started the investment of around £225m in the installation of flue gas desulphurisation (FGD) equipment at its coal-fired generation plant.
- Work has commenced on the £140m project to construct what will be Scotland's first large-scale conventional hydro electric scheme for 50 years, at Glendoe near Loch Ness.
- SSE delivered 140MW of new wind farm capacity during 2005/06, and has acquired two new developments, comprising 98MW, subject to planning consent and network capacity being secured.
- SSE has entered into a partnership with Mitsui Babcock, Siemens UK and UK Coal to undertake the front end engineering design of a 500MW cleaner coal plant at its Ferrybridge Power Station.
- The development of SSE's energy services business has reached an important milestone with the launch on 1 June 2006 of a new gas boiler installation and maintenance service.

SSE's core objective is the delivery of sustainable long-term real dividend growth. Our means of achieving this is unchanged and unchanging; maintaining and investing in energy networks; adding to our generation portfolio; growing our energy supply business; and developing further our presence in contracting, connections, gas storage and telecoms. This approach continued to serve us well during 2005/06 and we will maintain it during 2006/07 and beyond. With our major investment programme, focused on the UK's key priorities of reliable and lower carbon energy supplies, we have excellent opportunities to enhance and create value. The prospects for sustained real growth in the dividend therefore remain excellent.

*This Annual Report statement describes **adjusted profit before tax** before exceptional items, net finance income from pension assets (IAS 19), the impact of IAS 32 and IAS 39 and after the removal of taxation on profits from jointly-controlled entities and associates.

It also describes **adjusted earnings and earnings per share** before exceptional items, net finance income from pension assets (IAS 19), the impact of IAS 32 and IAS 39 and deferred tax.

In addition it describes **adjusted operating profit** before exceptional items, net finance income from pension assets (IAS 19), the impact of IAS 32 and IAS 39, and after the removal of taxation and interest on profits from jointly controlled entities and associates.

POWERFUL OPPORTUNITIES

FINANCIAL OVERVIEW

These are the first results that SSE has reported under International Financial Reporting Standards and the comparative results for the year to 31 March 2005 have been re-stated in line with the new standards. SSE focuses on profit before tax before exceptional items, net finance income from pension assets (IAS 19), the impact of IAS 32 and IAS 39, and after the removal of taxation on profits from jointly controlled entities and associates.

	March 06 £m	March 05 £m
Statutory profit before tax	896.9	789.3
Movement in derivatives	70.9	–
Exceptional items	(127.4)	(72.5)
Tax on JVs and Associates	29.9	15.3
Interest on convertible debt	3.6	–
Return on pension scheme assets	(115.7)	(107.1)
Interest on pension scheme liabilities	100.0	94.7
Adjusted profit before tax	**858.2**	**719.7**
Adjusted current tax charge	(231.5)	(182.0)
Adjusted profit after tax	**626.7**	**537.7**
Statutory profit after tax	642.3	559.8
Number of shares for basic and adjusted EPS	859.5	857.2
Adjusted EPS	**72.9**	**62.8**
Basic EPS	**74.7**	**65.3**
Dividend per share	**46.5p**	**42.5p**

Adjusted Profit before Tax*

Adjusted profit before tax grew by 19.2%, from £719.7m to £858.2m. SSE's statutory operating profit included an adverse movement on IAS 39 operating derivatives of £14.4m. Additionally, there was an adverse movement of £43.5m arising from financial derivatives used by Treasury which was compounded by a further adverse movement on joint venture financing derivatives of £13.0m. This meant that the impact of IAS 39 revaluations ('Movement in derivatives') was a charge of £70.9m.

There was profit growth throughout SSE's business. The most significant growth was achieved in Generation and Supply, which continues to benefit from the expansion of SSE's electricity generation portfolio and the increase in the number of energy supply customers achieved over the past four years.

Adjusted Earnings Per Share*

To monitor financial performance over the medium-term, SSE focuses on adjusted earnings per share, which increased by 16.1%, from 62.8p to 72.9p.

Dividend

The Board is declaring a final dividend of 32.7p, compared with 30.3p in the previous year, an increase of 7.9%, making a full-year dividend of 46.5p, an increase of 9.4%. This compares with 27.5p in 2000, since when the dividend has increased by 69.1%, which represents a compound annual growth rate of 9.2%.

Overall, SSE continued to perform well during 2005/06 and significant opportunities for investment in new assets have been identified for 2006/07 and beyond. These investments are aligned to the UK's key priorities of delivering reliable energy supplies and reducing carbon emissions. This means that SSE is well-positioned to achieve its target of at least 4% real growth in the dividend payable to shareholders in each of the years to March 2008, with sustained real growth thereafter.

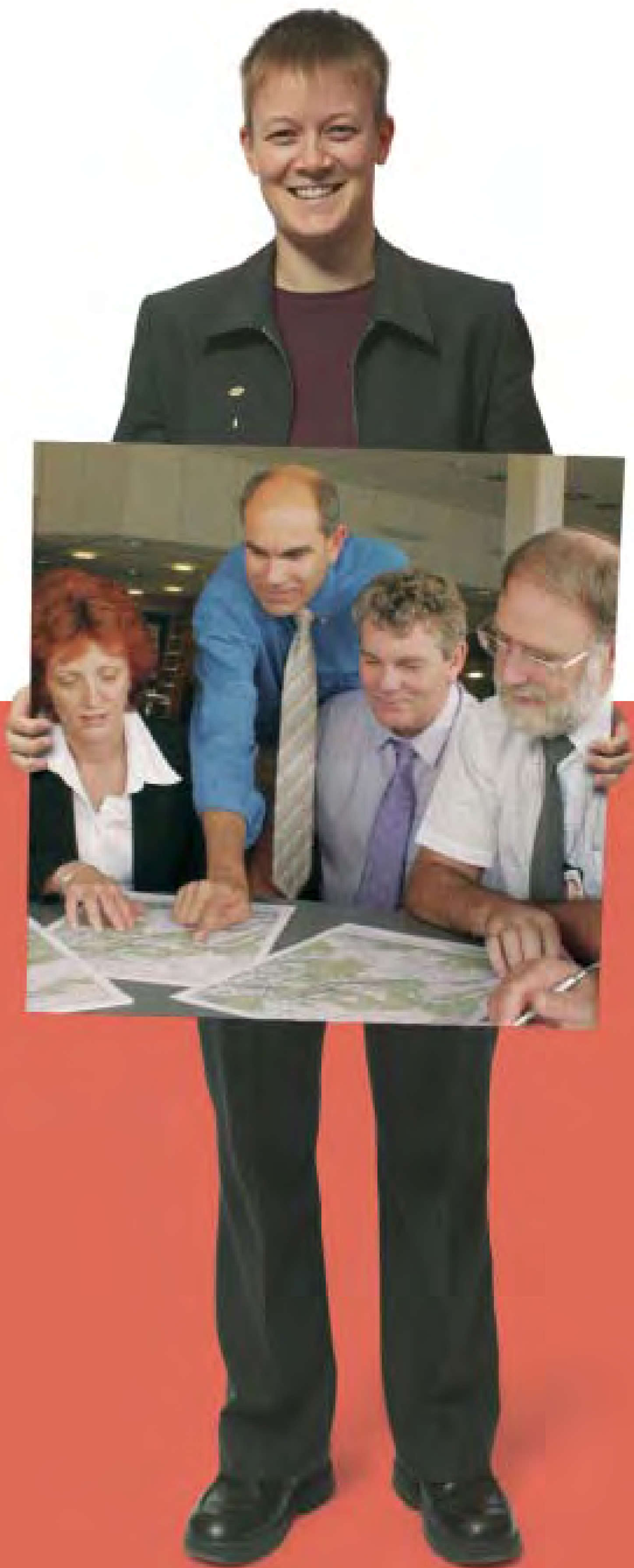
ENERGY SYSTEMS

Key Points:

- Operating profit* (excluding gas distribution) up 9.2% to £367.9m.
- Investment in electricity networks of £172.1m.
- Fewer Customer Minutes Lost in electricity in Scottish Hydro and Southern Electric Power Distribution.
- Fewer customer interruptions in electricity in Scottish Hydro and Southern Electric Power Distribution.
- Investment in Scotia Gas Networks (SGN) completed in June 2005.
- SSE's share of SGN's adjusted operating profit was £102.7m.

"Upgrading the transmission network in Scotland is essential to help meet the UK's target for 15% of electricity to come from renewable sources by 2015/16. We work hard and take our work seriously, but we don't take ourselves too seriously."

Ruth Liddicoat
Major Projects Administrator



MAJOR PROJECTS

SSE has a responsibility to ensure there is sufficient network capacity for all those seeking to connect new generation capacity to its network.

The £250m project to replace SSE's part of the electricity transmission line between Beauly in the Highlands and Denny in the Central Belt of Scotland is central to that responsibility. After two years' voluntary public consultation, SSE applied in September 2005 to the Scottish Ministers for consent to build the replacement line.

Energy Systems Introduction
SSE owns Southern Electric Power Distribution, Scottish Hydro Electric Power Distribution and Scottish Hydro Electric Transmission. These companies are the subject of incentive-based regulation by the Office of Gas and Electricity Markets (Ofgem), which sets for periods of five years the prices they can charge for the use of their electricity networks, their capital expenditure and their allowed operating expenditure. In broad terms, Ofgem seeks to strike the right balance between attracting investment in electricity and gas networks, encouraging companies to operate them as efficiently as possible and ensuring that prices for customers are no higher than they need to be. As at 31 March 2006, SSE estimates that Ofgem's valuation of the assets of SSE's distribution and transmission businesses (the Regulated Asset Value or 'RAV') was around £2.55bn.

SSE also has an equity interest of 50% in, and provides corporate and management services to, Scotia Gas Networks (SGN), which owns Southern Gas Networks and Scotland Gas Networks, companies which own and operate the medium and low pressure gas distribution networks in their parts of the UK. They are the subject of incentive-based regulation by Ofgem similar to that applied in electricity. SGN estimates that the RAV of the networks it owns was around £3.0bn as at 31 March 2006.

Energy Systems Overview
Operating profit* in Energy Systems, excluding gas distribution, increased by 9.2%, from £336.8m to £367.9m. SSE's share of SGN's operating profit in the 10 months from 1 June 2005 was £102.7m. In total, Energy Systems contributed 46.4% of SSE's total operating profit.*

Southern Electric Power Distribution
During 2005/06, Southern Electric Power Distribution's operating profit* increased by 12.2% to £226.1m. This reflected an increase in the number of units of electricity distributed compared with the previous year and follows the introduction of the new Distribution Price Control for 2005-10 and improved performance under Ofgem's incentives framework. SEPD distributed 34.9TWh of electricity, an increase of 0.75TWh.

The average number of minutes of lost electricity supply per customer was 71, compared with 84 in the previous year. The number of supply interruptions per 100 customers was 78, compared with 98 in the previous year. Performance in respect of both minutes lost and interruptions was ahead of targets set by Ofgem under its Information and Incentives Project (IIP) which gives financial benefits to distribution network operators that deliver good performance for customers. This together with income earned under other incentive arrangements is expected to lead to additional revenue of over £8m in 2007/08.

Scottish Hydro Electric Power Distribution and Scottish Hydro Electric Transmission
Operating profit* for Scottish Hydro Electric Power Distribution and Scottish Hydro Electric Transmission increased by 4.9% to £141.8m. This reflected an increase in the number of units distributed and follows the introduction of the new Price Control for 2005-10 and improved performance under Ofgem's incentives framework. In the Scottish Hydro Electric area, 8.9TWh of electricity were distributed during 2005/06,compared with 8.7TWh in the previous year.

The average number of minutes of lost electricity supply per customer was 65, compared with 86 in the previous year, making performance in 2005/06 the best since records began in the 1960s. The number of interruptions per 100 customers was 79, compared with 89 in the previous year. Performance in respect of both minutes lost and interruptions was ahead of Ofgem's IIP targets.This together with income earned under other incentive arrangements is expected to lead to additional revenue of over £4m in 2007/08.

Electricity Network Investment
The key responsibility of SSE's Power Systems businesses is to maintain safe and reliable supplies of electricity, and to restore supplies as quickly as possible in the event of interruptions. During the Price Control period 2000-05, SSE invested £780m in its electricity networks. A further £172.1m was invested in 2005/06.

In the course of the year, SSE added 974km to the length of its networks, taking the total to over 127,000km. It also rebuilt 378km of its networks as part of its programme of replacing 'open wire' overhead lines and low voltage Consac cable.

The Price Control Review for 2005-10 resulted in significantly increased allowances for capital expenditure to maintain and improve the electricity networks, and SSE's increased investment programme is now under way.

As a result, SSE forecasts that the RAV of its distribution and transmission businesses has increased by around £80m (nominal) to £2.55bn as at 31 March 2006. In addition, SSE expects to deliver an increase in capital expenditure, of over 20%, during 2006/07 and to sustain capital expenditure at this level until 2010. On this basis, the RAV is expected to grow by around £500m (or around £120m in real terms), excluding any major transmission investment, during the 2005-10 Price Control period.

Future Transmission Developments
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 remains responsible for operating, maintaining and investing in the transmission network in its area, which serves around 70% of Scotland. These arrangements are working well.

In March 2006, Ofgem published the third of six consultation documents that will form part of the Transmission Price Control Review for 2007-12. The objectives of the Review are to develop incentives for investment in electricity infrastructure, ensuring they are best able to provide efficient and timely investment and allocate risk appropriately. In this context, key issues include the arrangements for remunerating

Did you know?

We deliver electricity to
3.5
million customers

SSE owns one electricity transmission network and two electricity distribution networks, comprising 127,000km of overhead lines and underground cables across one third of the UK landmass. It delivers electricity to 3.5 million homes, offices and businesses. The income which SSE can earn by charging electricity generators and suppliers for using these networks is regulated by Ofgem, as is the level of investment in them.

Did you know?

We distributed
43.8
TWh of electricity

SSE distributed 43.8TWh of electricity to the homes, offices and businesses connected to its electricity networks in 2005/06. The average number of minutes that these customers were without their electricity supply during the year was 65 in the north of Scotland and 71 in central southern England. This means that the networks were more than 99.9% reliable.

investment in the transmission network, including the major upgrades likely to be required in the future to accommodate the generation of renewable energy. SSE is encouraged by Ofgem's previous work in relation to approving investment for such infrastructure development.

As the licensed transmission company for the north of Scotland, SSE has to ensure there is sufficient network capacity for those seeking to generate electricity from renewable sources, in response to the Renewables Obligation. 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 an investment by SSE of around £250m.

SSE's applications to Scottish Ministers for consent to build its part of the line were submitted in September 2005, but it is not yet clear how long it will take for the applications to make their way through the planning process.

Electricity Distribution and Transmission Priorities in 2006/07

During 2006/07, SSE's first objective in power systems will be to maintain safe and reliable supplies of electricity and to restore supplies as quickly as possible in the event of interruptions. This will be supported by a significant increase in investment in the networks, targeted at upgrading them where the greatest number of customers will benefit. SSE will also continue to work closely with Ofgem to secure a satisfactory outcome from the Transmission Price Control Review. It will also seek to make progress with the replacement of its part of the Beauly-Denny transmission line.

Scotia Gas Networks – Financial

In June 2005, Scotia Gas Networks plc (SGN), in which SSE holds 50% of the equity, acquired the Scotland and the Southern gas distribution networks from National Grid Transco. They comprise 73,000km of gas mains, delivering gas to around 5.6m industrial, commercial and domestic customers.

SGN funded the acquisitions through: £540.0m of shareholder subordinated debt; £427.8m of equity; and £2,250m of non-recourse bank borrowings. SSE's actual investment, including the shareholder subordinated debt, was £505.0m, which was £35.0m lower than was expected when the acquisitions were completed.

In return for this investment of £505.0m, SSE recognises 50% of the distributable earnings from SGN. SSE is also providing SGN with corporate and management services. The acquisitions have made SSE the second largest energy distribution business in the UK.

In the first 10 months, SSE's share of SGN's adjusted operating profit was £102.7m. Net of all items of interest, its contribution to SSE's profit before tax* was £48.6m. This was despite high gas prices leading to significantly increased 'shrinkage' costs.

Significant benefits have already arisen as a result of the synergies between SGN and SSE, as a provider of corporate and management services. For example, the two organisations share around 400 items of common stock which gives them the ability to make larger-scale purchases.

In October 2005, Scotland Gas Networks plc and Southern Gas Networks plc issued a combination of fixed rate, floating rate and index-linked bonds totalling £2.2bn, with an average maturity of 17 years. The transaction was heavily over-subscribed and was a benchmark transaction for the UK gas distribution sector. It was also the largest corporate financing in Europe in 2005 at the date of issue. With a rate of interest that is below that envisaged when the decision was made to acquire the two networks, the success of the issue will give SGN significant financial benefits over the long-term.

The proceeds were used by SGN to repay substantially the bank borrowings that were arranged to fund the purchase of the networks. As at 31 March 2006, SGN's net debt, which is non-recourse to SSE's balance sheet, was £2.1bn.

Scotia Gas Networks – Operational

SGN's overriding goal is to distribute gas safely and reliably. During 2005/06 it secured a reduction in the rate of lost-time incidents. It also embarked on a major programme of performance improvement. This has already delivered some early results, such as a fall of 52% to 166 in the number of complaints from customers sent to energywatch for resolution in 2005/06, compared with the previous year.

As part of their licence conditions, all gas network companies are required to commission quarterly independent customer satisfaction surveys relating to planned replacement work or unplanned repair work. In the results compiled in January 2006, overall satisfaction in Scotland was 4.04 and in Southern it was 4.00 (on a scale of 1.00 being 'very dissatisfied' and 5.00 being 'very satisfied').

SGN's focus on delivering a high standard of service to customers is reflected in its decision to undertake a pilot programme within its Operations Division in which the existing functionally-based structure is replaced by a geographically-based structure. This is expected to enable there to be more local, and customer-focused, management of the business' operations and to help secure cost savings.

Looking to the longer-term shape of the business, SGN will be undertaking major investment to upgrade its gas networks. The efficient and economic delivery of this capital investment will increase further SGN's RAV. To support this programme and its other activities in the most efficient way possible, it has in-sourced the work of around 700 people in gas contracting and gas connections who were previously employed by third party contractors.

Scotia Gas Networks Priorities in 2006/07

SSE's priority in gas distribution will be to provide SGN with the corporate and management services to support its ongoing reform of procedures, processes and practices. These are designed to secure cost savings and efficiencies. They will involve,

Did you know?

We expect to add

500

million pounds to our electricity networks' Regulated Asset Value

In 2005/06, SSE added 974km to the length of its electricity networks, taking the total to over 127,000km. It expects to deliver an increase in capital expenditure on the networks of over 20% during 2006/07 and that Ofgem's valuation of the assets of its distribution and transmission businesses (the Regulated Asset Value) will grow by around £500m by 2010.

Did you know?

We distribute gas to

5.6

million customers

SSE owns 50% of Scotia Gas Networks (SGN), the company which owns Scotland Gas Networks and Southern Gas Networks. It also provides corporate and management services for SGN. The Scotland and the Southern networks comprise around 73,000km of gas mains, delivering gas to 5.6 million industrial, commercial and domestic customers.

for example, more work in gas mains replacement being brought in-house. As part of this, SSE is supporting the introduction of new front office management systems, reducing the total number of systems from 56 to 11, which will be very important. SSE will also support SGN during the Gas Distribution Price Control Review, in which the existing Price Control is being extended for one year from 1 April 2007 and then reset for the next Price Control period from 1 April 2008.

GENERATION AND SUPPLY

Key Points:

- Operating profit* up 14.5% to £444.8m.
- Gas-fired power station availability 87% and coal-fired power station availability 92%.
- Good performance in new BETTA arrangements.
- Investment at Ferrybridge, Fiddler's Ferry and Glendoe.
- Partnership to undertake front end engineering design of 500MW cleaner coal plant at Ferrybridge.
- Acquisition of options to develop new wind farms.
- Net gain of 600,000 customers during 2005/06 following policy of responsible pricing.
- Further reduction of 15%, in number of complaints to energywatch.

Generation and Supply Introduction

A series of market reforms in Great Britain, culminating in the introduction of BETTA in 2005, means that wholesale gas and wholesale electricity are traded like any other commodities. SSE purchases gas and, where appropriate, some electricity via bilateral contracts and through trading, the latter complementing the electricity produced from its own generation portfolio. Within its integrated business model, SSE's power stations are used to support performance in electricity supply. Generation and Supply is, therefore, assessed as a single value chain.

Following the acquisition of an additional stake in Barking Power Ltd and the completion of the Hadyard Hill wind farm in early 2006, SSE owns over 10,000 megawatts (MW) of electricity generation capacity, including its share of joint ventures. This comprises almost 4,400MW of gas-fired capacity, 4,000MW of coal-fired capacity, over 1,500MW of hydro and wind capacity and 150MW of oil-fired capacity. As at 31 March 2006, SSE supplied electricity and gas to over 6.7 million homes, offices and businesses within the UK's competitive energy supply market.

Generation and Supply Overview

Operating profit* in Generation and Supply rose by 14.5%, from £388.6m to £444.8m, contributing 43.9% of SSE's total operating profit during 2005/06. The underlying financial performance of Generation and Supply has been reported excluding the impact of IAS 39 derivative movements (see 'Financial Overview' above) as SSE believes this better represents underlying business performance.

During 2005/06, SSE's power stations (wholly-owned and owned by joint ventures) generated 41.1TWh of electricity, compared with 38.8TWh in the previous year. SSE supplied 49.9TWh of electricity to industrial, commercial and domestic customers, compared with 47.7TWh in the previous year. Its number of energy supply customers grew by 600,000 during the year to over 6.7 million.

There were four main reasons for the growth in operating profit: ongoing benefits from the acquisition in July 2004 of the Ferrybridge and Fiddler's Ferry power stations; the successful deployment of SSE's Scottish power stations in the new Great Britain electricity market (BETTA); the abolition of the Hydro Benefit subsidy previously paid by SSE's Generation and Supply business; and sustained growth in energy supply customer numbers.

These reasons for growth were, however, offset by three factors: the impact of high wholesale energy prices driven partly by the price of carbon emissions allowances following the introduction of the EU Emissions Trading Scheme (EU ETS) in January 2005; SSE's decision to protect its customers from the worst impacts of volatile wholesale energy prices by delaying increases in the price of gas and electricity; and lower output from SSE's hydro electric schemes which was below the long-term average, having been significantly above the long-term average in the previous year.

The Hydro Benefit subsidy previously paid from SSE's generation activities was abolished on 1 April 2005 and was replaced by a separate scheme to assist customers with the high costs of distributing electricity in the north of Scotland. The abolition contributed £37.0m to SSE's profit from its generation activities during 2005/06. The profitability of its distribution businesses was unaffected.

EU ETS and BETTA

Since its launch in January 2005, the EU ETS has seen the price of carbon allowances fluctuate, with a peak of around 30 Euros a tonne in the first few months of 2006. SSE's emissions allowance, of around 20 million tonnes, was reasonable in comparison to the rest of the UK electricity generation sector, but was lower than the level of emissions that SSE requires in practice. As part of the cost of generating electricity, higher prices of carbon allowances add upward pressure to electricity prices. SSE's policy is to ensure it has minimal exposure to fluctuations in the price of carbon allowances.

SSE is one of a number of companies which has submitted an application to the European Court of First Instance under Article 230 of the EC Treaty challenging the European Commission's decision to reject the UK government's proposed amendment to the UK Phase I National Allocation Plan.

Uncertainty also surrounds the longer-term impacts of EU ETS, not least because: the first phase has less than two years left to run; the details of the second phase, due to start in 2008, have not been finally determined; and it is not yet certain that there will be an EU ETS after the end of the second phase in 2012. In its submission to the UK government's review of energy

Did you know?

We produce electricity from

10.0

GW of generating capacity

SSE owns just over 10GW (or 10,000MW) of gas-fired, coal and biomass-fired, oil-fired, hydro, pumped storage and wind generation capacity in England and Scotland. Its principal power stations are at Ferrybridge, Fiddler's Ferry, Keadby, Medway and Peterhead. SSE's portfolio of power stations is the second largest and most diverse in the UK. It is also the leading generator of electricity from renewable sources in the UK.

Did you know?

We generated

41.1

TWh of electricity

During 2005/06, the amount of electricity generated at SSE's power stations (wholly-owned and owned by joint ventures) was 41.1TWh. This was around 12% of the electricity generated in the UK as a whole and was enough to power around 11 million homes for one year.

policy, SSE argued that there should be confirmation that there will be a long-term carbon pricing framework from 2012 onwards, accompanied by as much clarity as possible on the second phase of the EU ETS.

Since the BETTA arrangements were introduced in April 2005, SSE has benefited from its ability to deploy its flexible power stations in Scotland to meet demand from the electricity market in England and Wales. This positive impact from Scottish-based generation contributed over £20m to operating profit.

Gas-fired Generation – Operations
Good performance in BETTA is dependent on power stations being available to generate electricity in response to customer demand and market conditions. SSE's principal wholly-owned gas-fired power stations are Fife, Keadby, Medway and Peterhead. During 2005/06 as a whole, they achieved 87% of their maximum availability to generate electricity, excluding planned outages, compared with 94% in the previous year. The plant delivered better performance during the second half of the year, following problems with reliability during the first half, and availability improved to 92%, up from 83% in the first six months.

The issues are being dealt with through well established long-term service agreements with contractors. In addition, the number of unplanned outages at SSE's four main gas-fired power stations was down by 40% during 2005/06.

Gas-fired Generation – Investment
In January 2006, SSE acquired an additional 8.35% stake in Barking Power Ltd from the administrators of TXU Europe Power Ltd for £14.7m. The acquisition gives SSE a total stake of 30.4% in the 1,000MW combined cycle gas turbine station, which was commissioned in 1995, and effectively added 84MW to the portfolio of electricity generation assets owned by SSE.

The acquisition of an additional stake in Barking Power Ltd complemented SSE's other investments in coal and biomass generation and in renewable energy. SSE believes there is a significant value in the diversity of its electricity generation portfolio and expects to make new investments in gas-fired generation plant to go alongside its plans in coal and biomass generation and in renewables.

The launch of the EU ETS has underlined the need to develop new technologies to reduce and capture carbon dioxide emissions caused by the use of fossil fuels and SSE is committed to looking for opportunities to participate in appropriate developments.

In June 2005, SSE and its partner BP, announced they are undertaking detailed front-end engineering design work on the world's first industrial-scale project to generate 'de-carbonised' electricity from hydrogen. The planned project would convert natural gas to hydrogen and carbon dioxide gases, then use the hydrogen gas as fuel for a power plant at Peterhead Power Station with a capacity now expected to be 475MW, and export the carbon dioxide to a North Sea oil reservoir for increased oil recovery and ultimate storage. SSE's interest in the project is limited to its onshore aspects.

The current phase of work is expected to be completed in the second half of 2006/07, which will then allow a final investment decision to be taken. The full project could require investment by SSE of around £150m and is subject to, amongst other things, the establishment of an appropriate policy and regulatory framework which encourages the capture of carbon from fossil fuel-based electricity generation and its long-term storage.

Coal and Biomass Generation – Operations
SSE acquired the Ferrybridge and Fiddler's Ferry power stations, each with a capacity of almost 2,000MW, and associated coal stocks, for £136.0m in July 2004. This equated to around £20 per kilowatt of installed capacity. The £123.3m paid by SSE for fuel in transit and contracts to supply fuel has now been more than recovered from the value of the contracts.

The stations achieved 92% of their maximum availability to generate electricity, excluding planned outages, during the year, compared with 88% in the previous year. The winter of 2005/06 demonstrated the value of coal as part of SSE's diverse generation portfolio. Against a background of very high wholesale gas prices, coal-fired plant met 50% of average weekday demand, compared with 40% under more normal conditions. The diversity of its primary fuel sources enabled SSE to manage its exposure to changes in primary fuel prices by balancing its gas portfolio with a coal portfolio. As part of SSE's single value chain in Generation and Supply, this diversity also enabled SSE to delay increases in electricity and gas prices for domestic customers.

The stations also 'co-fire' fuels from renewable sources (biomass) in order to displace fossil fuels, thus reducing the impact of carbon emissions resulting from their operation. The resulting output of electricity qualifies for Renewables Obligation Certificates (ROCs). During 2005/06, their output qualifying for ROCs was around 795GWh, an increase of 9.8% on the previous year.

Coal and Biomass Generation – Investment
Following investment of around £20m, SSE has developed additional facilities to increase further the ability to co-fire fuels from renewable sources at both power stations. The installation of new 'direct injection' burners at the stations gives them the ability to generate a total of up to 1,500GWh per year of output qualifying for ROCs.

SSE has opted in to the Large Combustion Plant Directive (LCPD) all of the capacity at Fiddler's Ferry and half of the capacity at Ferrybridge and in line with that is installing Flue Gas Desulphurisation (FGD) equipment in an investment estimated to be around £225m. Following the installation of the FGD equipment, which is expected to be completed during 2008, restrictions on the stations' ability to generate electricity between 2008 and 2015 will be lifted and they will be able to remain open beyond 2015. SSE believes that installing FGD represents a good investment opportunity and a step forward in environmental terms. It will also extend the contribution of its coal-fired plant

Did you know?

We own
4.4
GW of gas-fired generation capacity

SSE owns almost 4.4GW of gas-fired generation capacity at power stations in England and Scotland. This includes an additional 84MW at Barking Power Station, reflecting the further investment in Barking Power Ltd which SSE made in 2006. It also includes a number of 'embedded' power stations which are directly connected to SSE's electricity distribution network in the south of England.

Did you know?

We produced
795
GWh of electricity from biomass

Ferrybridge power station was the first in the UK to co-fire fuel from renewable sources in order to displace fossil fuels, and Fiddler's Ferry followed suit shortly thereafter. The renewable source is biomass. SSE has invested around £20m at the stations to increase further their ability to co-fire renewable fuels. In 2005/06, they produced 795GWh of electricity from biomass. This will increase significantly as a result of the new investment.

COAL AND BIOMASS GENERATION

SSE's coal and biomass-fired generation plant makes a major contribution to its total generation output, particularly after increases in gas wholesale prices. To ensure the long term contribution of its Fiddler's Ferry and Ferrybridge power stations, SSE is investing £225m to install Flue Gas Desulphurisation equipment. This will allow restrictions to be lifted that would otherwise be imposed by the Large Combustion Plant Directive.

In addition, SSE is developing additional facilities to allow it to increase the proportion of biomass burned, to give the stations the ability to generate a total of 1,500GWh per year of output qualifying for ROCs.

"I'm part of a team that ensures our power stations use leading edge technology to deliver efficient electricity generation. SSE is one of the biggest players in the UK energy market. The future looks bright."

Darren Bolton
Generation Engineer

to the security of the UK's energy supplies and means that SSE will continue to have the country's most diverse generation portfolio.

To complement the investment in FGD, SSE is investing £16m in installing re-designed high-pressure turbines and static blades at all four units at Fiddler's Ferry and at two units at Ferrybridge. This will increase their thermal efficiency by around 1.4%, resulting in significant fuel savings and delivering reductions in emissions of carbon dioxide.

In Budget 2006, the government stated that carbon abatement technologies which enable fossil fuels to be used with substantially reduced carbon emissions, could make an important contribution to meeting the UK's energy policy objectives. SSE has entered into a partnership with Mitsui Babcock, Siemens and UK Coal with a view to installing 'cleaner coal' technology at Ferrybridge, comprising a 500MW Supercritical Boiler, with a thermal efficiency of over 45% and the subsequent deployment of post-combustion carbon capture equipment.

The partnership's priorities will include the identification of secure supplies of coal, which may provide opportunities for deep-mined coal in the UK. The partners expect to make a final decision on whether to make this investment in early 2007. Installation of the Supercritical Boiler and related plant to meet all established environmental standards would require investment by SSE of around £250m.

As the UK Energy Minister observed, the winter of 2005/06 demonstrated the value of coal as part of the UK's diverse electricity generating mix. He also pointed out that cleaner generation is essential if coal is to survive the shift to more sustainable forms of energy. If SSE proceeds with the installation of the Supercritical Boiler at Ferrybridge, it will take its investment in cutting emissions from its coal-fired power plant to over £500m.

Hydro and Wind Generation – Operations
The output of refurbished hydro electric stations with capacity of up to 20MW qualifies for ROCs and therefore attracted a premium price of around £44/MWh during 2005/06. In total, SSE has 404MW of capacity in its sub-20MW stations (including the new 3.5MW Kingairloch plant which was officially opened by the Secretary of State for Scotland in August 2005 and the new 7MW plant at Fasnakyle, which has now been completed).

The ability to qualify for ROCs provided an incentive for SSE to invest in the refurbishment of its smaller hydro electric stations and a total of 66 stations were refurbished under a programme, which began in 2002 and which was completed in September 2005. This represents a major landmark in SSE's £350m programme of investment in refurbishing its existing hydro electric power stations and in developing new hydro capacity.

Water running off into reservoirs during 2005/06 was 7% below the long-term average, and significantly lower than in the previous year, when it was 14% above the long-term average. Total hydro output was 3,054GWh, also lower than the long-term average and compared with 3,544GWh in the previous year. Within this, SSE's ROC-qualifying hydro output during the year was 1,428GWh, compared with 1,448GWh in the previous year.

The Tangy, Spurness, Artfield Fell and Hadyard Hill wind farms also contributed 127GWh of ROC-qualifying output during the year, compared with 42GWh from SSE's then operational wind farms in 2004/05.

Assuming average 'run off' and typical wind conditions, SSE expects that the ROC-qualifying output from its hydro and wind generation for 2006/07 as a whole will be over 1,800GWh.

The completion of the programme of hydro refurbishment and of the Hadyard Hill wind farm (see 'Hydro and Wind Generation – Investment' below) means that SSE now has 566MW of ROC-qualifying capacity and so is more than half way towards its target of having around 1,000MW of such capacity, which it hopes to achieve before the end of this decade. Future developments will, however, depend on the progress of planning applications.

Hydro and Wind Generation – Investment
The Renewables Obligation Order 2005 came into force on 1 April 2005 and increased the UK's target for electricity generated from renewable sources to 15.4% by 2015/16. This confirmed the important part that hydro and wind generation will have to play in the future, and the framework for investment in renewable energy, based around the Obligation, remains positive.

In July 2005, SSE received consent for, and decided to proceed with, the construction of what will be the UK's second largest conventional hydro electric power station at Glendoe, near Loch Ness. With an installed capacity of 100MW, Glendoe will produce in an average year around 180GWh of electricity qualifying for ROCs. When synchronised, it will be able to generate electricity at full load within 30 seconds. The development of Glendoe will require investment of around £140m.

The Prime Minister and the First Minister of Scotland visited the site in February 2006 to mark the start of construction work. If the project goes according to schedule, it will begin generating electricity commercially from the winter of 2008/09.

SSE's first wind farm, at Tangy in Argyll (13MW), has been operating since 2003. Its second wind farm, at Spurness (9MW) on the Orkney Islands, was officially opened in March 2005, and its third wind farm, Artfield Fell (20MW) in Wigtownshire, was officially opened by the Energy Minister in July 2005.

Construction work at the wind farm at Hadyard Hill in Ayrshire was completed and in March 2006 it became the first ever wind farm in the UK to generate over 100MW of electricity. With a total installed capacity of 120MW, it takes SSE's portfolio of wind farms to 162MW. This will increase to 168MW following the completion in 2007 of the construction work to add 6MW to the wind farm at Tangy. These schemes comprise the first phase of SSE's wind energy development plans and, on the completion of the extension at Tangy, will have required investment of £125m.

Did you know?

We are investing

225

million pounds to reduce emissions

SSE is investing around £225m to install flue gas desulphurisation (FGD) equipment at its Fiddler's Ferry and Ferrybridge power stations. FGD equipment is designed and operated as a chemical absorption process. Injection of a limestone slurry removes at least 94% of the sulphur dioxide, one of the main causes of acid rain.

Did you know?

We have

566

MW of ROC-qualifying generation capacity

The system of Renewable Obligation Certificates (ROCs) was introduced by the UK government to encourage investment in renewable energy sources. It means that suppliers of electricity are obliged to buy an increasing proportion of the electricity they supply from specified renewable sources. SSE now has 566MW of capacity, the output of which qualifies for ROCs.

SSE is also continuing to develop plans for the next phase of its investment in wind energy. During 2006/07, it hopes that its applications in respect of seven wind farms in Scotland with a total capacity of 361MW will be determined and approved. This includes Drumderg (32MW), Gordonbush (87MW), Blackcraig (69MW), Fairburn (35MW) and Achany (40MW). It also includes sites at Toddleburn (36MW) and Calliachar (62MW) which SSE has acquired, subject to planning consent for the projects being secured and grid capacity becoming unconditional at Calliacher. The development of these seven sites, if consented, will require investment of over £400m over the next few years.

Nevertheless, the process for considering other applications for consent to build wind farms, including those proposed by SSE, is proving to be arduous and prolonged. The applications to build wind farms at Drumderg (32MW) and Gordonbush (87MW) have both been in the planning process for almost three years, but have yet to be finally determined – a rate of progress which is slow and disappointing.

The Drumderg proposal is the subject of a Public Inquiry which got under way during March 2006.The Highland Council agreed The Highland Renewable Energy Strategy and Planning Guidelines in May 2006 and the proposed wind farm at Gordonbush is located in a preferred area for wind farm developments.

Beyond this programme of investment, other opportunities are also being examined. In line with that, SSE and Viking Energy, the company formed to represent Shetland Island Council's interests in large-scale wind energy development in Shetland, have signed a Memorandum of Understanding which is expected to lead to the establishment of a joint venture aimed at developing on the Shetland Islands a wind farm with a capacity of up to 600MW. Viking Energy's involvement would make the scheme the largest community-backed wind farm development in the world.

A planning application for consent to build the wind farm is expected to be submitted during 2006. In advance of that, RSPB has commented that the proposal has avoided the most important designated wildlife areas in Shetland and that 'the degree of co-operation with conservation organisations on research and survey into wildlife has established a new level of best practice'. The proposal is subject to, amongst other things, being able to demonstrate to Ofgem the viability of a sub-sea cable from Shetland to the mainland of Scotland.

SSE's proposal to develop a 250MW wind farm on the Western Isles has been complicated by Scottish Ministers' decision to refer to the Scottish Land Court the interposed lease over the site of the proposed wind farm. Ministers have said that they are unable to say how long it will take the Court to make its determination or even whether the process will end there, as any decision will be subject to appeal.

New Technologies
Investment in the research, development and demonstration of new technologies for generating electricity from renewable sources is a key part of the government's energy policy, and is part of SSE's strategy to remain the UK's leading generator of electricity from renewable sources.

It is investing around £10m in a project, with Talisman Energy UK, to deploy two 5MW demonstrator wind turbines in deep water in the Moray Firth. Subject to suitable weather conditions being available, the turbines will be deployed in the water during the summer of 2006 with electricity being generated from 2007. In addition, SSE's marine energy venture, Renewable Technology Ventures Ltd (RTVL), is on course to deploy its 2.4MW tidal underwater turbine demonstrator at the European Marine Energy Centre in Orkney during 2007/08.

SSE is also investing up to £2.4m in a fund to support renewable energy projects and technologies being developed by companies in the east of Scotland. The fund will be managed by a subsidiary of Sigma Technology Group. The 10-year fund will have a total initial value of up to £6m and an investment period of three years. SSE expects that its investment will yield business development opportunities in technologies which have the potential to help the UK meet its targets for reducing emissions of carbon dioxide while being capable of generating significant amounts of electricity. Its first investment was in Edinburgh-based Ocean Power Delivery.

SSE's investment in the project to generate 'de-carbonised' electricity from hydrogen at Peterhead Power Station fully complements its diverse interests in generating electricity from renewable sources, as does its consideration of the issues surrounding the development of 'clean coal' technologies at Ferrybridge, including research by Heriot Watt University on the prospects for carbon capture near the station.

With interests in emerging technologies, including micro generation technologies (see 'Energy Services' below), allied to its established capability in generating electricity from the more mature technologies of hydro, onshore wind and biomass, SSE has the broadest range of interests in the UK in zero- and low-carbon electricity generation technologies.

Generation Priorities for 2006/07
During 2006/07, SSE's key objective in generation will be to ensure that its diverse portfolio of power stations is available to generate electricity in response to customer demand and market conditions, while complying fully with all safety standards and environmental regulations.

It will also be working to ensure that the installation of flue gas desulphurisation equipment at Fiddler's Ferry and Ferrybridge and the development of the Glendoe hydro electric scheme proceed on time and on budget. It also hopes to secure consent for the construction of additional wind farm capacity at up to seven sites with a total capacity of 361MW and to identify new opportunities to invest in gas-fired generation.

There are also significant decisions to be taken in terms of whether to go ahead with the projects to generate 'de-carbonised' electricity at Peterhead and to install a Super Critical Boiler and post-combustion carbon capture equipment at Ferrybridge.

Did you know?

We are building a

100

MW hydro electric power station near Loch Ness

SSE is investing around £140m in a new hydro electric scheme at Glendoe, to the east of Fort Augustus in Inverness-shire. The power station itself, which will be built under ground, will be located close to the south east corner of Loch Ness. With an installed capacity of 100MW, Glendoe will be Scotland's second largest conventional hydro electric station and the first large-scale station to be built since 1957.

Did you know?

We have wind farms with

162

MW of capacity

SSE owns and operates four wind farms in Scotland with a total capacity of 162MW. In March 2006, its Hadyard Hill wind farm in South Ayrshire became the first in the UK to generate over 100MW of electricity. Over a year, the £85m wind farm will generate enough electricity to power 80,000 homes, sufficient to supply every household in a city the size of York.

Energy Supply
SSE's energy supply business had over 6.7 million customers as at 31 March 2006, a net gain of 600,000 during 2005/06. Overall, SSE now has 2.2 million more customers than at the start of 2002, an increase of almost 50%. Within the overall total, SSE's business customers now cover almost 400,000 sites throughout Great Britain.

SSE's policy is to seek to protect its domestic customers from the worst impacts of volatile wholesale energy prices and to delay for as long as possible any increases in prices for gas and electricity. It has, therefore, increased prices for domestic customers more slowly than its major competitors. When the latest increase was announced in March 2006, SSE gave a commitment to hold electricity and gas prices at their revised levels until at least the start of 2007. SSE's decisions to delay price rises have saved a typical gas and electricity customer around £100 since the start of 2004, compared with what they would have paid had SSE increased prices at the same time as the UK's largest energy supplier.

The outlook for gas and electricity prices remains uncertain. Nevertheless, SSE will seek to maintain its reputation for responsible pricing and for protecting its customers from the worst impacts of volatile wholesale energy markets. It believes that this reputation for restraint has contributed to the sustained growth in the number of energy supply customers which has been achieved in recent years, and will support the achievement of additional growth in the future.

According to the Domestic Retail Market Report published by Ofgem in February 2006, SSE's three regional brands – Scottish Hydro Electric, Southern Electric and SWALEC – have been the most successful of the 'incumbent' electricity suppliers in the 14 regions in Great Britain in maintaining their market share within the competitive market.

In support of the Scottish Hydro Electric brand SSE announced in March 2006 a major three-year sponsorship of the Camanachd Cup. This complements the well-established sponsorship of the Southern Electric Premier Cricket League.These programmes will be followed by a SWALEC-supported sports initiative in south Wales.

Customer Service
Equally important to success in Energy Supply is maintaining the highest possible standards of customer service. The leading annual independent study, by JD Power, published in November 2005, found that SSE has the highest level of customer satisfaction among UK electricity suppliers and the second highest among gas suppliers. Despite the significant growth in customer numbers, SSE secured during 2005/06 a reduction of almost 15% in the number of customer complaints sent to energywatch for resolution, to 1,692 – the third successive year in which a significant reduction in the number of complaints has been achieved. In the statistics published by energywatch in March 2006, SSE had the lowest rate of complaints in respect of all three categories: account and billing matters; direct selling; and transfers between companies.

SSE believes that a high quality of service will become an increasingly important part of its customer proposition – and that customers' expectations of the service their energy supplier should provide will increase. In line with this, it has implemented a new Domestic Energy Customer Charter, the first of its kind in the UK. It makes a series of specific commitments in respect of customer service, such as a pledge to respond to letters from customers within five days of receipt and the right to independent arbitration where necessary to resolve issues.

The introduction of the Charter is part of the wider performance improvement programme in SSE's Customer Service division. This programme is geared to improving significantly customers' experience in dealing with SSE and, amongst other things, reducing the number of customers lost to other suppliers – an area in which there is scope for SSE to improve.

The programme involves a major re-organisation and simplification of the division, around the customer lifecycle, with over 30 process re-designs. These include, for example, increasing the frequency of reviews of direct debit payments being made by customers, to every six months, so they can be satisfied their payments are in line with their actual energy consumption. As part of the project, it is expected that the introduction of computer-telephony integration (CTI) will be completed well before the end of 2006. It will, amongst other things, reduce the number of 'menu' options customers have to deal with before they speak to a customer service adviser.

Product Development
Energy supply remains intensely competitive, and key to long-term success will be greater success in gaining and retaining customers' loyalty, and the performance improvement programme is designed to achieve that, as is product development.

In line with this, SSE has launched **energyplus pulse**. For every customer who switches gas and electricity supply to **energyplus pulse**, SSE donates £10 a year to the British Heart Foundation.

It forms part of the **energyplus** suite of 'loyalty' products which are available from SSE and which now have, in total, over 700,000 customers. In a highly competitive market, SSE believes that its ability to offer a range of 'loyalty' products positions it well to retain customers for the long-term. In addition, SSE has continued to look at options for new products, given the importance of developments in this field as a key contributor to long-term success in energy supply. For example, for customers who like peace of mind and wish to guard against future uncertainty in energy prices, SSE has introduced a 'fixed price' tariff for gas and electricity. While the fixed price is higher than the revised prices which took effect on 1 May 2006, it is guaranteed until 2010.

Energy Services
An increasing number of supply customers are likely to seek a wider range of energy-related services, covering renewable, sustainable and energy efficient products. In Budget 2006, the government said that supplying energy on an energy services basis

Did you know?

We supply energy to over
6.7
million customers

SSE is one of the largest suppliers of electricity and gas with over 6.7 million customers. It brings together the Southern Electric, Scottish Hydro Electric, SWALEC and Atlantic brands. These brands offer a range of energy-related products and services. SSE delivers sector-leading service from its centres in Basingstoke, Cardiff, Perth and Portsmouth. SSE's Energy Services unit provides a comprehensive range of 'beyond the meter' services.

Did you know?

We give
10
pounds to the British Heart Foundation with energyplus pulse

With SSE's **energyplus pulse** product, customers don't pay any more than SSE's standard prices for energy – and SSE gives £10 a year to the British Heart Foundation for every customer who buys electricity and gas through **energyplus pulse**. The money that SSE's donates on customers' behalf is used by the British Heart Foundation to support patient care, emergency skills and equipment, research and education.

CUSTOMER SERVICE

The 2005 leading annual independent study, by JD Power, found that SSE has the highest level of customer satisfaction among UK electricity suppliers, and the second highest among gas suppliers.

SSE believes that a high quality of customer service will be an increasingly important part of customers' expectations. In line with this, it has introduced, as part of major reorganisation of its customer service division involving over 30 process re-designs, a Domestic Energy Customer Charter. These initiatives are geared to improving significantly customers' experience of dealing with SSE and, amongst other things, reducing the number of customers lost to other suppliers.

"I'm responsible for ensuring new staff aren't thrown in at the deep end, We have excellent training and lots of support. After all, they're going to be making promises on our behalf – promises we must keep."

Ryan Sadler
Customer Service Training Manager

helps shift the focus of energy producers and customers from the supply of units of electricity and gas to the supply of the overall services for which energy is used.

SSE is very well positioned to capture a significant proportion of this developing market over the remainder of this decade because it combines established contracting, private networks, connections and appliance retail businesses with a portfolio of micro generation technologies.

In terms of micro generation technologies, SSE has invested £1.12m to increase its stake in Edinburgh based Swift Turbines to 10% of the share capital, with options over a further 20%, and £2.0m to increase its stake in solarcentury to 13.3% of the share capital. Swift Turbines has developed what is believed to be the world's first feasible rooftop-mountable wind energy system and London-based solarcentury is the largest independent solar photovoltaics company in the UK.

In addition to its investments, SSE is working with both companies to market the provision and installation of the technologies to an increasing number of customers in the UK.

SSE is also launching a new domestic boiler installation and maintenance and repair service for gas central heating systems. The initial offering is being made in 13 postcode areas covering 3.5 million households. The product features an annual inspection, full breakdown and emergency cover and a 24-hour, 365-day manned customer helpline. It covers customers' entire gas central heating system, including the boiler, pipe work, radiators, cylinders and tanks.

The establishment by SSE of an Energy Services unit anticipated a growing demand for services 'beyond the meter'. Its ability to provide these services is a natural long-term complement to its existing business of distributing and supplying energy to the meter.

Energy Supply Priorities in 2006/07
During 2006/07, SSE will seek to capitalise on its strong regional brands, its best-in-sector customer service, its responsible pricing policy and its range of value-adding offers to increase further its number of energy supply customers. Amongst other things, this will require a continuing focus on delivering the highest possible standard of service to customers and completing the delivery of the performance improvement programme in the Customer Service division, with the explicit aim of increasing customer loyalty. SSE is committed to keeping domestic electricity and gas prices at their current levels until at least the start of 2007.

As the energy supply market evolves to include more energy services, SSE will seek to increase further its activity in gas and electricity infrastructure, microgeneration and, in particular, the provision and maintenance of gas boilers. It will actively encourage the UK government, in the context of its review of energy policy, to develop further the framework for energy services, in general, and micro generation in particular.

CONTRACTING, CONNECTIONS AND METERING

Key points:

- Operating profit* up 5.2% to £50.4m.
- Acquisition of Harrison Smith in February 2006.
- Secured Leeds City Council street lighting PFI.
- 50,800 electrical and gas connections completed.
- Number of 'out-of-area' electricity networks up to 19, with agreement on a further 12.

Introduction to Contracting, Connections and Metering
SSE's contracting business, Southern Electric Contracting, has five main areas of activity: industrial, commercial and domestic, mechanical and electrical contracting; data communications; high voltage design and maintenance; electrical and instrumentation engineering; and public and highway lighting. It is one of the largest electrical contracting businesses in the UK and operates from 48 regional offices throughout Great Britain and trades as SWALEC Contracting in Wales, Scottish Hydro Contracting in Scotland, Eastern Contracting in the east of England and Harrison Smith in the north of England.

SSE's national Connections business provides utility infrastructures and connections for new developments. It finances, plans and constructs projects and owns and operates gas, electricity and telecommunications networks throughout the country.

During the Distribution Price Control Review for 2005-10, Ofgem reviewed the price control treatment of the provision, installation and maintenance of meters and separated it from the electricity distribution RAV. This resulted in a reduction in SSE's RAV of £23m on 1 April 2005.

Contracting, Connections and Metering Overview
Contracting, Connections and Metering delivered operating profit* of £50.4m during 2005/06, an increase of 5.2%. This includes £3.4m of operating profit from Thermal Transfer, SSE's specialist contracting business, which was sold to ETDE on 31 March 2006 for £20m.

Contracting
The sale of Thermal Transfer will allow SSE's core contracting business, Southern Electric Contracting (SEC), to develop its mechanical and electrical capability. It is continuing to make significant progress.

It acquired the Yorkshire-based plumbing and heating contractor, Harrison Smith (Batley) in February 2006 in a transaction with a value of around £1.2m. The acquisition has given SEC the scope to offer a more comprehensive range of electrical, heating and plumbing services to customers in the north of England. It followed the acquisition in January 2005 of the electrical contracting division of what was previously Eastern Contracting, a business which is now a fully-integrated part of SEC.

SEC's joint venture with Interserve, 'PriDE', has now completed the first year of a seven

Did you know?

We received
9.2
million calls from customers

'During 2005/06, SSE received 9.2 million telephone calls from its gas and electricity supply customers. In its new Domestic Energy Customer Charter, the first of its kind in the UK, SSE's commitment is to answer telephone calls within 20 seconds. It forms part of a wide-ranging performance improvement programme in SSE's Customer Service division which will be completed during 2006/07.

Did you know?

We have
48
regional offices in the contracting business

SSE has one of the UK's leading Mechanical and Electrical contracting businesses in the UK. Operating from 48 regional offices around the country, and employing 3,000 experienced engineers and electricians, it offers customers: local client management; local project management; IOSH qualified managers; and local resources, including directly employed labour.

year contract worth around £400m to provide mechanical and electrical maintenance for over 100 Ministry of Defence sites in London and the south east of England. The profit contribution of the venture in its first year was in line with that expected when the contract was awarded.

In partnership with the asset finance division of The Royal Bank of Scotland, SEC also has contracts with a value of over £700m to replace and maintain streetlights for four local authorities in England under the Private Finance Initiative. This includes the largest-ever street lighting PFI in the UK, agreed with Leeds City Council in February 2006.

SSE has contracts with 28 local authorities to maintain around one million lighting units, making it the UK's largest street lighting contractor and operating profit from SSE's lighting services activities grew by over 50% during 2005/06.

Connections

The Connections business completed 42,900 electrical connections during 2005/06. Its rate of connecting new premises to its gas networks continued to grow, and during the the year, it connected a further 7,900 premises, up 12.9% on the previous year, taking the total number of gas connections now owned by SSE to more than 35,000.

In addition, the Connections business has continued to expand its portfolio of electricity networks outside the Southern Electric and Scottish Hydro Electric Power Distribution areas. It now owns and manages 19 electricity networks outside SSE's two electricity distribution areas, a gain of three during the year. The three new networks are at Waterfront Edinburgh, Braehead Glasgow and Doncaster Interchange.

It has also won during 2005/06 a total of 12 new contracts to provide energy infrastructure, including schemes for Cardiff International Sports Village, Dagenham and Warrington Golden Square. These projects further demonstrate SSE's capability to provide energy networks to customers across the whole of the UK and will take its total number of 'out-of-area' electricity networks to 31.

Metering

SSE's Metering business provides services to most electricity suppliers with customers in central southern England and the north of Scotland. It supplies, installs and maintains domestic meters and carries out metering work in the commercial, industrial and generation sector. It also offers data collection services to the domestic and SME sectors.

In total, SSE owns 3.6 million meters and changes around 250,000 meters each year as they reach the end of their useful life or to meet customer requests for changed functionality. Each year, it collects around 5.1 million electricity readings and 1.3 million gas readings. It is focused on providing an efficient service in SSE's two licensed electricity distribution areas.

Contracting, Connections and Metering Priorities in 2006/07

The priorities for SEC in 2006/07 are to complete the integration of the Harrison Smith business and to make a successful start to the Leeds PFI. It is also important to ensure that there continues to be good performance in other long-term contracts, such as the Ministry of Defence 'PriDE' contract. Given such a significant proportion of its business is 'repeat', its over-riding priority is to deliver a high standard of service to all customers in all of the sectors in which it operates.

The connections business' focus will be on the successful delivery of a growing number of utility connections and on continuing to expand its range of electricity networks outside the Southern Electric and Scottish Hydro Electric Power Distribution areas. In particular, it expects to construct and energise 12 new out-of-area networks. The Metering business will continue to focus on delivering a good service at competitive prices.

GAS STORAGE

Key points:

- Operating profit* up 43.7% to £27.3m.
- 100% availability to meet customers' nominations.
- Nine wells drilled at the Aldbrough development.
- 'Leaching' under way at five caverns.

Introduction to Gas Storage

SSE owns and operates the UK's largest onshore gas storage facility at Hornsea in East Yorkshire. Nine man made salt cavities have been leached into a salt layer 1.8 kilometres below the surface creating 325 million cubic metres of gas storage space. Gas can be withdrawn at a rate of 18 million cubic metres per day, the equivalent of the requirements of around four million homes. The services offered at Hornsea provide customers with a reliable source of flexibility with which to manage their supply/demand balance and exploit market opportunities.

Gas Storage Operations

Gas Storage delivered an operating profit* of £27.3m during 2005/06, an increase of 43.7% compared with the previous year. The value of, and demand for, gas storage facilities in the UK remains high and, in a volatile gas market, SSE has continued to enter into new contracts to provide storage at a significantly higher value than the contracts they replace.

The facility at Hornsea has a good record of reliability and during 2005/06 was 100% available to customers except in instances of planned maintenance. This enables customers to manage their gas market risks and exploit gas trading opportunities.

Gas Storage Investment

SSE's joint venture with Statoil (UK), in which SSE is investing £150m, to develop what will become the UK's largest onshore gas storage facility at Aldbrough, is continuing to make good progress. With a total new capacity of around 420 million cubic metres, of which SSE will have the ownership interest in 280 million cubic metres, Aldbrough will

Did you know?

We manage and maintain

1.0

million street lights

SSE's contracting business is one of the UK's largest contracting businesses and has five main areas of activity: industrial, commercial and domestic, mechanical and electrical contracting; data communications; high voltage design and maintenance; electrical and instrumentation engineering; and public and highway lighting. It is responsible for maintaining around one million lighting units, making it the UK's largest street lighting contractor.

Did you know?

We manage

19

'out-of-area' electricity networks

In addition to its electricity networks in its central southern England and the north of Scotland areas, SSE owns and manages 19 networks elsewhere in the UK. These include networks at Waterfront Edinburgh, Braehead Glasgow and Doncaster Interchange. This number is increasing, as SSE has signed new contracts to provide energy infrastructure, including the Cardiff International Sports Village.

provide essential additional gas storage for the UK energy industry.

Nine caverns will be used to store gas at Aldbrough. They are being created by directionally drilling from a central processing area down to the salt strata. Seawater is then pumped into the boreholes to dissolve the salt and form the caverns. This is the process known as 'leaching'. All nine wells have been drilled and the leaching is at full capacity at five caverns. The process will take another three years to complete, with the first cavern expected to be ready to store gas in 2007.

Gas Storage Priorities in 2006/07
All storage capacity at Hornsea for 2006/07 was sold before the end of March 2006. SSE's priorities in Gas Storage during the year are to ensure that Hornsea maintains its excellent record of reliability and to ensure that the Aldbrough development remains on course to begin storing gas in 2007, with the completion of the leaching of the first storage cavern by the end of this financial year.

TELECOMS

Key points:

- Operating profit* up 22.1% to £13.2m.
- Increased sales to major customers.
- Improved project delivery.

Introduction to Telecoms
SSE Telecom provides radio sites for local authorities, mobile operators and emergency services throughout central southern England and the north of Scotland, enabling customers to improve their network coverage and capacity. Its subsidiary, Neos Networks, operates a 7,500km UK-wide telecoms network, including 1,100km of underground and overhead fibre optic cable installed on SSE's electricity network, providing networking services to other telecoms providers, companies and public sector organisations.

Telecoms Operations
SSE's combined Telecoms business (SSE Telecom and Neos) achieved an operating profit* of £13.2m during 2005/06, compared with £10.8m in the previous year, an increase of 22.1%. The business offers customers a national telecoms network, and has a UK-wide sales force and a broad range of products including Ethernet, SDH Leased Lines and Dark Fibre. As a subsidiary of SSE, it is also able to position itself as one of the UK's most financially secure telecoms network operators, which gives a significant competitive advantage.

The improvement in performance during 2005/06 was mainly the result of higher sales, and important contracts have recently been signed with a diverse range of major organisations, such as Opal Telecom (part of the Carphone Warehouse), College of Law (the largest provider of legal education and training in Europe) and Savvis (for easyJet).

During the year the business secured further improvements in the quality of project delivery.

Telecoms Priorities in 2006/07
SSE's priority in Telecoms in 2006/07 is to continue to grow its sales, using its already-established nationwide network, with its competitive range of products targeted at commercial and public sector customers.

EXCEPTIONAL ITEMS

TXU Europe Group plc
In August 2005, SSE received its second net distribution payment, of £41.6m, from the administrators of TXU Europe Group plc and certain of its subsidiaries, with regard to its claim of £294.2m in respect of a 14-year contract originally entered into in 1997. A third net distribution payment, of £50.5m, was received in January 2006. To these has been added SSE's share (£16.7m) of the distributions paid by the administrator to Barking Power Ltd, the operators of Barking Power Station, in which SSE now has a total stake of 30.4%.This gives a total receipt during 2005/06 of £108.8m.

These payments followed the first net distribution payments of £159.1m to SSE and SSE's share of £22.3m to Barking Power Ltd, which were received from the administrator in March 2005. Following the second and third payments, SSE expects to receive further distributions later in 2006 and that, in total, well over 90% of its claim will be settled.

Thermal Transfer
In March 2006, SSE completed the sale of Thermal Transfer to ETDE, the electrical contracting/maintenance subsidiary of the French-owned Bouygues Construction. The profit on disposal was £18.6m.

CAPITAL EXPENDITURE

Investment and capital expenditure, excluding acquisitions, totalled £502.1m during 2005/06, compared with £383.5m in the previous year, an increase foreshadowed in the Annual Report 2005.

Capital expenditure in Power Systems was £172.1m, compared with £171.5m in the previous year. A major part of the ongoing capital expenditure programme is focused on the replacement of parts of the electricity network that date back to the 1960s.

In addition, there was investment of £133.6m for growth in Generation during the year, with the refurbishment work carried out at hydro electric power stations, the development of new hydro electric and wind energy schemes leading to the production of ROC-qualifying electricity and investment in biomass co-firing and other developments at Fiddler's Ferry and Ferrybridge.

As well as Power Systems and Generation, £46.7m was invested in the ongoing development of the new gas storage facility at Aldbrough. In addition, in February 2006, SSE acquired a building in Havant for £10.5m which it is now refurbishing and which will become its regional base for southern England. This will enable SSE to bring together in a single, higher-quality building, employees who currently work in separate sites in Portsmouth and Havant, which will be vacated and sold.

Within the overall total, capital expenditure for growth was £287.7m during 2005/06, including £133.6m of the overall capital expenditure in Generation. As previously stated, capital expenditure will continue to be significant

Did you know?

We own and operate
325
million cubic metres of gas storage

SSE owns the UK's largest onshore gas storage facility at Hornsea in East Yorkshire, which has a total storage capacity of around 325 million cubic metres. It operates as a tool for meeting peak demand for gas. SSE is now developing an even larger facility at nearby Aldbrough. This will have a total new capacity of around 420 million cubic metres, of which SSE will have an ownership interest in 280 million cubic metres.

Did you know?

We provide services to
400
major telecoms customers

SSE's telecoms business comprises SSE Telecom and Neos Networks. SSE Telecom provides radio sites for local authorities, mobile operators and emergency services throughout central southern England and the north of Scotland, enabling customers to improve their network coverage and capacity. Neos Networks operates a 7,500km UK-wide telecoms network, providing networking services to other telecoms providers, companies and public sector organisations.

during the rest of this decade, with investment in generation, including FGD installation, electricity networks and gas storage, and is expected to be over £650m in 2006/07. All investments are expected to achieve returns which are greater than the cost of capital and are expected to enhance earnings.

FINANCIAL MANAGEMENT

Treasury Policy

SSE's operations are financed by a combination of retained profits, bank borrowings, long-term debt issuance and commercial paper. As a matter of policy, a minimum of 50% of SSE's interest rate exposure is kept at fixed rates of interest.

Within this policy framework, SSE borrows as required, at both fixed and floating rates, with interest rate swaps and forward rate agreements being used to achieve the desired profile. All borrowings in foreign currencies are swapped back into Sterling. At 31 March 2006, 83.2% of SSE's borrowings were at fixed rates, after taking account of interest rate swaps.

Liquidity policy requires SSE to ensure that it has committed borrowings and facilities equal to at least 105% of forecast borrowings over a rolling 12 month period. SSE had undrawn committed bank facilities of £650m, with a weighted average period, until maturity, of 3.7 years as at 31 March 2006. As the United Kingdom is SSE's main area of operation, foreign currency risk is limited mainly to procurement contracts, fuel purchases and commodity hedging transactions. Its policy is to hedge all material foreign exchange exposures through the use of forward currency purchases and/or derivative instruments. Indirect exposures created by SSE's gas purchases are similarly hedged on an ongoing basis.

Net Debt and Cash Flow

During 2005/06, SSE's net debt increased by £736.4m to £2,166.4m. Net debt includes £26.2m owed by the PFI street lighting companies, which is non-recourse to SSE. The increase followed: the £505m acquisition cost of the 50% stake in SGN; increased capital expenditure for growth, principally in electricity generation and gas storage, totalling £287.7m; and an adverse movement in working capital. This reflected higher commodity costs incurred during the year which were lagged by cash collections from electricity and gas customers. Working capital is forecast to improve in 2006/07 as this lag is reversed during the year.

There was a cash inflow of £92.1m from the administration of TXU businesses. In April 2004, SSE acquired over 300,000 electricity and gas customers and the customer debt book from Atlantic Electric & Gas for £85.3m. In the two years since the acquisition, all of the money which SSE paid for the customer debt book has been collected.

Borrowings and Facilities

The objective for SSE is to maintain a balance between continuity of funding and flexibility, with a range of maturity dates. Its average age of debt as at 31 March 2006 was 12.7 years, compared with 12.0 years as at 31 March 2005.

The maturity profile continues to reflect the medium to long-term nature of SSE's underlying assets and means that its debt structure continues to be in a strong position going forward, with around £1.85bn of borrowings in medium to long-term funding in the form of issued Bonds and European Investment Bank borrowings. A total of 18.7% of SSE's borrowings will mature in the 12 months to March 2007.

In February 2006, SSE issued a £325m long-dated sterling bond for Southern Electric Power Distribution to pre-finance pending maturities and to provide funding for its capital expenditure programme. This bond which matures in 2037, has a coupon of 4.625%, which will help to reduce significantly SSE's interest costs over the long-term.

Net Finance Costs

The basis of the presentation of net finance costs has changed under IFRS and the table below reconciles published net finance costs to adjusted net finance costs which SSE believes is a more meaningful measure. In line with that, SSE's adjusted net finance costs in 2005/06 was £155.3m, compared with £90.9m in the previous year. Of the £155.3m, SGN interest was £54.1m (net of loan stock interest payable to SSE).

	March 06 £m	March 05 £m
Published net finance costs (Note 6)	89.4	61.3
add/(less)		
Share of JCE*/ Associate interest	97.3	17.2
Convertible debt IAS 32 adjustment	(3.6)	–
Interest on pension plan liabilities	(100.0)	(94.7)
Return on pension plan assets	115.7	107.1
Movement on derivatives	(43.5)	–
Adjusted net finance costs	155.3	90.9

*Jointly Controlled Entities

The average interest rate for SSE, excluding JCE/Associate interest, during the year was 5.42%, compared with 5.91% in the previous year. Underlying interest cover was 9.2 times, compared with 9.0 times in the previous year; including SGN it was 6.6 times.

TAX

To assist the transparency of SSE's tax position, the adjusted current tax charge is calculated as follows:

	March 06 £m	March 05 £m
Published tax charge	254.6	229.5
add back:		
Share of JCE/Associate tax	29.9	15.3
less:		
Deferred tax	(37.7)	(35.6)
Tax on exceptional items and remeasurements	(15.3)	(27.2)
Adjusted current tax charge	231.5	182.0

The effective adjusted underlying current tax rate, based on adjusted profit before tax, was 27.0%, compared with 25.3% in the previous year. The headline tax charge was 28.3%, compared with 29.1% in the previous year.

Did you know?

We invested over

500

million pounds in capital projects

During 2005/06, SSE's investment and capital expenditure (excluding acquisitions) totalled just over £500m. This included investment to upgrade its electricity networks, build new hydro electric and wind energy schemes and develop new gas storage facilities.

Did you know?

We had a

5.42

per cent average interest rate

During 2005/06, the average interest rate for SSE was 5.42%, compared with 5.91% in the previous year. In February 2005, SSE issued a £325m long-dated sterling bond for Southern Electric Power Distribution. This bond, which matures in 2037, has a coupon of 4.625%, which will help to reduce significantly SSE's interest costs over the long-term.

"I manage a team of technicians responsible for leaching the caverns by pumping sea water at high pressure to dissolve the salt. This involves 'hands on' practical work where common sense and a practical approach are as valuable as qualifications."

Scott Maxwell
Leaching Engineer

GAS STORAGE FACILITY

As the UK becomes more dependent on imported gas, gas storage facilities become increasingly important in enabling suppliers to balance supply and demand. SSE already owns the UK's largest onshore gas storage facility at Hornsea in East Yorkshire. Now, in a joint venture with Statoil (UK), it is investing £150m to develop a second storage facility, at nearby Aldbrough.

Nine man made cavities are being leached into a deep salt layer 1.8 kilometres below the surface. The new facility will have a total capacity of around 420 million cubic metres, with SSE having an ownership interest in 280 million cubic metres. The first of the cavities is expected to be ready to store gas in 2007.

BALANCE SHEET

SSE continues to maintain one of the strongest balance sheets in the global utility sector, which continues to give it significant competitive advantage in terms of cost of funding and supporting new developments.

During the year, the trustees of both the Southern Electric scheme and the scheme for employees at Fiddler's Ferry and Ferrybridge agreed to merge their final salary schemes. The merger has no impact on members' benefits. The merger has created an enlarged pension scheme with a more balanced investment strategy and lower costs, giving increased security for all members.

In line with the IAS 19 treatment of pension scheme assets, liabilities and costs, pension scheme liabilities of £284m and a pension scheme asset of £90.2m are recognised in the balance sheet at 31 March 2006, gross of deferred tax. Overall, this represents an improvement of £33.8m compared with the position at March 2005.

During 2005/06, employer cash contributions to the Scottish Hydro Electric pension scheme amounted to £9.2m. Contributions to the Southern Electric pension scheme amounted to £46.5m during the year. This includes a contribution towards the deficit of £31.7m that was agreed in March 2005, in addition to an ongoing contribution rate of 19.9% of salaries. As part of the Distribution Price Control for 2005-2010, it was agreed that allowance for 76% of deficit repair contributions should be included in price controlled revenue.

At 31 March 2006, there was a net asset arising from IAS 39 of £46.5m, before tax, compared with a net asset of £31.8m, before tax, at 1 April 2005.

PURCHASE OF OWN SHARES

The Directors of SSE have not exercised their authority to purchase, in the market, the company's own shares during 2005/06. The Directors are, however, seeking renewal of their authority to purchase, in the market, the company's own shares at the Annual General Meeting on 27 July 2006. It remains the policy of the Board of SSE to take opportunities to return value to shareholders through the purchase of the company's own shares should the conditions be appropriate.

CORPORATE RESPONSIBILITY

Safety and the Environment

SSE aims to create value for shareholders by running the business with a strong emphasis on safety and on caring for the environment. During 2005/06, the actual number of lost time and reportable accidents within the company was 17, the same as in the previous year. This equates to 1.38 per 1,000 employees, compared with 1.54 per 1,000 employees in the previous year which, on this basis, was SSE's best-ever safety performance.

The number of serious, or potentially serious, road traffic accidents involving employees driving company vehicles fell from 24 in 2004/05 to 17 in 2005/06. Performance in 2005/06 equates to 0.28 accidents per 100 vehicles compared with 0.42 in the previous year.

SSE's target for any given year is zero reportable environmental incidents. There were no such incidents during 2005/06.

Corporate Responsibility Index and Business in the Environment Index

Business in the Community's Corporate Responsibility Index provides an authoritative benchmark for companies to evaluate their management practice in four key areas of corporate responsibility (community, environment, marketplace and workplace) and performance in a range of environmental and social impact areas material to their business.

The results of the Index for 2005, in which 131 companies participated, were published in May 2006. SSE's score was 97.5%, compared with 93.0% in the previous year. This placed SSE joint 7th in the Index, compared with joint 14th in the previous year, and made it the joint top-ranked company in its sector.

Within the main Index is the Business in the Environment Index. SSE's score was 99.20%, compared with 98.80% in the previous year. As with the overall Index, making SSE best in its sector.

STRATEGY AND OUTLOOK

In a sector which remains subject to significant change, SSE continues to focus on enhancing and creating value for shareholders from its energy and infrastructure-related businesses in the UK. The businesses have been expanded in recent years through incremental growth and investment in assets, and they are well-placed to deliver further growth. That growth will be based on SSE's core strengths, amongst which the achievement of continuous improvement and the delivery of operational excellence in all activities continue to be fundamental.

There are excellent opportunities to grow these businesses further through the major investment programme planned for the rest of this decade, which will add significantly to SSE's asset base in energy networks, electricity generation, energy supply and gas storage. All of this investment is in line with the UK's key goals of delivering reliable and lower carbon energy supplies.

SSE can take advantage of these opportunities because of its carefully maintained financial strength. SSE is, therefore, in a very good position to expand its businesses further through incremental growth and investment in assets and, most importantly of all, to deliver sustained real growth in the dividend.

Did you know?

We scored
97.5
per cent in the Corporate Responsibility Index

SSE was one of 131 companies which participated in Business in the Community's Corporate Responsibility Index, the leading UK benchmark of responsible business practice. SSE's score in the Index was 97.5% and its position was joint 7th, which made it the joint top-performing company in its sector.

Did you know?

We scored
99.2
per cent in the Environment Index

SSE was one of 155 companies which participated in Business in the Community's Environment Index 2005. It is widely recognised as the leading benchmark of corporate environmental engagement. SSE's score in the Index was 99.2%, which made it the top-performing company in its sector and placed it in BitC's 'Premier League' of participating companies.

Directors' Statement Continued

CR KEY PERFORMANCE INDICATORS

Responsible Business Practice
Scottish and Southern Energy (SSE) seeks to ensure that responsible business practice is fully integrated into the management of all of its operations and into the culture of all parts of its business. It believes that the consistent adoption of responsible business practice is the pre-requisite of operational excellence, which, in turn, underpins the delivery of its core objective of sustained real growth in the dividend.

The Board is satisfied that corporate responsibility matters do not represent a material threat to SSE. Overall, it is confident that there are in place within SSE effective systems to assess and manage corporate responsibility-related issues and risks. These systems are regularly monitored and reviewed. SSE's principles of corporate responsibility will remain central to its activities in 2006/07.

BitC Corporate Responsibility Index
To benchmark its approach to corporate responsibility, SSE was one of 131 companies which participated in Business in the Community's Corporate Responsibility Index 2005, the results of which were published in May 2006. The Index enables companies to evaluate their management practice in BitC's four key areas of corporate responsibility – environment, marketplace, workplace and community – and their performance in a range of environmental and social impact areas material to their business.

SSE's score in the Index was 97.5%, compared with 93.0% in the previous year and its position was joint 7th, compared with joint 14th the year before.

Corporate Responsibility Report 2006
SSE's Corporate Responsibility Report 2006 sets out its approaches to, and performance in respect of, issues related to the environment, marketplace, workplace and community. It is available at scottish-southern.co.uk. Key performance indicators from the Report are summarised opposite. The Report provides background information and commentary on each of these performance indicators and on other corporate responsibility-related matters. They include, for example, information about emissions related to the generation and supply of electricity. Background to this is also set out in the Generation and Supply section of the Directors' Statement, on pages 13 to 20.

ENVIRONMENT

Indicator	2006	2005	Change
CO_2 from SSE's power stations – mte	25.34	18.90	+34.1%
Non-power station CO_2 emissions – mte	16,865	17,460	-3.4%
CO_2 from electricity supplied – kg/kWh	617	440	+40.2%
SO_2 from electricity supplied – g/kWh	1.5820	1.1033	+43.4%
NOx of electricity supplied – g/kWh	1.197	0.730	+64.0%
Breaches of IPC/IPPC	6	7	-14.3%
Renewable energy generation capacity – MW	1,516	1,363	+11.2%
Thermal efficiency of gas-fired power stations – %	50.4	54.3	-7.2%
Thermal efficiency of coal-fired power stations – %	36.2	35.6	+1.7%
Oil leaked – litres	27,941	38,105	-26.7%
Waste produced – tonnes	28,378	28,776	-1.4%
Waste sent to landfill – tonnes	10,215	11,281	-9.4%
Water consumption at power stations – cubic metres	3,485,992	4,659,768	-25.2%
Non-power station water consumption – cubic metres	104,774	88,652	+18.2%
Travel on SSE business – km	194,537,400	167,430,609	+16.2%
Business flights	8,054	7,602	+5.9%
Business rail journeys	1,546	550	+181.1%

MARKETPLACE

Customers with 'tailor-made' payment arrangements		
2006	235,630	+48.9%
2005	158,284	

Customers registered with 'Careline'		
2006	219,870	+27.4%
2005	172,557	

Total complaints to energywatch		
2006	1,692	-14.6%
2005	1,981	

Complaints to energywatch direct selling – number per 1,000 transfers		
2006	0.85	-60.1%
2005	2.16	

Complaints to energywatch transfers – number per 1,000 transfers		
2006	2.57	-38.1%
2005	4.15	

Complaints to energywatch account and billing – number per 1,000 customers		
2006	0.147	-2.7%
2005	0.151	

WORKPLACE

Number of employees		
2006	12,287	+11.4%
2005	11,034	

Average age of employees		
2006	39	+0%
2005	39	

'Turnover' of employees		
2006	11.2	+5.7%
2005	10.6	

Lost time and reportable accidents – number per 1,000 employees		
2006	1.38	-10.4%
2005	1.54	

Serious, or potentially serious, road traffic accidents – number per 100 vehicles		
2006	0.28	-33.3%
2005	0.42	

Injury-free business units		
2006	50	-2%
2005	51	

Absence from work per employee – days		
2006	5.75	+5.9%
2005	5.43	

Employees in Share Incentive Plan – %		
2006	48	+33.3%
2005	36	

COMMUNITIES

Southern Electric Power Distribution customer interruptions – number per 100 customers		
2006	78	-20.4%
2005	98	

Scottish Hydro Electric Power Distribution customer interruptions – number per 100 customers		
2006	79	-11.2%
2005	89	

Southern Electric Power Distribution – customer minutes lost		
2006	71	-15.5%
2005	84	

Scottish Hydro Electric Power Distribution – customer minutes lost		
2006	65	-24.4%
2005	86	

Charitable donations – £000s		
2006	496	+24.0%
2005	400	

ENVIRONMENT AND MARKETPLACE

Standardised energy savings under the Energy Efficiency Commitment – GWh		
2006	4,891	+57.3%
3-year average	3,109	

Homes benefiting from insulation measures		
2006	200,000	+66.6%
2005	120,000	

Low energy lamps subsidised		
2006	410,000	+71.5%
2005	239,000	

Energy efficient appliances subsidised		
2006	24,826	+349.9%
2005	5,518	

Calls handled by the energy efficiency advice line		
2006	55,822	+208.7%
2005	18,081	

Directors' Report

Principal Activities

Scottish and Southern Energy plc is a holding company. Its subsidiaries are organised into the main businesses of: generation, transmission, distribution and supply of electricity; storage and supply of gas; electrical and utility contracting; domestic appliance retailing and telecoms. A review of the year's operations and future developments is contained in the Chief Executive's Statement and the Directors' Statement on pages 9 to 27 and Corporate Governance Statements on pages 29 to 33 which form part of this report.

Business Review

The Business Review has been divided into three areas and dealt with in the Annual Report as follows:

- Principal risks and uncertainties – pages 32 and 33 of the Corporate Governance report;
- Balanced and comprehensive review of the development and performance of the business – included in the Directors' Statement on pages 9 to 27;
- Key performance indicators – on pages 6 and 7 and pages 26 and 27.

Directors

The Directors at the date of this report are:

Executive	Non-Executive
Gregor Alexander	Sir Robert Smith (Chairman)
Colin Hood	René Médori
Ian Marchant	David Payne
Alistair Phillips-Davies	Susan Rice
	Kevin Smith

Henry Casley retired as a non-Executive Director on 17 May 2005.

Gregor Alexander, David Payne and Susan Rice, retire by rotation at the Annual General Meeting and, being eligible and in accordance with the Articles of Association, offer themselves for re-election. Biographical details for all Directors are set out on pages 34 and 35. Details of the service contract for Gregor Alexander and letters of appointment for David Payne and Susan Rice, all of whom are standing for re-election, are set out in the Remuneration Report on pages 38 and 39 respectively. The interests of the Directors in the ordinary shares of the company are set out in the Remuneration Report on page 40.

Resolution 2 to be proposed at the Annual General Meeting seeks shareholders' approval of the Remuneration Report.

Directors' Indemnity

The Directors have the benefit of the indemnity provision contained in the company's Articles of Association. This provision, which is a qualifying third party indemnity provision as defined by section 309B of the Companies Act 1985, was in force throughout the financial year and is currently in force. The company also purchased and maintained throughout the financial year directors' and officers' liability insurance in respect of itself and its directors.

Results and Dividends

The Group profit attributable to shareholders for the financial year amounted to £642.3m. The Directors recommend a final dividend of 32.7p per ordinary share which, subject to approval at the Annual General Meeting, will be payable on 22 September 2006 to shareholders on the register at close of business on 25 August 2006. With the interim dividend of 13.8p per ordinary share paid on 24 March 2006, this makes a total dividend of 46.5p per ordinary share.

Share Capital

Details of the company's authorised and issued share capital at 31 March 2006, which includes options granted under the Group's employee share option schemes, are detailed in notes 24 and 28 to the Financial Statements.

Annual General Meeting

The 17th Annual General Meeting of the company will be held on 27 July 2006 at 12 noon at the Bournemouth International Centre, Exeter Road, Bournemouth, BH2 5BH. The Notice of Meeting, together with full explanations of special business, is set out on pages 101 to 104.

Substantial Shareholdings

As at the date of this report the company had received the following notifications of beneficial interests of three per cent or more in the company's issued share capital.

	Number of shares	Percentage
The Capital Group Companies Inc	34,048,224	3.96%
Legal & General plc	28,226,847	3.28%
Barclays plc	26,313,232	3.06%

Research and Development

The company pursues a variety of research and development initiatives, which are generally environmentally driven and which are designed to secure changes in the way in which electricity is produced and used. Many of the principal initiatives are set out in the Generation and Supply section of the Directors' Statement. There are initiatives in other parts of the Group. For example, the Power Systems business is actively engaged in responding to Ofgem's Innovation Funding Incentive, which encourages electricity network companies to innovate in ways which deliver benefits to customers in areas such as quality of electricity supply, safety, the environment or cost savings. During 2005/06 a new Research and Development Manager was appointed to support and advance the company's work in these fields.

Employees

The number of staff directly employed by the Group at 31 March 2006 was 12,287. They are encouraged to participate in the business of the company in a variety of ways. In support of the Board's commitment to providing opportunities for employees to become shareholders, and in extra recognition of employees' efforts in 2004/05, employees were offered shares free of charge in the early part of 2005/06. 50 free shares in the company were offered to employees, with 94% of eligible staff taking up the offer in August 2005. A total of 48% of the company's employees now take part in its Share Incentive Plan. The Share Incentive Plan was commended by Proshare in 2005.

The company also offers a Sharesave Scheme which is open to all eligible employees. A total of 35% of the company's employees participate in Sharesave.

Participation by employees generally is encouraged through team meetings, briefings, an internal magazine, intranet, and also specific surveys.

The company has in place an extensive range of policies to safeguard the interests of 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 sex, marital status, race, disability or other reasons not justified in law or relevant to performing the 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 company's approach to these and related matters is set out in its Corporate Responsibility Report 2006 (see scottish-southern.co.uk).

Creditor Payment Policy

The company complies with the CBI Prompt Payment Code. The main features of the Code are that payment terms are agreed at the outset of a transaction and are adhered to; that there is a clear and consistent policy that bills are paid in accordance with the contract; and that there are no alterations to payment terms without prior agreement. The numbers of suppliers' days represented by trade creditors was 30 at 31 March 2006.

Auditors

Resolutions to re-appoint KPMG Audit Plc as auditors, and to authorise the Directors to fix their remuneration, will be proposed at the forthcoming Annual General Meeting.

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the company's auditors are unaware; and each director has taken all the steps that ought to have been taken as a director to be aware of any relevant audit information and to establish that the company's auditors are aware of that information.

By Order of the Board
Vincent Donnelly, Company Secretary
30 May 2006

Corporate Governance

The Board is committed to the highest standards of corporate governance and believes that strong governance improves the performance of the Group and enhances shareholder value. It has due regard to the continuing developments in this field, including policy guidelines which are regularly issued and updated by organisations such as the ABI, NAPF and PIRC. This report sets out the key governance principles and practices of Scottish and Southern Energy. The Remuneration Report on pages 36 to 41 details the remuneration policies and practices.

Combined Code Compliance

The Board considers that this report on how the company complies with the UK Financial Reporting Council's Combined Code on Corporate Governance (the 'Combined Code') provides the information necessary to enable shareholders to evaluate how the principles of the Combined Code have been applied. Throughout the year, the company has complied with the provisions of the Combined Code except for the following matter:

As explained last year, Henry Casley retired as a non-Executive Director on 17 May 2005. He was considered not to be independent in terms of the Combined Code. Since 17 May 2005, the company has complied with all the provisions set out in Section 1 of the Combined Code.

Taking account of the above explanation, the Board therefore considers that the company has satisfied its obligations under the Combined Code.

ORGANISATION AND STRUCTURE

Board Membership

The non-Executive Chairman, Sir Robert Smith, chairs the Board. The Board consists of four non-Executive Directors and four Executive Directors in addition to the Chairman, ensuring an appropriate balance of independence and experience.

Gregor Alexander, David Payne and Susan Rice come up for re-election at the forthcoming AGM. Following the performance evaluation reported on below, it is confirmed that the performance of all three Directors coming up for re-election continues to be effective and they have demonstrated commitment to their respective roles. In addition, David Payne and Susan Rice as non-Executive Directors, have the appropriate experience, knowledge, and independence to scrutinise effectively the performance of management. Biographical details for all the Directors are shown on pages 34 and 35.

Division of Responsibilities

The roles of the Chairman and the Chief Executive are separate and clearly defined and have been approved by the Board. The Chairman is responsible for the operation, leadership and governance of the Board and the Chief Executive for the management of Group business and the implementation of strategy and policy once agreed by the Board. In discharging his responsibility, the Chief Executive is advised and assisted by a number of committees including the Executive Committee comprising the senior management of the Group's main businesses.

Director Independence

All of the non-Executive Directors are considered to be independent according to the principles of the Combined Code.

The non-Executive Directors bring a wide range of skills and experience to the Group, including independent judgement on issues of strategy, performance, financial controls and systems of risk management.

The Senior Independent Director is the Deputy Chairman, David Payne. He is chairman of the Remuneration Committee and a member of the Audit and Nomination Committees.

The Chairman and non-Executive Directors met during the year without the executive management being present. The non-Executive Directors would consider meeting without the Chairman if there were concerns which the Chairman had failed to resolve or if there were any issues concerning his performance. The Directors are fully briefed in advance of all Board meetings on all matters to be discussed, including regular business and financial reports, and they also receive copies of analysts' and brokers' reports on the company.

The non-Executive Directors' appointment letters are available on the company's website (scottish-southern.co.uk).

In addition to the AGM, the Board had nine scheduled meetings during the year and meets more frequently as required. The attendance of Directors at Board meetings and meetings of its Committees during the year are set out in the table below. René Médori was unable to attend on two occasions due to a change to his external executive commitments. To facilitate a fuller understanding of the business and its people, Board meetings have been held throughout the year at various operational sites, and senior managers have had opportunities to present to the Board as well as to meet the Board on more informal occasions.

Directors' Attendance

	Board 9 meetings	Audit Committee 3 meetings	Nomination Committee 1 meeting	Remuneration Committee 7 meetings	Executive Committee 12 meetings	Risk Committee 12 meetings	Health, Safety and Environmental Committee 4 meetings
Gregor Alexander	9	–	–	–	12	12	–
Colin Hood	9	–	–	–	12	–	4
Ian Marchant	9	–	1	–	12	12	4
René Médori	7	3	–	6	–	–	–
David Payne	9	3	1	7	–	–	–
Alistair Phillips-Davies	9	–	–	–	12	12	–
Susan Rice	8	3	1	–	–	–	–
Kevin Smith	9	–	1	7	–	–	4
Sir Robert Smith	9	–	1	–	–	–	–

Board Procedures

The Board has a schedule of matters specifically reserved to it for decision, which includes strategic items, Board and Committee appointments and related governance matters, approval of the annual budget, Company Reports and Financial Statements, significant contracts and capital expenditure and certain key policies. The Board regularly reviews this schedule.

The Board receives detailed financial and operational information to allow it to monitor effectively the performance of the key areas of the business. It also receives regular updates on the progress and performance of investments and other major decisions made by it, together with regular business reports and presentations from senior management.

Any Director appointed by the Board during the year is subject to election at the first AGM following their appointment to the Board. Thereafter, in accordance with the Combined Code and the Articles of Association they are subject to re-election every three years.

All of the non-Executive Directors have been appointed for fixed terms of three years.

BOARD EFFECTIVENESS

Induction and Professional Development

Directors receive a comprehensive induction course on joining the Board, tailored to their individual requirements, which includes meetings with senior management, visits to key sites, and a meeting with the company broker and analysts. It also covers a review of all risks facing the Group including key operational issues such as safety and environmental performance.

During the year, the Board and its key committees received briefings on new developments affecting the Group's activities, such as the Government Energy Policy Review, corporate governance and regulatory developments, and financial reporting standards. Directors were also able to update their knowledge of the business through regular presentations by senior management on the full range of the Group's activities, and visits to key offices and operational sites. There is an agreed procedure for Directors to be able to take independent professional advice in the furtherance of their duties, if necessary, at the Group's expense and all Directors have access to the advice and services of the Company Secretary.

This year, an enhanced programme of performance coaching was developed for members of the Executive Committee, and this will be rolled out to senior managers of the Group. The purpose is to develop the Executive Directors and senior management and maximise individual and group performance to ensure that the business is managed effectively.

Performance Evaluation

During the year, the Chairman conducted a comprehensive evaluation of the performance of the Board, its six Committees and the individual Directors. The process used in previous years was developed this year to take forward the results of previous evaluations. Each Director completed a questionnaire which covered such areas as Board development, strategy, management of risk and corporate responsibility. The Chairman (and, where appropriate, the Chairmen of the Committees) then discussed these matters with each Director and the Company Secretary during a series of individual meetings. The outcome of this process was reported to the Board at its meeting on 26 January 2006. Following the review, a number of improvements were made to the Board and Committee procedures. However, the outcome was that generally the Board set clear objectives, it monitored performance well and was focused on the correct areas. This review will continue to be carried out on an annual basis. The Board was satisfied that the review of its performance was a worthwhile exercise and the Directors had participated in an open and frank basis.

Led by the Senior Independent Director, David Payne, the non-Executive Directors evaluated the performance of the Chairman.

BOARD COMMITTEES

The Board has six committees. The terms of reference of each Committee were reviewed as part of the evaluation process. The Company Secretary acts as Secretary of each of the Remuneration and Nomination Committees and the Deputy Secretary acts as Secretary of the Audit Committee. The terms of reference for all Committees are available on the Company's website (www.scottish-southern.co.uk).

AUDIT COMMITTEE

Role of the Committee

The principal responsibilities of the Audit Committee are:

- ensuring the financial reports represent an accurate, clear and balanced assessment of the company's position;
- monitoring the effectiveness of internal control and risk management in areas such as Energy Trading and Treasury;
- monitoring and reviewing the Group's internal audit function; and
- ensuring the independence of the external auditor.

The Chairman of the Committee reports to the Board following each Committee meeting on the main areas and subjects the Committee has reviewed such as risk management, internal control, internal audit reports and any issues arising from its review of Group Financial Statements.

Membership and Experience

All members of the Committee are independent non-Executive Directors. The membership of the Committee is as follows:

- René Médori (Committee Chairman);
- David Payne, (the Company's Senior Independent Director and Deputy Chairman); and
- Susan Rice.

The Board considers that the membership of the Audit Committee as a whole has sufficient recent and relevant financial experience to discharge its functions. René Médori has particular relevant financial experience in his executive career. Currently he is the Finance Director of Anglo American plc.

Evaluation of the Committee
As reported above, an evaluation of the performance of this Committee was carried out during the year. This evaluation also included the principal attendees of the Committee, namely the Finance Director, the Group Audit Manager and the external auditors.

Activities of the Committee in 2005/06
The Committee had three meetings during the year. Where appropriate other Directors, the internal and external auditors and senior management attended Committee meetings to present reports and respond to questions posed by the Committee.

Financial Statements
The Committee ensured that the annual and interim statements represented an accurate, clear and balanced assessment of the Group's position. It reviewed the effectiveness of the overall audit process and met with the external auditor and management separately to identify any areas of concern in the preparation of the financial statements.

During the year the Committee received briefings on new accounting developments, such as reports and presentations on the International Financial Reporting Standards and how those standards are expected to affect the Group's reported results.

Internal Financial Control and Risk Management Systems
The Committee considers areas where there could be significant risk such as Energy Trading and Treasury. Follow-up reports are also provided to the Committee to ensure appropriate actions are completed. The review by the Committee of the effectiveness of the company's internal financial control and risk management systems is described in the Internal Control and Risk Management section below.

External Auditors
The Committee has an established policy which restricts the engagement of the auditors for non-audit services. The policy details non-audit work from which the auditors are excluded, and other non-audit work which may be awarded to them in a competitive tender process where non-audit fees exceed a threshold of £30,000 for general advice and £75,000 for tax related advice. Where such non-audit work was awarded, the Committee was satisfied that it was best handled by the auditors because of their knowledge of the Group. The non-audit work awarded during the year included:

- International Financial Reporting Standards advice;
- taxation advice;
- accounting due diligence; and
- advice on the disposal of Thermal Transfer (their appointment followed a competitive tender).

The Committee is confident that the objectivity and independence of the auditors was not affected by this further work. It is clear from independent surveys that the company continues to award a low amount of non-audit work to its auditors KPMG, compared to most FTSE 100 companies. Full disclosure of the non-audit fees paid during the year is made in Note 3 to the Accounts.

The external auditors attended each committee meeting. In addition, the Committee met with the external auditors without the presence of management. During the year the Committee approved the terms of appointment of the external auditors and their remuneration. The Committee recommended to the Board that KPMG Audit Plc be proposed for reappointment, having been satisfied with the scope and results of the audit work, their objectivity and their independence. The Board endorsed the Committee's recommendation.

Internal Audit
The Committee reviews the plans and work of internal audit. The Group Audit Manager reports to the Committee on the audit programme, progress against the programme and any follow-up actions. Further details relating to internal audit can be found below in the section headed 'Internal Control and Risk Management'.

REMUNERATION COMMITTEE

The principal responsibilities of the Remuneration Committee are:

- formulation of remuneration policy and approval of all aspects of the Executive Directors' remuneration, including bonuses and the granting of incentives under the company's schemes;
- ensuring that an appropriate proportion of pay is linked to corporate and individual performance; and
- review and approval of the Chairman's fees.

During the year the Remuneration Committee met seven times.

All members of the Remuneration Committee are independent non-Executive Directors. The Committee is chaired by David Payne, with the other members being Kevin Smith and René Médori.

As part of the Committee evaluation process, the Chairman of the Committee sought the views of the Company Secretary and the Director of Human Resources.

Full details of Directors' remuneration, general policy and developments during the year are given in the Remuneration Report set out on pages 36 to 41.

NOMINATION COMMITTEE

The Nomination Committee reviews the composition and balance of the Board and following a formal and rigorous review recommends suitable candidates for appointment as Directors.

Membership of the Nomination Committee is made up of: three non-Executive Directors, David Payne, Susan Rice and Kevin Smith; the company Chairman, Sir Robert Smith (who chairs the committee); and Ian Marchant. Members do not take part in discussions about their own appointment.

During the year the Nomination Committee met on one occasion to review the current and future structure of the Board. After consideration it recommended the reappointment of Sir Robert Smith, Susan Rice and René Médori as Directors of the company for a further period of three years.

RISK COMMITTEE

The Risk Committee comprises Alistair Phillips-Davies (Chairman), Ian Marchant, Gregor Alexander and senior managers from Energy Trading, Electricity Generation and Finance. It met 12 times during the year to review and manage the operational and financial risks and exposures in Energy Trading, interest rates and currency markets. Following the Committee evaluation programme, the terms of reference of the Risk Committee were reviewed and updated. As a result of the review the authority levels for the approval of wholesale energy trading were revised to reflect current market conditions.

EXECUTIVE COMMITTEE

The Executive Committee comprises all the Executive Directors and other senior Group Executives. The Chairman is Ian Marchant, apart from meetings on operational performance matters, which are chaired by Colin Hood. It met 12 times during the year and was responsible for all key management issues arising from the business of the Group; the implementation of the Group strategy; and monitoring the operational and financial performance and assessing and reviewing risks arising from the Group's business.

HEALTH, SAFETY AND ENVIRONMENTAL ADVISORY COMMITTEE

The Committee met quarterly. It is responsible for ensuring that health, safety and environmental policies have been implemented, setting targets and monitoring performance, and promoting awareness of these issues throughout the Group.

Following the Committee evaluation programme the membership was revised, and the terms of reference updated, to reflect the strategic focus on these areas with primary responsibility remaining with management. The membership now comprises Colin Hood (Chairman), the Director of Human Resources, the Group Health, Safety and Environmental Manager and Kevin Smith, non-Executive Director.

INTERNAL CONTROL AND RISK MANAGEMENT

The Directors acknowledge that they have responsibility for the Group's systems of internal control and risk management and for monitoring their effectiveness. The purposes of these systems are to manage, rather than eliminate, the risk of failure to achieve business objectives, to provide reasonable assurance as to the quality of management information and to maintain proper control over the income, expenditure, assets and liabilities of the Group.

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 Group's businesses, to the materiality of the risks inherent in these businesses, and to the relative costs and benefits of implementing specific controls.

The Board and its Committees maintain an ongoing process of identifying, evaluating and managing the significant commercial, financial, social, ethical, environmental and general risks to the Group's business. Throughout the year, each business unit evaluates risks with the key risks being reflected in reports to the Board and/or the appropriate Committee. This process is regularly reviewed by the Board and, has been in place throughout the year up to the date of approval of the accounts. As part of this process the Audit Committee reviews the arrangements by which staff can, in confidence, raise concerns about any possible improprieties in financial and other matters.

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.

The main financial risk which the Group could face is in respect of interest rates and, to a lesser extent, inflation, foreign exchange, liquidity and credit. The Board reviews and agrees policies for addressing each of these risks. The key issue of exposure to energy prices and volume is addressed by the Risk Committee.

There is relatively little exposure to foreign currency risk as the United Kingdom is the Group's main area of operation. If either fuel or plant are contracted in foreign currency, it is the Group's policy to hedge all material purchases through the use of foreign currency swaps and forward rate contracts.

There is also the risk of mechanical or process failure in the Group's operations. Any material failure in the Group's licensed operations in electricity generation, transmission, distribution and supply and in the supply and storage of gas would be particularly significant. Operating risk is addressed through the Group's focus on seeking operational excellence and on maintaining the highest standards of safety and quality.

The Group is exposed to economic regulation and government policy. There are management structures in place to mitigate, influence and respond to such developments, and to engage with the Industry Regulator, government ministers and officials, and other key bodies.

There are established procedures in place for regular budgeting and reporting of financial information. The Group'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 Group 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 Group's operations are regularly assessed by the Board and the Audit Committee. The Risk Committee comprising three Executive Directors, together with senior managers, meets regularly to review risks and authority levels in key areas of the Group's activities.

Review of the System of Internal Control
The effectiveness of the Group's systems of internal control is monitored by the internal audit department which distributes reports and, where appropriate, action plans to senior managers, Directors and the external auditors. Throughout the year, the Audit Committee kept these systems under review reporting regularly to the Board. The Board during its annual review of the effectiveness of the Group's systems of internal control and risk management did not identify, nor was advised of, any failings or weaknesses which it has determined to be significant. Therefore a confirmation in respect of necessary actions has not been considered appropriate. The Board is satisfied that the Group complies with the Turnbull Guidance on Internal Control.

This process did not extend to joint ventures and associates for the purposes of this report, although the Group seeks to ensure such joint ventures and associates have appropriate corporate governance systems in place.

GOING CONCERN

The Directors consider that the Group has adequate resources to continue in operational existence for the foreseeable future. The Financial Statements are therefore prepared on a going concern basis.

COMMUNICATION WITH SHAREHOLDERS AND MAJOR BUSINESS STAKEHOLDERS

The Directors acknowledge the importance of communication with shareholders. There is a continuing programme of meetings between Executive Directors and institutional shareholders on a wide range of issues. The non-Executive Directors receive feedback on these meetings on a regular basis to allow them to form a view of the priorities and concerns of institutional investors.

All Directors were present at the Annual General Meeting in 2005 and all intend to be present at the Annual General Meeting in 2006 to answer shareholders' questions. The company's shareholders are widely distributed throughout the country. To ensure that the maximum number of shareholders have the chance to attend an AGM, its location is alternated between Scotland and the south of England.

The Chairman introduces the presentation of the company's interim and preliminary results to analysts and investors and he and the Senior Independent Director also meet with major shareholders from time to time.

In September 2005, the Board held its meeting in London and took the opportunity of hosting a meeting with representatives of a number of organisations which have an interest in the Group's activities in areas such as the environment, energy efficiency, and regulation. The purpose of this was to hear their views, suggestions, and any concerns and also to explain the Group's position on a wide range of business and policy issues.

The company promotes the use of electronic communications with shareholders. For all shareholders who have opted for this service where they can view documents online and lodge their proxy vote over the internet, the company has undertaken to plant a native species tree in a designated woodland. To date 10,000 trees have been planted. The next phase of tree planting will take place later this year.

The company also runs a dividend reinvestment plan, details of which can be found on the company's website.

Shareholders can access Investor Centre, a free-internet based service provided through the registrar where shareholders can view their shareholdings, update their details and manage their share portfolio online. In addition shareholders can make use of the share dealing service also provided through the registrar. Details of both services can be found on the company's website.

To ensure that shareholders have easy access to as much information as possible, the new company website (scottish-southern.co.uk) contains financial and other information about the Group, including shareholder presentations, stock exchange announcements, and general business news. In addition, the website contains information relating to the governance of the company, including the Memorandum and Articles of Association, the schedule of matters reserved to the Board, the terms of reference for each Board Committee and the letters of appointment for the non-Executive Directors.

Directors' Biographies and Responsibilities

Ian Marchant David Payne Sir Robert Smith Alistair Phillips-Davies René Médori Gregor Alexander

Sir Robert Smith
(61) Chairman

Sir Robert joined the Board as a non-Executive Director in June 2003 and was appointed Deputy Chairman in November 2003. He became Chairman following the retirement of Dr Bruce Farmer on 31 December 2004. He is Chairman of The Weir Group plc and a non-Executive Director of 3i Group plc, Standard Bank Group Limited, and Aegon UK plc. Sir Robert was formerly Chief Executive of Morgan Grenfell Asset Management Limited, a member of the Financial Services Authority and the Financial Reporting Council, a Governor of the BBC, a Board Trustee of the British Council and Chairman of Stakis plc. He is Chairman of the Nomination Committee.

Ian Marchant
(45) Chief Executive

Ian was appointed Chief Executive in October 2002 having been Finance Director since 1998. He joined Southern Electric in 1992 and joined the Board on becoming Finance Director in 1996. Previously he worked for Coopers & Lybrand (now PwC), including a two-year secondment to the Department of Energy working on electricity privatisation. Ian is Chairman of the United Kingdom Business Council for Sustainable Energy, a member of the Forum for Renewable Energy Development in Scotland, Ofgem's Environmental Advisory Group and the Energy Research Partnership. Ian is a non-Executive Director of Maggie's Cancer Centres and was appointed as a non-Executive Director of John Wood Group PLC on 18 May 2006. He is a member of the Nomination Committee and is lead Director for Corporate Responsibility.

Gregor Alexander
(43) Finance Director

Gregor joined the Board of Scottish and Southern Energy as Finance Director in October 2002. He was appointed Group Treasurer and Tax Manager in 1998 having held a number of senior positions within the Finance team. He worked with accountants Arthur Andersen for five years before joining Scottish Hydro Electric in 1990, six months before privatisation. Gregor is a Director of Scotia Gas Networks plc.

Colin Hood
(51) Chief Operating Officer

Colin joined the Board of Scottish and Southern Energy as Power Systems Director in January 2001, becoming Chief Operating Officer in October 2002. Previously he was Director of Distribution for Southern Electric, having joined the industry with the North of Scotland Hydro Electric Board in 1977. He is Chairman of Scotia Gas Networks plc and a Fellow of the Institute of Electrical Engineers. Colin is the lead Director for the Environment and Health and Safety matters and has Board level responsibility for Generation, Power Systems, Customer Service, Human Resources, I.T. and Contracting.

René Médori
(48) Audit Committee Chairman

René joined the Board as a non-Executive Director in June 2003. He is Finance Director of Anglo American plc and is a non-Executive Director of AngloGold Ashanti and DB (De Beers) Investments. He is a former Finance Director of the BOC Group plc, and previously worked for Accenture and Schlumberger Limited. He is Chairman of the Audit Committee and a member of the Remuneration Committee.

David Payne
(63) Deputy Chairman

David joined the Board as a non-Executive Director of Scottish Hydro Electric in June 1998 and became Deputy Chairman in January 2005. He held a number of senior positions with the BP Group and was Deputy Chief Executive of BP Oil. He is the Senior Independent Director, Chairman of the Remuneration Committee and a member of the Audit and Nomination Committees.

Kevin Smith Colin Hood Susan Rice

Alistair Phillips-Davies
(38) Energy Supply Director
Alistair joined the Board in January 2002. He was previously Director of Energy Supply Operations, overseeing the introduction of the New Electricity Trading Arrangements. He joined Southern Electric in February 1997 having previously worked for HSBC and the National Westminster Bank in corporate finance and business development roles. He is a Chartered Accountant and a Director of the Energy Retail Association. Alistair is Chairman of the Risk Committee and has Board level responsibility for Energy Trading, Electricity and Gas Supply, Marketing and Energy Services.

Susan Rice CBE
(60) Non-Executive Director
Susan joined the Board as a non-Executive Director in July 2003. She is Chief Executive of Lloyds TSB Scotland plc, having previously been Managing Director, Personal Banking, for the Bank of Scotland. Susan is a member of the Audit and Nomination Committees.

Kevin Smith CBE
(51) Non-Executive Director
Kevin joined the Board as a non-Executive Director in June 2004. He is Chief Executive of GKN having previously been Managing Director, Aerospace. Prior to GKN, he held various positions in BAE Systems over a 20-year period, latterly as Group Managing Director – New Business. Kevin is a Vice-President of The Society of Motor Manufacturers and Traders Ltd, and Deputy President of The Society of British Aerospace Companies Ltd. He is a member of the Nomination and Remuneration Committees.

Statement of Directors' Responsibilities in Respect of the Annual Report and the Financial Statements

The Directors are responsible for preparing the annual report and the group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare Group and parent company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRS as adopted by the EU and have elected to prepare the parent company financial statements on the same basis.

The Group and company financial statements are required by law and IFRS as adopted by the EU to present fairly the financial position of the Group and the parent company and the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of the Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the Group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRS as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent company will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have a general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulation, the Directors are also responsible for preparing a Directors' Report, Directors' Remuneration Report and the Corporate Governance Statement that comply with that law and those regulations.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The following is the report of the Board of Directors in compliance with the Directors' Remuneration Report Regulations 2002 (the Regulations).

The Remuneration Committee
The Remuneration Committee is a Committee of independent non-Executive Directors, the members of which are David Payne, who chairs the Committee, René Médori and Kevin Smith. Biographical details of the current Committee members are given on pages 34 and 35. During the year, the Committee met on seven occasions, with full attendance at all meetings apart from the meeting held on 29 June 2005 which René Médori was unable to attend. The company Chairman attends the meetings of the Committee by invitation but does not do so when the review of his fees is being considered. The Terms of Reference of the Committee were reviewed during the year as part of the Committee evaluation process, to ensure they conform to best practice, and they are available on the company's website scottish-southern.co.uk.

The Committee sets the overall remuneration policy and determines, on behalf of the Board, the detailed remuneration terms of the Executive Directors including their service contracts. It also reviews the remuneration of the Chairman and the Company Secretary. The Board as a whole reviews the fees of the non-Executive Directors. Where requested by the Committee the Chief Executive, Ian Marchant, attends and assists the Committee in respect of those Directors reporting to him. He does not participate in decisions regarding his own remuneration. The Director of Human Resources, Jim McPhillimy, provides information and advice on various issues relating to the Directors' remuneration, including comparative data drawn from published remuneration and benefit surveys, and advice on appropriate awards of bonuses and long-term incentives.

The Company Secretary, Vincent Donnelly, provides information to the Committee on developments in corporate governance guidelines as they affect Committee business. During the year, the Committee appointed the actuaries, Hymans Robertson, to advise them on the implications of legislative changes to pensions. Hymans Robertson are the actuaries to the Scottish Hydro-Electric Pension Scheme. The Committee also received advice from Towers Perrin on remuneration package structures and in particular received advice from them and from Freshfields Bruckhaus Deringer on the new Performance Share Plan. Both Towers Perrin and Freshfields Bruckhaus Deringer were appointed by the company on behalf of the Committee.

Company Policy on Executive Directors' Remuneration
The Remuneration Committee's composition, responsibilities and operation comply with Section B of the Combined Code issued by the Financial Reporting Council. In forming remuneration policy, the Committee has given full consideration to the best practice provisions set out in Section B1 of the Combined Code.

This report sets out the company's policy on Executive Directors' remuneration for the year ended 31 March 2006 and, so far as is reasonable, for subsequent years. The Committee considers that a successful remuneration policy needs to be sufficiently flexible to take account of future changes in the company's business environment and in remuneration practice. Any changes in policy for years after 2006 will be described in future Remuneration Reports, which will continue to be subject to shareholder approval.

The company's policy is to attract, retain and incentivise Executive Directors to run the company effectively and meet the expectations of shareholders whilst adopting a conservative and prudent approach to overall remuneration. This has been achieved by providing remuneration consisting of basic salary, benefits, an Annual Bonus Scheme and a Deferred Bonus Scheme both of which require the achievement of demanding performance targets.

During the year, the Committee undertook a comprehensive review of the company's performance-related incentive arrangements in the light of developments in best practice in this area. As a result of this review, the Committee considers that the current remuneration policy is more geared towards short-term performance than it thinks desirable. Following consultation with the company brokers Merrill Lynch, and with the ABI, RREV, and major shareholders, the Committee proposes to replace the current Deferred Bonus Scheme with a redesigned annual bonus plan and a new long-term incentive plan, the Performance Share Plan (PSP). The objective of these proposals is not to increase the overall remuneration package but rather to enhance the extent to which the remuneration package is genuinely forward looking as well as requiring deferral of a portion of annual bonus into shares for retention purposes. Once the transition from Deferred Bonus Scheme to PSP is effective, the Committee expects that total remuneration for median performance will remain unchanged, but the expected value of total remuneration for upper quartile performance will increase by around 10%. Excluding pensions, half of the total remuneration for target performance is variable. Approval of the PSP will be sought at the AGM, and further information is set out in this report and in the explanatory notes accompanying the Notice of AGM.

The company has had in place, on a contingency basis, a formal policy for rewarding performance defined as 'exceptional'. The policy was that a further bonus of up to a maximum of 75% of base salary may be paid, with a proportion being paid in shares. Any such bonus would not be pensionable. The option of awarding such a bonus would only have been considered in truly exceptional circumstances. No such payment was made during the year, nor in previous years. As part of the new bonus and PSP arrangements, it is proposed that this exceptional bonus policy be dropped.

The Committee is fully aware of the need to ensure there is an appropriate relationship between Executive Director remuneration and the levels of remuneration of other Senior Management within the Group. The Committee continues to take account of this when reviewing Executive Director remuneration.

Shareholding Policy
Share ownership is encouraged throughout the Group. The company has adopted a policy that the Executive Directors and certain other senior Executives should acquire and maintain a level of shareholding approximately equivalent to one year's salary. This level should be attained within a reasonable timescale. Consent to sell shares under the company's Share Dealing Code is not normally given (unless in exceptional circumstances or to fund a connected tax liability) until this level of shareholding is reached. It is also expected that all non-Executive Directors should hold a minimum of 2,000 shares in the company.

Annual Salary and Benefits
The Committee continues to follow the broad principle that salaries should take account of those in comparable companies with variations to reflect individual performance, experience and job size. Salary and benefits levels are generally set below median, while having regard to retention objectives.

As part of the current review of remuneration, the Committee considered independent salary survey data and also the advice of Towers Perrin. Both the data and advice of Towers Perrin confirmed that the overall levels of remuneration continued to be well below median, and the Committee was satisfied that in order to maintain an effective retention regime, salaries should increase whilst remaining within the prudent, below median, policy approach. The Executive Directors' salary increases with effect from 1 January 2006 were therefore in the range 10%-15%. The current annual base salary levels for the Executive Directors are as follows: Ian Marchant £660,000; Gregor Alexander £345,000; Colin Hood £495,000; Alistair Phillips-Davies £345,000.

The Committee is satisfied that, subject to approval of the new PSP at the forthcoming AGM, the overall remuneration structure is set at a level which is reasonable and appropriate.

Current Incentive Arrangements
Annual Bonus
The 2005/06 Annual Bonus Scheme for Executive Directors provides for cash bonuses of up to a maximum of 75% of basic salary, attributable approximately two-thirds to corporate performance based on achievement of profit targets and one-third to personal objectives. The bonuses are non-pensionable. The personal objectives are based on a wide range of specific business activities. Whilst the specific targets are commercially confidential, they include objectively measurable improvements in areas such as:

- → improvement in Group safety performance;
- → reduction in customer complaints;
- → exceeding network quality of supply targets;
- → delivery of specific business plans;
- → achievement of further efficiency savings;
- → successful delivery of results from recent acquisitions;
- → improvement in the number of customer gains and reduction of customer losses; and
- → delivery of major projects on or ahead of schedule.

The company's performance in all these areas is described in the Chief Executive's Statement and the Directors' Statement on pages 8 to 25 of this Annual Report. The majority of targets set are operational in nature, set against measurable and verifiable data either within the Group or more generally within the energy sector. However, some targets are set which require some subjective assessment. This is done by the Chief Executive and reported by the Director of Human Resources to the Committee for consideration, except in the case of targets for the Chief Executive himself, where they are assessed by the Committee, with assistance from the Director of Human Resources and the company Chairman.

To achieve the maximum corporate element of bonus, performance had to exceed by 10%, the budgeted profit before tax target which is approved by the Board as part of the annual budget. This represents a more stretching target than applied in previous years. No corporate element of the bonus would have been payable if performance had fallen below 90% of target.

Deferred Bonus Scheme
The Deferred Bonus Scheme, which applies to Executive Directors and a selection of senior managers, is designed to contribute to increasing shareholder return and motivation of senior management over the longer-term. It also facilitates the building of share ownership in the company.

Directors are granted awards based on their actual annual bonus. Therefore, if the annual bonus were to be zero, there would be no award under the Deferred Bonus Scheme. The value of the award is adjusted by reference to three retrospective factors: the company's relative performance in terms of Total Shareholder Return (TSR) over the three-year period to the date of the award (compared to the FTSE 100); Safety (which is externally verified and compared to other energy companies by the Electricity Networks Association); and relative performance in terms of Account and Billing Complaints, as recorded by the independent regulatory body, energywatch. Dependent on actual performance each factor gives a multiplier of between 0.7 and 1.35 with the highest multiplier requiring upper quartile performance. A weighted average is then taken using TSR (40%), Safety (40%) and Account and Billing Complaints (20%), to create a single factor which is then applied to the award. The award in 2005 applied the factor of 1.35. The resultant amount is then used to determine the number of shares to be awarded based on the market value of the shares at the time of the award. The requisite shares are purchased in the market by the independent trustees of the company's Employee Share Ownership Trust and held in trust for three years, at which point the participant is entitled to realise the award. Upon realisation, the participant usually receives additional shares representing the dividends paid on the shares during the three-year period they are held in trust. The performance conditions were chosen because they were closely aligned with the interests of shareholders, customers and staff.

If a participant resigns voluntarily in the three years following award, all outstanding awards lapse (rather than 50% of the awards, which was the position until 2003). The shares under award can normally vest after three years, but can vest earlier in certain exceptional circumstances such as retirement or redundancy.

Awards will be granted in June 2006 in accordance with the current policy and based on performance until March 2006. If the new Performance Share Plan is approved by shareholders, no further awards to Executive Directors will be made.

Proposed Future Incentive Arrangements
Following the Committee's review of performance related remuneration, the following changes are proposed for 2006/07 and future years. It is proposed that contingent awards under the new PSP commence in 2006 with a performance period from April 2006 to March 2009, and that the new Annual Bonus arrangements are operated from 2007 based on the annual bonus payable in respect of 2006/07.

The contingent awards will only vest if performance meets the demanding criteria described below.

Annual Bonus Scheme
The maximum bonus level for any year will be increased from 75% to 100% of base salary and will comprise 60% for corporate performance, 25% for personal objectives and 15% for relative safety and service standards based on externally verified data from the relevant trade association and energywatch. Of the bonus so determined, 75% will be paid in cash (so that cash payout is broadly the same as under the current scheme), and the remainder will be compulsorily deferred into shares which will only vest, subject to continued service, after three years. The number of shares under an award will be determined by dividing the relevant pre-tax amount of bonus by the share price shortly after announcement of results for the Financial Year to which the bonus relates. The share awards will be satisfied by a transfer of shares from the Employee Share Ownership Trust.

For the year 2006/07, the maximum corporate element remains payable if performance exceeds by 10% or more the budgeted profit before tax target, but no corporate element will be payable if performance falls below 95% of this target (formerly 90%).

Individual targets for the Annual Bonus Scheme have been set using the same approach as 2005/06 save that the current targets have now been reviewed by the Committee and made more demanding.

The Committee will cease to have a discretion to award an exceptional bonus (as described above).

Performance Share Plan (PSP)

Subject to shareholder approval at the AGM in 2006, it is proposed that the PSP will replace the existing Deferred Bonus Scheme.

Under the PSP, the maximum value of share awards made to Executive Directors and other Senior Executives each year is 100% of base salary. Awards will vest after three years to the extent that performance conditions are met. One-half of the award is subject to a TSR target relative to other FTSE 100 companies. For full vesting, the company's TSR must be at or above the 75th percentile over the three-year performance period. 30% of this element of the award will vest if the company's TSR is at the median. Awards will vest on a straight-line pro rata basis between median and 75th percentile. Awards based on TSR will only vest if the Committee is also satisfied with the underlying financial performance of the company over the performance period. The remaining one-half of the award will be subject to an adjusted earnings per share (EPS) growth target. For the three-year cycle commencing in 2006/07, full vesting will occur if the annual growth in adjusted EPS is equivalent to 8% above RPI per annum. 30% vesting will occur if the annual growth in adjusted EPS is equivalent to 3% above RPI per annum, with vesting on a straight-line basis between 3% and 8% above RPI. There will be no vesting of the relevant portion of award if the TSR minimum target of median is not achieved, or if the minimum real annual growth of EPS is not achieved.

The Committee considers the use of two measures, in these proportions, to be appropriate. The TSR performance measure is dependent on the company's relative long-term share price performance, and therefore brings a market perspective to the PSP. Furthermore vesting of this element requires the Committee to be satisfied with the underlying financial performance of the company. The TSR measure is balanced by a key internal measure, adjusted EPS growth, which is critical to the company's long-term success and ties in with its strategic goals. The Committee considers that the achievement of annual adjusted EPS growth of 8% above RPI per annum is a suitably demanding target for maximum vesting in light of the regulatory regime in which the company operates and on the basis of independent advice. The target range has been set in the light of consensus expectations and the company's own forecasts. The Committee believes that for 2006/07 this target range strikes the right balance between being stretching at the top end, and being achievable and motivational at the lower end. The Committee may set different vesting levels in future years for the EPS or TSR elements in order to ensure that the target remains sufficiently stretching. There will be no retesting of either the TSR or EPS performance measures. Further information is contained in the explanatory notes accompanying the Notice of AGM which includes details on the consequences of leaving employment, and change of control arrangements.

All-Employee Share Schemes

Executive Directors are eligible to participate in the company's all-employee share schemes on the same terms as other employees. These schemes comprise:

(a) the Sharesave Scheme, a savings-related share option scheme available to all employees. This scheme operates within specific tax legislation (including a requirement to finance exercise of the option using the proceeds of a monthly savings contract of up to £250 per month), and, in common with all such schemes, exercise of the option is not subject to satisfaction of a performance target. The option price is set at a discount of 10% to market value; and

(b) the Share Incentive Plan (the SIP), also available to all employees, under which employees allocate part of their pre-tax salary to purchase shares up to a maximum of £125 per month. The SIP operates within specific tax legislation. During the year, the company matched the first five shares purchased by the participating employees each month and intends to continue to do so. The company also offered 50 free shares to all eligible employees during the year, with no performance conditions attached, in recognition of the contribution of all staff to the performance of the Group.

In the past, the company operated a Discretionary Share Option Scheme, under which Senior Executives and staff were awarded options over shares. This scheme has now been terminated. No options have been granted under this scheme since 1998, and all options granted to Executive Directors have been exercised or have lapsed.

Service Contracts

It is the company's policy that Executive Directors should have service contracts with the company which are terminable on 12 months' notice given by either party. The key aspects of each contract are as follows:

The Executive Directors are employed under service contracts with the company each dated 11 March 2005. They are eligible under the contracts to participate in the company's Executive Directors' bonus scheme, the company's Sharesave or other employee share schemes and profit sharing schemes (if any). They are each entitled to a company car (or a cash allowance), membership of the company's pension scheme including life assurance cover equal to four times salary, and private health insurance which also covers dependants.

The contracts are each for an indefinite term ending automatically on retirement date (expressed to be age 60), but may be terminated by 12 months' notice given by the company or by 12 months' notice given by the Director. The company may at its discretion elect to terminate any Executive Director's contract by making a payment in lieu of notice equal to the basic salary which would have been received during the notice period (excluding any bonus and any other emolument referable to the employment). Payments in lieu of notice will be made in staged payments, and such payments will either reduce or cease completely in circumstances where the departing Executive Director gains new employment. There is also a specific provision obliging the departing Executive to mitigate his/her loss in these circumstances. There are no special provisions applying in the event of change of control.

Remuneration and Pensions

The remuneration of Directors who served during the year was as shown below. All the Executive Directors participate in either the Southern Electric Pension Scheme or the Scottish Hydro-Electric Pension Scheme, which are funded final salary pension schemes. The Directors' service contracts provide for a possible maximum pension of two-thirds final salary at age 60. In relation to Executive Directors who are subject to the earnings cap imposed by the Finance Act 1989 (broadly, those becoming employed by a Group company since 1989), the company provides top-up (unfunded) arrangements which are designed to provide an equivalent pension on retirement at age 60 to that which they would have earned if they had not been subject to the earnings cap.

During the year, the Committee considered the potential impact of legislative changes on pensions' policy. From April 2006, current HM Revenue & Customs limits will cease to apply to benefits provided by the pension schemes. If a member's accrued fund exceeds the new lifetime allowance ('LTA'), the benefits payable by the scheme from that excess will be subject to a higher rate of income tax. The company intends to maximise the use of the new allowance thereby providing Executive Directors with more of their existing benefits via registered schemes. In the case of Colin Hood, who was not subject to the previous earnings cap but is now limited by the LTA, further accrual will be via an unfunded top-up arrangement. There will be no arrangements to compensate members for any change in their personal tax liability. The Committee takes the view that the overall approach meets its objective of fulfilling existing contractual obligations in a cost effective way.

Non-Executive Directors

The remuneration of non-Executive Directors, apart from the company Chairman, is determined by the Board, with the non-Executive Directors concerned not participating in this process. The non-Executive Directors do not have service contracts but instead have letters of appointment. They are appointed for fixed terms of three years, subject to retirement by rotation and re-election at AGMs in terms of the company's Articles of Association. They do not participate in the Annual Bonus Scheme, Deferred Bonus Scheme, any of the share option schemes, or contribute to any Group pension scheme. The Chairman of the Audit Committee receives an additional fee of £10,000, and the non-Executive Directors who are members of the Audit Committee receive an additional annual fee of £5,000 in respect of their responsibilities as members of that Committee. The non-Executive Director who is a member of the Health, Safety and Environmental Advisory Committee receives a fee of £5,000.

Performance Graph

The following graph charts the cumulative Total Shareholder Return of the company since 1 April 2001 compared to the FTSE 100 Index over the same period. The company is a member of the FTSE 100 index, and this was considered to be the most relevant index for comparative purposes.

Total Shareholder Return

The auditors are required to report on the information contained in tables A, B and D.

Table A – Directors' Emoluments

The emoluments of each of the Directors were as follows:

	Salary/fee £000	Bonuses £000	Benefits £000	Total 2006 £000	Total 2005 £000
Executive Directors					
Ian Marchant	615	409	16	1,040	803
Gregor Alexander	311	207	13	531	403
Colin Hood (i)	461	297	14	772	600
Alistair Phillips-Davies	311	207	13	531	404
Non-Executive Directors					
Henry Casley (ii)	6	–	–	6	38
René Médori	44	–	–	44	43
David Payne	64	–	–	64	44
Susan Rice	39	–	–	39	38
Kevin Smith (iii)	36	–	–	36	26
Sir Robert Smith(Chairman) (iv)	218	–	–	218	99
Former Directors					
David Sigsworth (v)	0	–	–	0	449
Bruce Farmer (vi)	0	–	–	–	177
Sir Graeme Odgers (vii)	0	–	–	0	7
	2,105	1,120	56	3,281	3,131

(i) During the year Colin Hood was paid £67,431 in respect of relocation expenses.
(ii) Retired from the Board 17 May 2005.
(iii) From date of appointment to the Board on 24 June 2004.
(iv) 2005 figure reflects appointment as Chairman from 1 January 2005.
(v) Following his retirement from the Board on 31 March 2005, David Sigsworth has provided consultancy services to the company in the Energy Services business and represents the company in general industry forums. He received £105,000 for the provision of these services during the year. These consultancy services have been extended with a reduced time commitment until September 2006.
(vi) Retired from the Board on 31 December 2004.
(vii) Retired from the Board on 18 May 2004.

Table B – Retirement Benefits
Details of Directors' retirement benefits are as follows:

		Accrued benefit			Transfer value of accrued benefit			
			Increase in year					
	Years of industry service	**At 31 March 2006 £000**	Including inflation	Excluding inflation	**At 31 March 2006 £000**	At 31 March 2005 £000	Increase less Directors' contributions £000	Increase in year excluding inflation £000
Ian Marchant	14	**199**	42	37	**2,944**	1,877	1,051	546
Gregor Alexander	15	**103**	22	20	**1,329**	808	505	259
Colin Hood	28	**207**	41	36	**3,424**	2,093	1303	488
Alistair Phillips-Davies	9	**69**	17	15	**797**	459	322	179

Members of the pension schemes have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the above table. The normal retirement age of Executive Directors is 60.Their service contracts provide for a maximum pension of two-thirds of final salary. This was unchanged during 2005/06. The following is information relating to the Director's pension of Gregor Alexander as participant in the HMRC approved Scottish Hydro-Electric Pension Scheme:

(i) Dependants' pensions on death are half of members' pension entitlements, together with a capital sum equal to four times pensionable pay. On death in retirement, the Director's spouse will receive a pension equal to half of that payable to the Director. In addition, on death within the first five years of retirement, a lump sum is payable equal to the balance outstanding of the first five years' pension payments.
(ii) All benefit payments are guaranteed to increase annually by the same percentage as state pensions, which are currently linked to movements in the UK Retail Price Index.

The following is information relating to the Directors' pensions of Colin Hood, Ian Marchant and Alistair Phillips-Davies, as participants in the HMRC approved Southern Electric Group of the Electricity Supply Pension Scheme:

(i) Dependants' pensions on death are four-ninths of the member's pensionable pay, together with a capital sum equal to four times pensionable pay. If death occurs after attaining the age of 55 an additional lump sum between three to five times notional pension is payable dependent upon age and length of service. On death in retirement, the Director's spouse will receive a pension equal to two-thirds of that payable to the Director. In addition, on death within the first five years of retirement, a lump sum is payable equal to the balance outstanding of the first five years' pension payments.
(ii) Post retirement increases are expected to be in line with inflation (guaranteed up to the level of 5% per annum and discretionary above that level).

Ian Marchant, Alistair Phillips-Davies and Gregor Alexander have unfunded retirement benefits for salary above the Inland Revenue cap which are included in their pension benefits above with provision in respect of their accrued value included in the company's Balance Sheet.

Table C – Directors' Interests
The interests of the Directors, all of which are beneficial, in the ordinary shares of the company on the dates shown were as follows:

	31 March 2006		1 April 2005	
	Shares held	**Shares under option**	Shares held	Shares under option
Gregor Alexander	**13,034**	**48,161**	9,279	42,047
Colin Hood	**24,896**	**88,640**	21,651	64,016
Ian Marchant	**73,155**	**103,224**	64,580	80,198
René Médori	**2,000**	**0**	2,000	0
David Payne	**8,000**	**0**	8,000	0
Alistair Phillips- Davies	**20,498**	**50,754**	13,144	40,120
Susan Rice	**4,000**	**0**	2,000	0
Kevin Smith	**2,000**	**0**	2,000	0
Sir Robert Smith	**15,800**	**0**	15,800	0

From 31 March 2006 to 30 May 2006, the following changes to the interests of Directors took place:

Under the Share Incentive Plan, on 28 April 2006, Ian Marchant, Colin Hood, Gregor Alexander and Alistair Phillips-Davies each acquired 16 shares.

A further analysis of the Directors' shares under option as at 31 March 2006, and options granted and exercised during the year, is set out below.

The Register of Directors' Interests (which is open to shareholders' inspection) contains full details of Directors' shareholdings and options to subscribe for shares.

Table D – Directors' Share Options

	Option scheme	Options at 1 April 2005	Awarded during year	Options exercised	Closing price at date of exercise (pence)	Options at 31 March 2006	Weighted average option price per share (pence)	Normally exercisable
Ian Marchant	Savings related	2,253	0	0	–	2,253	607	10/06-03/10
	Deferred Bonus	77,945	35,107	14,063	970.5	100,971	*	7/06-7/15
Colin Hood	Savings related	3,543	1,492	2,947	–	2,088	795	12/06-3/11
	Deferred Bonus	60,473	26,079	0	970.5	86,552	*	7/06-7/15
Gregor Alexander	Discretionary	10,000	0	10,000	962	0	547	–
	Savings related	2,330	0	0	–	2,330	578	10/08-03/10
	Deferred Bonus	29,717	17,386	1,477	970.5	45,831	*	7/06-7/15
Alistair Phillips-Davies	Savings related	3,684	1,865	3,684	–	1,865	886	10/10-03/11
	Deferred Bonus	36,436	17,386	5,740	970.5	48,889	*	7/06-7/15

* £1 per grant. No price was paid for the award of any option.

Shares exercised under the Deferred Bonus Scheme included the following arising from dividend reinvestment: Ian Marchant – 1,982 shares, Alistair Phillips-Davies – 807 shares, Gregor Alexander – 205 shares.

The closing market price of the shares at 31 March 2006 was 1132.5p and range for the year was 879.25p to 1174.25p. The options granted during the year were granted under either the Deferred Bonus Scheme or the Savings-related Scheme.

The aggregate amount of gains made by Directors on the exercise of share options during the year was £284,723 (2005 – £242,497). Under the Deferred Bonus Scheme, the aggregate value of the shares placed in trust for Directors in the year to 31 March 2006 was £972,294 (2005 – £784,597). The aggregate amount of gains made by the highest-paid Director, Ian Marchant was £136,481 (2005 – £105,851). In accordance with the company's policy for retiring participants, the award to David Sigsworth (who retired from the Board on 31 March 2005) was satisfied in cash (£177,188) rather than by an award of shares under the Deferred Bonus Scheme.

This report was approved by the Board and signed on its behalf by:

David Payne
Remuneration Committee Chairman
30 May 2006

Independent Auditors' Report

to the members of Scottish and Southern Energy plc

We have audited the Group and Company financial statements (the financial statements) of Scottish and Southern Energy plc for the year ended 31 March 2006 which comprise the Consolidated Income Statement, the Consolidated and Company Balance Sheets, the Consolidated and Company Cash Flow Statement, the Consolidated and Company Statement of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective Responsibilities of Directors and Auditors

The Directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and International Financial Reporting Standards as adopted by the EU (adopted IFRS) are set out in the Statement of Directors' Responsibilities on page 35.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Directors' Statement that is cross referenced from the Business Review section of the Directors' Report. We also report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of Audit Opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

- → the information given in the Directors' Report is consistent with the financial statements;
- → the consolidated financial statements give a true and fair view, in accordance with adopted IFRS, of the state of the Group's affairs as at 31 March 2006 and of its profit for the year then ended;
- → the Company financial statements give a true and fair view, in accordance with adopted IFRS as applied in accordance with the provisions of the Companies Act 1985, of the state of the Company's affairs as at 31 March 2006; and
- → the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

KPMG Audit Plc
Chartered Accountants
Registered Auditor
Edinburgh
30 May 2006

Consolidated Income Statement

for the year ended 31 March 2006

	Note	2006 Before exceptional items and certain re-measurements £m	2006 Exceptional items and certain re-measurements (note 4) £m	2006 Total £m	2005 Before exceptional items and certain re-measurements £m	2005 Exceptional items and certain re-measurements (note 4) £m	2005 Total £m
Revenue	2	10,145.2	–	10,145.2	7,424.6	–	7,424.6
Cost of sales		(8,816.4)	(14.4)	(8,830.8)	(6,257.2)	(61.0)	(6,318.2)
Gross profit		1,328.8	(14.4)	1,314.4	1,167.4	(61.0)	1,106.4
Operating costs	3	(482.4)	–	(482.4)	(407.6)	–	(407.6)
Other operating income	4	–	92.1	92.1	–	111.2	111.2
Gain on disposal of subsidiary	14	–	18.6	18.6	–	–	–
Operating profit before jointly controlled entities and associates		846.4	96.3	942.7	759.8	50.2	810.0
Jointly controlled entities and associates:							
Share of operating profit		167.1	16.7	183.8	50.8	22.3	73.1
Share of interest		(97.3)	–	(97.3)	(17.2)	–	(17.2)
Share of movement on derivatives		-	(13.0)	(13.0)	–	–	–
Share of tax		(28.8)	(1.1)	(29.9)	(8.6)	(6.7)	(15.3)
Share of profit on jointly controlled entities and associates	12	41.0	2.6	43.6	25.0	15.6	40.6
Operating profit	2	887.4	98.9	986.3	784.8	65.8	850.6
Finance income	6	164.9	–	164.9	126.8	–	126.8
Finance costs	6	(210.8)	(43.5)	(254.3)	(188.1)	–	(188.1)
Profit before taxation		841.5	55.4	896.9	723.5	65.8	789.3
Taxation	7	(244.3)	(10.3)	(254.6)	(209.0)	(20.5)	(229.5)
Profit for the year		597.2	45.1	642.3	514.5	45.3	559.8
Attributable to:							
Equity holders of the parent		597.2	45.1	642.3	514.6	45.3	559.9
Minority interest		–	–	–	(0.1)	–	(0.1)
		597.2	45.1	642.3	514.5	45.3	559.8
Basic earnings per share (pence)	9			74.7p			65.3p
Diluted earnings per share (pence)	9			72.9p			64.5p
Dividends paid in the year (£m)	8			£378.8m			£330.8m

The accompanying notes are an integral part of these financial statements.

Balance Sheets

as at 31 March 2006

	Note	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Assets					
Property, plant and equipment	11	**4,646.6**	4,386.1	**–**	–
Intangible assets:					
Goodwill	10	**293.4**	292.6	**–**	–
Other intangible assets	10	**297.2**	107.8	**–**	–
Investments in associates and jointly controlled entities	12	**703.1**	212.0	**521.9**	–
Investments in subsidiaries	13	**–**	–	**777.9**	777.9
Other investments		**3.3**	1.4	**–**	–
Trade and other receivables	16	**–**	–	**1,794.3**	2,197.0
Retirement benefit assets	27	**90.2**	98.9	**90.2**	98.9
Deferred tax assets	22	**86.0**	97.9	**–**	–
Derivative financial assets	29	**24.8**	–	**–**	–
Non-current assets		**6,144.6**	5,196.7	**3,184.3**	3,073.8
Inventories	15	**164.2**	134.1	**–**	–
Trade and other receivables	16	**1,662.9**	1,073.7	**1,083.1**	637.4
Cash and cash equivalents	17	**49.9**	232.2	**25.7**	199.6
Derivative financial assets	29	**157.6**	–	**-**	–
Current assets		**2,034.6**	1,440.0	**1,108.8**	837.0
Total assets		**8,179.2**	6,636.7	**4,293.1**	3,910.8
Liabilities					
Loans and other borrowings	21	**417.3**	29.4	**384.8**	2.1
Trade and other payables	18	**1,834.6**	1,361.0	**1,900.5**	1,849.4
Current tax liabilities	19	**165.4**	138.0	**18.1**	10.4
Provisions	23	**2.8**	20.3	**–**	–
Derivative financial liabilities	29	**59.8**	–	**–**	–
Current liabilities		**2,479.9**	1,548.7	**2,303.4**	1,861.9
Loans and other borrowings	21	**1,797.6**	1,653.6	**816.5**	982.6
Deferred tax liabilities	22	**919.1**	888.3	**24.9**	28.3
Trade and other payables	18	**396.7**	266.3	**–**	–
Provisions	23	**79.0**	91.0	**–**	–
Retirement benefit obligations	27	**284.0**	326.5	**–**	–
Derivative financial liabilities	29	**77.5**	–	**20.9**	–
Non-current liabilities		**3,553.9**	3,225.7	**862.3**	1,010.9
Total liabilities		**6,033.8**	4,774.4	**3,165.7**	2,872.8
Net assets		**2,145.4**	1,862.3	**1,127.4**	1,038.0
Equity					
Share capital	24	**430.2**	429.4	**430.2**	429.4
Share premium	25	**90.7**	81.6	**90.7**	81.6
Capital redemption reserve	25	**13.7**	13.7	**13.7**	13.7
Equity reserve	25	**14.6**	–	**14.6**	–
Hedge reserve	25	**6.6**	–	**3.1**	–
Retained earnings	25	**1,589.6**	1,338.0	**575.1**	513.3
Total equity attributable to equity holders of the parent		**2,145.4**	1,862.7	**1,127.4**	1,038.0
Minority interest	26	**–**	(0.4)	**–**	–
Total equity		**2,145.4**	1,862.3	**1,127.4**	1,038.0

These financial statements were approved by the Board of Directors on 30 May 2006 and signed on their behalf by:

Gregor Alexander
Finance Director

Sir Robert Smith
Chairman

Statement of Recognised Income and Expense

for the year ended 31 March 2006

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
(Losses) / gains on effective portion of cash flow hedges (net of tax)	**(11.7)**	–	**9.8**	–
Actuarial loss on retirement benefit schemes (net of tax)	**(9.9)**	(12.7)	**(20.3)**	(0.9)
Other movements	**(0.4)**	–	**–**	–
Net expense recognised directly in equity	**(22.0)**	(12.7)	**(10.5)**	(0.9)
Profit for the year	**642.3**	559.8	**472.7**	119.1
Total recognised income and expense for the year	**620.3**	547.1	**462.2**	118.2
Cumulative adjustment for the adoption of IAS 32 and IAS 39	**36.8**	–	**(3.9)**	–
Total	**657.1**	547.1	**458.3**	118.2
Attributable to:				
Equity holders of the parent	**620.3**	547.2	**462.2**	118.2
Minority interest	**–**	(0.1)	**–**	–
	620.3	547.1	**462.2**	118.2

Cash Flow Statement

for the year ended 31 March 2006

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Cash flows from operating activities				
Profit for the year after tax	**642.3**	559.8	**–**	–
Taxation	**254.6**	229.5	**–**	–
Movement on financing and operating derivatives	**57.9**	–	**–**	–
Finance costs	**210.8**	188.1	**–**	–
Finance income	**(164.9)**	(126.8)	**–**	–
Share of jointly controlled entities and associates	**(43.6)**	(40.6)	**–**	–
Gain on disposal of subsidiary	**(18.6)**	–	**–**	–
Pension service charges less contributions paid	**(22.3)**	(1.0)	**(9.3)**	(8.9)
Depreciation and impairment of assets	**200.1**	270.6	**–**	–
Amortisation and impairment of intangible assets	**3.9**	3.5	**–**	–
Deferred income released	**(16.4)**	(62.3)	**–**	–
(Increase)/decrease in inventories	**(30.8)**	9.5	**–**	–
(Increase) in receivables	**(585.1)**	(177.9)	**(11.4)**	(8.8)
Increase in payables	**436.8**	339.4	**11.3**	190.4
(Decrease) in provisions	**(14.5)**	(29.9)	**–**	–
Employee share awards share purchase	**(9.5)**	(2.8)	**–**	–
Charge in respect of employee share awards	**4.0**	1.6	**–**	–
Profit on disposal of property, plant and equipment	**(5.2)**	(7.7)	**–**	–
Loss on disposal of replaced assets	**5.2**	–	**-**	-
Cash generated from operations	**904.7**	1,153.0	**(9.4)**	172.7
Dividends received from jointly controlled entities	**8.0**	12.5	**–**	–
Dividends received from subsidiaries	**–**	–	**458.6**	105.3
Finance income received	**51.4**	20.5	**148.5**	–
Finance costs paid	**(119.5)**	(92.5)	**(135.1)**	–
Income taxes paid	**(217.9)**	(152.9)	**3.8**	(4.0)
Net cash from operating activities	**626.7**	940.6	**466.4**	274.0
Cash flows from investing activities				
Purchase of property, plant and equipment	**(529.4)**	(345.0)	**–**	–
Purchase of software	**(1.2)**	(2.3)	**–**	–
Deferred income received	**7.9**	3.1	**–**	–
Proceeds from sale of property, plant and equipment	**16.3**	19.5	**–**	–
Net proceeds from sale of subsidiary (note 14)	**17.3**	–	**–**	–
Proceeds from sale of investments	**–**	2.9	**–**	–
Loans to jointly controlled entities	**–**	(1.0)	**–**	–
Loans to associates	**(0.7)**	–	**–**	–
Investment in Scotia Gas Networks (note 12)	**(505.0)**	–	**(505.0)**	–
Loans repaid by jointly controlled entities	**10.8**	10.8	**–**	–
Loans repaid by associates	**7.3**	2.7	**–**	–
Investment in associate	**(15.0)**	–	**–**	–
Increase in other investments	**(1.9)**	–	**–**	–
Purchase of businesses and subsidiaries (note 14)	**(0.6)**	(339.0)	**–**	–
Net cash from investing activities	**(994.2)**	(648.3)	**(505.0)**	–
Cash flows from financing activities				
Proceeds from issue of share capital	**9.9**	9.7	**9.9**	9.7
Dividends paid to company's equity holders	**(378.8)**	(330.8)	**(378.8)**	(330.8)
New borrowings	**552.4**	331.3	**235.7**	297.8
Repayment of borrowings	**–**	(98.3)	**–**	(62.2)
Net cash from financing activities	**183.5**	(88.1)	**(133.2)**	(85.5)
Net (decrease)/increase in cash and cash equivalents	**(184.0)**	204.2	**(171.8)**	188.5
Cash and cash equivalents at the start of year (note 17)	**227.8**	23.6	**197.5**	9.0
Net (decrease)/increase in cash and cash equivalents	**(184.0)**	204.2	**(171.8)**	188.5
Cash and cash equivalents at the end of year (note 17)	**43.8**	227.8	**25.7**	197.5

1. SIGNIFICANT ACCOUNTING POLICIES

General information
Scottish and Southern Energy plc (the Company) is a company registered in Scotland. The address of the registered office is given on page 101. The Group's operations and its principal activities are set out in the Directors' Statement at pages 9 to 25. The consolidated financial statements for the year ended 31 March 2006 comprise those of the Company and its subsidiaries (together referred to as the Group). The Company's financial statements present information about the Company as a separate entity and not about the Group. Under section 230(4) of the Companies Act 1985 the Company is exempt from the requirement to present its own income statement and related notes. The financial statements were authorised for issue by the Directors on 30 May 2006.

Basis of preparation and consolidation

Basis of preparation and statement of compliance
The financial statements of the Group and the Company are prepared on the historical cost basis except that the following assets and liabilities are stated at their fair value: derivative financial instruments and financial instruments classified as available for sale. The financial statements have also been prepared in accordance with International Financial Reporting Standards and its interpretations as adopted by the European Union (adopted IFRS). The financial statements are presented in pounds sterling.

These are the first annual financial statements of the Group and the Company prepared in accordance with adopted IFRS and the Group and the Company have applied a number of the exemptions contained within IFRS 1 *First-Time Adoption of International Financial Reporting Standards*. An explanation of how the transition to adopted IFRS has affected the reported financial position, financial performance and cash flows of the Group and the Company is provided in notes 33 and 34.

The following exemptions under IFRS 1 have been adopted:

- IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, have been adopted retrospectively as at 1 April 2005 but as permitted by the transition provisions of IFRS 1, the Group has not restated comparative information.
- Business Combinations which took place prior to 1 April 2004 have not been reassessed under IFRS 3 *Business Combinations*.
- The Group has elected, under IAS 16 *Property, Plant and Equipment*, to measure a category of assets, Hydro Civil Assets, based on deemed cost.
- The application of IFRS 2 *Share-based Payments*, has been restricted to equity instruments that were granted on or after 7 November 2002, and had not vested by 1 January 2005.

As permitted by IAS 1 *Presentation of Financial Statements*, the Group has disclosed additional information in respect of jointly controlled entities and associates, exceptional items and certain re-measurements on the face of the income statement to aid understanding of the Group's financial performance. An item is treated as exceptional if it is considered unusual by nature and scale and of such significance that separate disclosure is required for the financial statements to be properly understood.

The preparation of financial statements conforming with adopted IFRS requires the use of certain accounting estimates. It also requires management to exercise judgement in the process of applying accounting policies. The Group's critical accounting estimates are summarised at pages 53 and 54.

Basis of consolidation of the Group
The financial statements consolidate the financial statements of the Company and its subsidiaries together with the Group's share of the results and net assets of its jointly controlled entities and associates.

Subsidiaries
Subsidiaries are those entities controlled by the Group or the Company. Control exists when the Group has the power, directly or indirectly, to govern the financial and operating policies of an entity in order to obtain benefits from its activities. In assessing control, potential voting rights that are exercisable or convertible are taken into account.

The financial statements of subsidiaries acquired are consolidated in the financial statements of the Group from the date that control commences until the date control ceases, using the acquisition method of accounting.

In the Company, investments in subsidiaries are carried at cost less any impairment charges. Pre-acquisition dividends are accounted for as a reduction in the cost of investment in the subsidiary.

Associates
Associates are those entities in which the Group has significant influence but not control over the financial and operating policies, namely where the Group has a shareholding of between 20% and 50% of the voting rights. The consolidated financial statements include the Group's share of the total recognised gains and losses of associates on an equity accounted basis, from the date that significant influence commences until the date that significant influence ceases.

Joint ventures
Jointly controlled entities are those entities over whose activities the Group has joint control, established by contractual agreement. In the consolidated financial statements, investments are accounted for under the equity method of accounting, as permitted by International Accounting Standard 31: *Interests in Joint Ventures* (IAS 31). Jointly controlled operations are businesses which use assets and liabilities that are separable from the rest of the Group. In these arrangements, the Group accounts for its own share of property, plant and equipment, carries its own inventories, incurs its own expenses and liabilities and raises its own finance.

In the Company, investments in jointly controlled entities are carried at cost less any impairment charges.

1. SIGNIFICANT ACCOUNTING POLICIES Continued

Basis of preparation and consolidation Continued

Transactions eliminated on consolidation
Intra-group balances and any unrealised gains and losses or income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates and jointly controlled entities are eliminated to the extent of the Group's interest in the entity. Unrealised losses are eliminated in the same way as unrealised gains.

Accounting policies

Revenue recognition: energy, services and goods relating to the sale of energy
Revenue is recognised to the extent that it is probable that economic benefits will flow to the Group and that the revenue can be reliably measured. Revenue comprises sales of energy, use of system income, gas storage facility revenue, the value of services and facilities provided and goods sold during the year in the normal course of business.

Revenue on energy sales, including monies received from the electricity and gas balancing markets in the UK, includes an estimate of the value of electricity and gas supplied to customers between the date of the last meter reading and the year end.

Revenue from use of energy systems includes an estimation of the volume of electricity distributed or transmitted by customers based on independently procured electricity settlement systems data. Annual revenue is dependent on being approved by the industry regulator, Ofgem. Certain circumstances may result in the regulatory 'allowed' income being over- or under-recovered in the financial year. Any over- or under-recovery is included in the calculation of the following year's regulatory use of system revenue. No adjustment is made for over- or under-recoveries in the year that they arise.

Where the Group has an ongoing obligation to provide services, revenues are recognised as the service is performed and amounts billed in advance are treated as deferred income and excluded from current turnover.

Gas storage facilities revenues are recognised evenly over the contract period, whilst revenues for the injection and withdrawal of gas are recognised at the point of gas flowing in or out of the storage facilities.

Sales of goods are recognised when goods are delivered and title has passed, along with the risks and rewards of ownership.

Government grants and customer contributions
A government grant is recognised in the balance sheet initially as deferred income when there is reasonable assurance that it will be received and that the Group will comply with the conditions attaching to it. Grants that compensate the Group for expenses incurred are recognised as revenue in the income statement on a systematic basis in the same years in which the expenses are incurred. Grants that compensate the Group for the cost of an asset are recognised in the income statement on a systematic basis over the useful life of the asset to match the depreciation charge. Customer contributions and capital grants have been recorded as deferred income and released to the income statement over the estimated life of the related assets.

Operating lease payments
Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease expense.

Finance lease payments
Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability. The finance charge is allocated to each year during the lease term in order to produce a constant periodic rate of interest on the remaining balance of the liability.

Net finance costs
Finance income comprises interest receivables on funds invested and returns on pension scheme assets that are recognised in the income statement. Finance expenses comprise interest payable on borrowings, the release of discount on provisions, interest on pension scheme liabilities, accretion of the debt component of the convertible less capitalised interest.

Interest income and charges are recognised in the income statement as they accrue, on an effective rate basis. The issue costs and interest payable on bonds, and all other interest payable and receivable is reflected in the income statement on that basis.

Foreign exchange
Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. At the year end, monetary assets and liabilities denominated in foreign currencies are translated at the rate of exchange ruling at the balance sheet date. Any gain or loss arising on the restatement of such balances is taken to the income statement.

Taxation
Taxation on the profit for the year comprises current and deferred tax. Taxation is recognised in the income statement except if it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

1. SIGNIFICANT ACCOUNTING POLICIES Continued

Accounting policies Continued

Taxation Continued

Deferred tax is recognised in respect of all temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: goodwill not deductible for tax purposes, the initial recognition of assets or liabilities other than in business combinations that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Dividends

Dividend income is recognised on the date the entity's right to receive payments is established.

Property, plant and equipment

(i) Owned assets

Items of property, plant and equipment are stated at cost less accumulated depreciation and impairments. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads. Interest on the funding attributable to major capital projects is capitalised during the years of construction and depreciated as part of the total cost over the useful life of the asset. All items of property, plant and equipment are accounted for under the cost model within IAS 16.

Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for as separate items of property, plant and equipment, and depreciated in the appropriate manner.

It is the Group policy to capitalise replacement expenditure and depreciate it over the expected useful life of the replaced asset. Replaced assets are derecognised at this point. Where an item of property, plant and equipment is replaced and it is not practicable to determine the carrying amount of the replaced part, the cost of the replacement will be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

(ii) Leased assets

Leases where the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. All other leases are classified as operating leases. Rentals payable under operating leases are charged to the income statement on a straight line basis over the lease term.

Assets held under finance leases are recognised as assets of the Group at the fair value or, if lower, at the present value of the minimum lease payments, each determined at the inception of the lease. The corresponding liability is included in the balance sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income, unless they are directly attributable to qualifying assets, in which case they are capitalised in accordance with the Group's general policy on borrowing costs.

Benefits received and receivable as an incentive to enter into an operating lease are also allocated on a straight line basis over the lease term.

(iii) Hydro civil assets

The Group is obliged under the Reservoirs Act 1975 to maintain its hydro infrastructure network, including its dams, tunnels and other hydro civil engineering structures (hydro civil assets). All items of property, plant and equipment within hydro civil assets, with the exception of land, are subject to depreciation.

In accordance with the transition provisions of IFRS 1, the Group identified the carrying value of these assets at privatisation and has treated this value as deemed cost. Following this assessment, the assets, and all subsequent enhancement and replacement expenditure, has been subject to depreciation over a useful economic life of 100 years. All subsequent maintenance expenditure is chargeable directly to the income statement.

1. SIGNIFICANT ACCOUNTING POLICIES Continued

Accounting policies Continued

Property, plant and equipment Continued

(iv) Depreciation

Depreciation is charged to the income statement to write off cost, less residual values, on a straight line basis over their estimated useful lives. Depreciation policy, useful lives and residual values are reviewed at least annually, for all asset classes to ensure that the current method is the most appropriate. The estimated useful lives are as follows:

	Years
Hydro civil assets	100
Power stations	20 to 60
Overhead lines and gas storage facilities	40 to 80
Other transmission and distribution buildings, plant and equipment	10 to 45
Shop refurbishment, fixtures, equipment, vehicles and mobile plant	3 to 10

Heritable and freehold land is not depreciated.

Assets held under finance leases are depreciated over their expected useful lives on the same basis as owned assets or, where shorter, over the term of the relevant lease.

(v) Subsequent expenditure

Expenditure incurred to replace a component of an item of property, plant and equipment that is accounted for separately is capitalised. Other subsequent expenditure is capitalised only when it increases the future economic benefits of the item of property, plant and equipment to which it relates.

Business combinations

The acquisition of subsidiaries is accounted for under the purchase method. The acquired business is measured at the date of acquisition as the aggregate fair value of assets, liabilities and contingent liabilities as required under IFRS 3 *Business Combinations*. The excess of the cost of acquisition over the fair value of the acquired business is represented as goodwill.

Intangible assets

i) Goodwill

Goodwill arising on a business combination represents the excess of the cost of acquisition over the Group's interest in the fair value of the identifiable assets and liabilities of a subsidiary at the date of acquisition. All business combinations are accounted for using the purchase method.

Goodwill is recognised as an asset and is reviewed for impairment at least annually. Any impairment is recognised immediately as a charge to the income statement and is not subsequently reversed.

From 1 April 1998 to 31 March 2004, any purchased goodwill was capitalised and amortised on a straight-line basis to the income statement. This was normally over a period of up to 20 years from the date of acquisition, with the exception of goodwill relating to the acquisitions of Hornsea and Neoscorp, which were amortised over a period of 30 years and 10 years respectively. Goodwill arising on acquisitions purchased prior to 1 April 1998 was written-off to reserves in accordance with the accounting standard then in force. In respect of acquisitions prior to 1 April 2004 goodwill is included on the basis of its deemed cost, which represents the carrying amount recorded under UK GAAP which was broadly comparable save that only separable intangibles were recognised and goodwill was amortised. The goodwill amortised between 1 April 2004 and 31 March 2005 has been reinstated. On disposal or closure of a previously acquired business, any attributable goodwill will be included in determining the profit or loss on disposal, with the exception of any goodwill written off prior to 1 April 1998.

ii) Research and development

Expenditure on research activities is charged to the income statement as incurred. Expenditure on development activities, whereby research findings are applied to a plan or design for the production of new or substantially improved products or processes, is capitalised if the product or process is considered to be technically and commercially feasible and the Group intends to complete the intangible asset for use or for sale.

iii) Allowances and emissions

The European Emissions trading scheme (EU ETS) has been in operation since 1 January 2005. The IASB withdrew IFRIC 3 *Emission Rights* in June 2005 and it has not been replaced with definitive guidance or interpretation for carbon trading. The Group recognises carbon allowances granted as an intangible asset at fair value at the date of grant and carbon emission liabilities incurred are recorded as a current liability. Carbon allowances purchased are recorded at cost. Up to the level of allowances held the liability is measured at the cost of purchased or granted allowances held. When emissions liabilities exceed the carbon allowances held, the net liability is measured at the market price of allowances ruling at the balance sheet date. Forward contracts for the sale of allowances are measured at fair value.

1. SIGNIFICANT ACCOUNTING POLICIES Continued

Accounting policies Continued

Intangible assets Continued

iii) **Allowances and emissions** Continued

The Renewable Obligations Certificates (ROCs) scheme is administered and accounted for in a similar, but not identical, manner to the European Emissions trading scheme. ROCs obtained from own generation are awarded by a third party. Self-generated ROCs are recorded at market value and purchased ROCs are recognised at cost within intangible assets. The liability under the renewables obligation is recognised based on electricity supplied to customers, the percentages set by Ofgem and the prevailing market price.

iv) **Other intangible assets**

Other intangible assets that have been acquired by the Group, including the Atlantic brand, are stated at cost less accumulated amortisation and impairment losses. Software licences are stated at cost less accumulated amortisation. Expenditure on internally generated brands is expensed as incurred. Amortisation is charged to the income statement on a straight-line basis over the estimated useful life of these other intangible assets. The amortisation periods utilised are as follows:

	Years
Brand values	10
Application software licences	5

Impairment testing

The carrying amounts of the Group's assets, other than inventories or deferred tax assets, are reviewed each financial year to determine whether there is any indication of impairment. If there is evidence of impairment, the recoverable amount of the asset is estimated to determine the extent of any such impairment. For goodwill and other intangible assets with an indefinite life, the test for impairment is carried out annually.

The recoverable amount is the higher of fair value less costs to sell and value in use. Value in use is based on projected cash flows which are discounted for risks and the time value of money. Where the cash flows of the asset under review cannot be assessed independently from other assets, the Group estimates to which cash-generating unit (CGU) the asset belongs. Once established, the discounted projected cash flows of the asset or CGU are calculated and measured against the carrying amount of the asset or CGU. Where the recoverable amount is lower than the carrying amount an impairment charge is recognised.

Inventories and work in progress

With the exception of fuel stocks, inventories are valued at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses. The cost of fuel stocks is based on the weighted average principle. The valuation of work in progress is based on the cost of labour, the cost of contracts, the cost of materials plus appropriate overheads.

Recognition of revenue and profit on construction contracts

Where the outcome of a construction contract can be estimated reliably, revenue and costs are recognised by reference to the stage of completion of the contract activity at the balance sheet date. This is normally measured as the proportion of cost incurred on work performed to date compared to the estimated total contract cost, except where this would not be representative of the stage of completion. Variations in contract work, claims and incentive payments are included to the extent that they have been agreed with the customer.

When it becomes probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately in the income statement.

Employee benefit obligations

i) **Defined benefit pension schemes**

The Group operates a number of defined benefit pension schemes, one of which is operated by the Company. Pension scheme assets are measured using market values. Pension scheme liabilities are measured using the projected unit credit actuarial method and are discounted at the current rate of return on a high quality corporate bond of equivalent term and currency to the liability.

Any increase in the present value of liabilities within the Group's defined benefit pension schemes expected to arise from employee service in the year is charged as service costs to operating profit.

The expected return on the schemes' assets and the increase during the year in the present value of the schemes' liabilities arising from the passage of time are included in finance income and finance costs, respectively. Actuarial gains and losses are recognised in the consolidated statement of recognised income and expense. Pension scheme surpluses, to the extent that they are considered recoverable, or deficits are recognised in full and presented on the face of the balance sheet.

ii) **Defined contribution pension schemes**

The Group also operates a number of defined contribution pension schemes. The assets of the schemes are held separately from those of the Group in independently administered funds. The amounts charged represent the contributions payable to the schemes in the year and are charged directly to the income statement.

iii) **Equity and equity-related compensation benefits**

Applying the transitional provisions of IFRS 1, the requirements of IFRS 2 *Share based payments* have been applied to all grants of equity instruments after 7 November 2002 that had not vested as at 1 January 2005.

1. SIGNIFICANT ACCOUNTING POLICIES Continued

Accounting policies Continued

Employee benefit obligations Continued

iii) Equity and equity-related compensation benefits Continued

The Group operates a number of all employee share schemes as described in the Remuneration Report and note 28. These schemes enable Group employees to acquire shares of the Company.

The exercise prices of the sharesave scheme are set at a discount to market price at the date of the grant. The fair value of the sharesave scheme option granted is measured at the grant date by use of a Black-Scholes model. The fair value of the options granted is recognised as an expense on a straight-line basis over the period that the scheme vests. Estimates are updated at each balance sheet date with any adjustment in respect of the current and prior years being recognised in the income statement.

The costs associated with the other main employee schemes, the share incentive plan and the deferred bonus scheme, are recognised over the period to which they relate.

Financial instruments: from 1 April 2005

The Group adopted IAS 32 and IAS 39 with effect from 1 April 2005 as permitted by the transition provisions of IFRS 1. The comparative information for the year to 31 March 2005 has been prepared in accordance with FRS 4 *Capital Instruments* and the requirements of the Companies Act and is commented upon below. IAS 39 requires that financial instruments are initially recognised and subsequently measured at fair value. Financial assets and liabilities are recognised when the Group becomes a party to the provisions of the instrument.

The Group uses a range of derivatives to hedge exposures to financial risks, such as interest rate, foreign exchange and energy price fluctuations in its normal course of business and in accordance with the Group's risk management policies. The Group's risk management policies are further explained in note 29.

Accounting policies under IAS 32 and 39

i) Interest rate and foreign exchange derivatives

Financial derivative instruments are used by the Group to hedge interest rate and currency exposures. All such derivatives are recognised at fair value and are re-measured to fair value each reporting period. Certain derivative financial instruments are designated as being held for hedging purposes. The designation of the hedge relationship is established at the inception of the contract and procedures are applied to ensure the derivative is highly effective in achieving its objective and that the effectiveness of the hedge can be reliably measured. The treatment of gains and losses on re-measurement is dependent on the classification of the hedge and whether the hedge relationship is designated as either a 'fair value' or 'cash flow' hedge. Derivatives that are not designated as hedges are treated as if held for trading, with all fair value movements being recorded through the income statement.

A derivative classified as a 'fair value' hedge recognises gains and losses from re-measurement immediately in the income statement. Loans and borrowings are measured at cost except where they form the underlying transaction in an effective fair value hedge relationship. In such cases, the carrying value of the loan or borrowing is adjusted to reflect fair value movements attributable to the risk being hedged with the gain or loss being reported in the income statement.

A derivative classified as a 'cash flow' hedge recognises the portion of gains or losses on the derivative which are deemed to be effective directly in equity in the hedge reserve. Any ineffective portion of the gains or losses is recognised in the Income Statement. The gains or losses that are recognised directly in equity are transferred to the income statement in the same period in which the forecast transaction actually occurs.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point, any cumulative gain or loss on the hedging instrument recognised in equity remains in equity until the forecast transaction occurs. If the transaction is no longer expected to occur, the cumulative gain or loss recognised in equity is recognised in the income statement.

ii) Commodity derivatives

Within its regular course of business, the Group routinely enters into sale and purchase derivative contracts for commodities such as electricity, gas, coal and oil. Where the contract was entered into and continues to be held for the purpose of receipt or delivery in accordance with the Group's expected sale, purchase or usage requirements, the contracts are designated as 'own use' contracts and are measured at cost. These contracts are not within the scope of IAS 39.

Derivative commodity contracts which are not designated as own use contracts are accounted for as trading derivatives and are recognised in the balance sheet at fair value. Where a hedge accounting relationship is designated and is proven to be effective, the changes in fair value will be recognised in accordance with the rules noted in part (i) to this note.

Other commodity contracts, where own use is not established and a hedge accounting relationship is not designated, are measured at fair value with gains and losses on re-measurement being recognised in the income statement.

iii) Embedded derivatives

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives where the characteristics of the derivatives are not closely related to those of the host contracts.

1. SIGNIFICANT ACCOUNTING POLICIES Continued

Accounting policies Continued

Financial instruments: from 1 April 2005 Continued

Accounting policies under IAS 32 and 39

iv) Convertible bond

The Group has issued a convertible bond that represents debt that can be converted to share capital at the option of the holder, where the number of shares issued does not vary with changes in their fair value. This is accounted for as a compound financial instrument, net of transaction costs. The equity component of the convertible bond is calculated as the excess of the issue proceeds over the present value of the future interest and principal payments, discounted at the market rate of interest applicable to similar liabilities that do not have a conversion option. The interest expense recognised in the income statement is calculated using the effective interest method.

v) Cash and cash equivalents

Cash and cash equivalents comprise cash balances and call deposits. Bank overdrafts that are repayable on demand and form an integral part of the Group's cash management are included as a component of cash and cash equivalents for the purpose of the statement of cash flows.

vi) Trade receivables

Trade receivables do not carry any interest and are measured at nominal value less an appropriate allowance for irrecoverable receivables.

vii) Interest-bearing loans and borrowings

All such loans and borrowings are initially recognised at fair value including transaction costs and are subsequently measured at amortised cost, except where the loan or borrowing is the hedged item in an effective fair value hedge relationship.

viii) Share capital

Ordinary shares are accounted for as equity. Costs associated with the issue of new shares are deducted from the proceeds of issue.

Financial instruments: accounting policies to 31 March 2005

The comparative information was prepared in accordance with FRS 4 *Capital Instruments* and the requirements of the Companies Act.

i) Derivatives

Interest receipts and payments were accrued to match the net income or cost with the related finance expense. Revenue and costs under commodity contracts were recognised as incurred. Where contracts were held to hedge particular exposures, the gain or loss was deferred until the crystallisation of the underlying transaction. No amounts were recognised in respect of future periods. Premiums, discounts or termination payments were spread over the shorter of the life of the instrument or the underlying exposure. Gains and losses on early termination of interest rate swaps or repayment of borrowings were taken to the income statement where the hedged exposure no longer existed.

ii) Convertible bond

The convertible bond was accounted for as a loan with no equity component being recognised.

Provisions

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

Critical accounting judgements and key sources of estimation uncertainty

In the process of applying the Group's accounting policies, management necessarily makes judgements and estimates that have a significant effect on the amounts recognised in the financial statements. Changes in the assumptions underlying the estimates could result in a significant impact to the financial statements. The most critical of these accounting judgement and estimation areas are noted.

(i) Revenue recognition

Revenue on energy sales includes an estimate of the value of electricity or gas supplied to customers between the date of the last meter reading and the year end. This will have been estimated by using historical consumption patterns and takes into consideration industry reconciliation processes for total consumption by supplier. At the balance sheet date, the estimated consumption by customers will either have been billed (estimated billed revenue) or accrued (unbilled revenue). Management apply judgement to the measurement of the quantum of the estimated consumption and to the valuation of that consumption. The judgements applied, and the assumptions underpinning these judgements are considered to be appropriate. However, a change in these assumptions would impact upon the amount of revenue recognised.

(ii) Retirement benefits

The assumptions in relation to the cost of providing post-retirement benefits during the period are set after consultation with qualified actuaries. While these assumptions are believed to be appropriate, a change in these assumptions would impact the earnings of the Group.

(iii) Impairment testing

The Group reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that the value of those assets is impaired. In assessing for impairment, assets that do not generate independent cash flows are allocated to an appropriate cash generating unit (CGU). The recoverable amount of the assets, or the appropriate CGU, is measured as the higher of their fair value less costs to sell and value in use.

Management necessarily apply judgement in allocating assets that do not generate independent cash flows to appropriate CGUs. The value in use calculation also requires estimation of the timing and value of underlying projected cash flows. Subsequent changes to these estimates or judgements may impact the carrying value of the assets within the respective CGUs.

2. SEGMENTAL INFORMATION

Primary reporting format – business segments

The primary segments are as reported for management purposes and reflect the day-to-day management of the business. The Group's primary segments are the distribution and transmission of electricity in the north of Scotland, the distribution of electricity in the south of England (together referred to below as Power Systems), the generation and supply of electricity and sale of gas in Great Britain (Generation and Supply). The Group's 50% equity share in Scotia Gas Networks plc, a business which distributes gas in Scotland and the south of England (see note 14) is included as a separate business segment where appropriate due to its significance.

Analysis of revenue, operating profit, assets, liabilities and other items by segment is provided below. All revenue and profit before taxation arise from operations within Great Britain and Ireland.

a) Revenue by segment

	Total revenue		Intra-segment revenue		External revenue	
	2006 £m	2005 £m	**2006 £m**	2005 £m	**2006 £m**	2005 £m
Power Systems						
Scotland	**261.1**	258.9	**104.1**	188.1	**157.0**	70.8
England	**415.9**	369.2	**204.0**	185.5	**211.9**	183.7
	677.0	628.1	**308.1**	373.6	**368.9**	254.5
Generation and Supply	**9,287.8**	6,766.1	**27.4**	15.7	**9,260.4**	6,750.4
Other businesses	**783.3**	645.5	**267.4**	225.8	**515.9**	419.7
	10,748.1	8,039.7	**602.9**	615.1	**10,145.2**	7,424.6

Revenue from the Group's investment in Scotia Gas Networks plc (SSE's share being £261.5m) is not recorded in the revenue line in the income statement.

b) Operating profit by segment

2006

	Adjusted £m	**JCE/Associate share of interest and tax (i) £m**	**Before exceptional items and certain re-measurements £m**	**Exceptional items and certain re-measurements £m**	**Total £m**
Power Systems					
Scotland	**141.8**	**–**	**141.8**	**–**	**141.8**
England	**226.1**	**–**	**226.1**	**–**	**226.1**
	367.9	**–**	**367.9**	**–**	**367.9**
Scotia Gas Networks	**102.7**	**(97.9)**	**4.8**	**(9.1)**	**(4.3)**
Energy Systems	**470.6**	**(97.9)**	**372.7**	**(9.1)**	**363.6**
Generation and Supply	**444.8**	**(28.2)**	**416.6**	**89.4**	**506.0**
Other businesses	**106.0**	**–**	**106.0**	**18.6**	**124.6**
	1,021.4	**(126.1)**	**895.3**	**98.9**	**994.2**
Unallocated expenses (ii)	**(7.9)**	**–**	**(7.9)**	**–**	**(7.9)**
	1,013.5	**(126.1)**	**887.4**	**98.9**	**986.3**

2005

	Adjusted £m	JCE/Associate share of interest and tax (i) £m	Before exceptional items and certain re-measurements £m	Exceptional items and certain re-measurements £m	Total £m
Power Systems					
Scotland	135.2	–	135.2	–	135.2
England	201.6	–	201.6	–	201.6
	336.8	–	336.8	–	336.8
Generation and Supply	388.6	(26.5)	362.1	65.8	427.9
Other businesses	93.6	0.7	94.3	–	94.3
	819.0	(25.8)	793.2	65.8	859.0
Unallocated expenses (ii)	(8.4)	–	(8.4)	–	(8.4)
	810.6	(25.8)	784.8	65.8	850.6

(i) The adjusted operating profit of the Group is reported after removal of the Group's share of interest, fair value movements on financing derivatives and tax from jointly controlled entities and associates. The share of Scotia Gas Networks plc interest includes loan stock interest payable to the consortium shareholders. The Group has accounted for its 50% share of this, £28.8m, as finance income (note 6). The gas distribution network businesses owned by Scotia Gas Networks plc were acquired on 1 June 2005 (note 14).
(ii) Unallocated expenses comprise corporate office costs which are not directly allocable to particular segments.

2. SEGMENTAL INFORMATION Continued

c) Assets and liabilities

	Segment assets (i) 2006 £m	2005 £m	Segment liabilities (ii) 2006 £m	2005 £m	Capital additions to property plant and equipment (note 11) 2006 £m	2005 £m
Power Systems						
Scotland	**1,338.7**	1,278.4	**473.4**	388.3	**61.0**	61.1
England	**2,030.7**	1,956.5	**1,331.4**	1,063.1	**111.1**	110.4
	3,369.4	3,234.9	**1,804.8**	1,451.4	**172.1**	171.5
Scotia Gas Networks (iii)	**455.0**	–	**–**	–	**–**	–
Energy Systems	**3,824.4**	3,234.9	**1,804.8**	1,451.4	**172.1**	171.5
Generation and Supply	**7,589.9**	7,351.2	**6,105.4**	6,297.7	**228.7**	149.7
Other businesses	**4,600.9**	3,996.7	**3,930.7**	3,420.5	**101.3**	62.3
Corporate and unallocated	**2,231.5**	1,959.0	**4,260.4**	3,509.9	**–**	–
	18,246.7	16,541.8	**16,101.3**	14,679.5	**502.1**	383.5
Less: inter-segment	**(10,067.5)**	(9,905.1)	**(10,067.5)**	(9,905.1)	**–**	–
	8,179.2	6,636.7	**6,033.8**	4,774.4	**502.1**	383.5

(i) Segment assets consist of property, plant and equipment, goodwill, other intangible assets, investments in jointly controlled entities and associates, inventories, financial assets (operating derivatives), receivables and cash. Unallocated assets include pension assets, deferred tax assets, financial assets (financing derivatives) and investments.

(ii) Segment liabilities consist of operating liabilities. Unallocated liabilities include taxation, corporate borrowings, pension liabilities and deferred taxation.

(iii) The asset balance represents the Group's net investment in Scotia Gas Networks plc. The Group's share of Scotia Gas Networks plc capital additions is not recorded within property, plant and equipment.

d) Other non-cash expenses

	Depreciation/impairment on property, plant and equipment (note 11) 2006 £m	2005 £m	Amortisation of intangible assets (note 10) 2006 £m	2005 £m
Power Systems				
Scotland	**37.4**	37.8	**–**	–
England	**60.7**	61.3	**–**	–
	98.1	99.1	**–**	–
Generation and Supply	**71.6**	147.6	**0.9**	0.8
Other businesses	**30.4**	23.9	**–**	–
Corporate and unallocated	**–**	–	**3.0**	2.7
	200.1	270.6	**3.9**	3.5

(i) The Group's share of Scotia Gas Networks plc depreciation (£34.9m) and amortisation (£nil) is not recorded within operating costs.

3. OTHER OPERATING INCOME AND EXPENSE

Group operating costs can be analysed thus:

	2006 £m	2005 £m
Distribution costs	**238.6**	224.1
Administration costs	**243.8**	183.5
	482.4	407.6

Group operating profit is stated after charging (or crediting) the following items:

	2006 £m	2005 £m
Depreciation of property, plant and equipment (note 11)	**200.1**	209.6
Impairment of property, plant and equipment (note 4)	**–**	61.0
Research and development costs	**1.4**	0.6
Operating lease rentals (note 31)	**14.3**	14.5
Release of deferred income in relation to customer contributions and capital grants	**(16.4)**	(35.9)
Gain on disposal of property, plant and equipment	**(5.2)**	(7.7)
Loss on disposal of replaced assets	**5.2**	–
Amortisation of brand costs (note 10)	**0.9**	0.8
Amortisation of intangible assets (note 10)	**3.0**	2.7
Staff costs (note 5)	**332.9**	286.7
Auditors' remuneration for audit services (see below)	**0.4**	0.4

Auditor's remuneration	Consolidated		Company	
	2006 £m	2005 £m	2006 £m	2005 £m
Statutory audit services	**0.4**	0.4	**0.1**	0.1
Tax services	**0.1**	0.1	**–**	–
Further assurance service	**0.5**	0.1	**–**	–
	1.0	0.6	**0.1**	0.1

In addition to the amounts shown above, the auditors received fees of £0.03m (2005 – £0.02m) for the audit of the Scottish Hydro-Electric Pension Scheme. A description of the work of the Audit Committee is set out on pages 30 and 31 and includes an explanation of how auditor objectivity and independence is safeguarded when non-audit services are provided by the auditors.

4. EXCEPTIONAL ITEMS AND CERTAIN RE-MEASUREMENTS

i) Exceptional items

During the year, net dividends of £92.1m (2005 – £159.1m) were received in relation to the administration of TXU Europe Energy Trading Limited which had been placed into administration in 2002. The net receipts of £92.1m (2005 – £111.2m after extinguishing debtor balances) have been shown separately in the income statement. In addition to this, the Group's share of the net dividend from the administration of TXU Europe Energy Trading Limited recognised as income by an associate company, Barking Power Limited, amounting to £16.7m, (2005 – £22.3m) is shown separately within share of operating profit from jointly controlled entities and associates.

In the year a gain on disposal of Thermal Transfer Limited, a wholly owned subsidiary, of £18.6m was recognised. Details of this disposal are included at note 14. There is no tax effect on this exceptional item.

The financial statements to 31 March 2005 included an exceptional impairment charge in respect of Peterhead power station of £61.0m.

ii) Certain re-measurements

Certain re-measurements arising from the adoption of IAS 39 are disclosed separately to aid understanding of the underlying performance of the Group. This category includes the movement on derivatives as described in note 29.

These transactions can be summarised thus:

	2006 £m	2005 £m
Exceptional items		
Distributions from TXU administrator	**108.8**	133.5
Peterhead impairment	**–**	(61.0)
Disposal of Thermal Transfer	**18.6**	–
	127.4	72.5
Certain re-measurements		
Movements on operating derivatives (note 29)	**(14.4)**	–
Movements on financing derivatives (note 29)	**(43.5)**	–
Share of movement on derivatives in jointly controlled entities (note 14)	**(13.0)**	–
	(70.9)	–
Profit before taxation	**56.5**	72.5
Taxation (1)	**(11.4)**	(27.2)
Impact on profit for the year	**45.1**	45.3

(1) Taxation includes £1.1m (2005 – £6.7m) recognised within share of associates and jointly controlled entitities on the face of the income statement.

5. DIRECTORS AND EMPLOYEES

(i) Staff Costs

	Consolidated 2006 £m	Consolidated 2005 £m
Staff costs		
Wages and salaries	**324.3**	284.5
Social security costs	**30.5**	25.1
Share-based remuneration	**4.0**	1.6
Pension costs (note 27)	**25.2**	23.0
	384.0	334.2
Less: capitalised as property, plant and equipment	**(51.1)**	(47.5)
	332.9	286.7

Employee numbers:

	Consolidated 2006 Number	Consolidated 2005 Number	Company 2006 Number	Company 2005 Number
Numbers employed at 31 March	**12,287**	11,034	**4**	4

The monthly average number of people employed by the Group (including Executive Directors) during the year was:

	Consolidated 2006 Number	Consolidated 2005 Number	Company 2006 Number	Company 2005 Number
Power Systems	**2,249**	2,308	**–**	–
Generation and Supply	**4,102**	3,588	**–**	–
Other businesses and corporate services	**5,404**	4,746	**4**	5
	11,755	10,642	**4**	5

The costs associated with the employees of the Company, who are the Executive Directors of the Group, are borne by Group companies.

(ii) Directors' remuneration and interests
Information concerning Directors' remuneration, shareholdings, options, long term incentive schemes and pensions is shown in the Remuneration Report on pages 36 to 41. No Director had, during or at the end of the year, any material interest in any contract of significance in relation to the Group's business.

6. NET FINANCE COSTS

	Year ended 31 March 2006 £m	Year ended 31 March 2005 £m
Finance income:		
Return on pension scheme assets	**115.7**	107.1
Interest income from short term deposits	**3.3**	3.2
Other interest receivable (i)	**45.9**	16.5
Total finance income	**164.9**	126.8
Finance costs:		
Bank loans and overdrafts	**(40.1)**	(33.6)
Other loans and charges	**(71.1)**	(60.2)
Interest on pension scheme liabilities	**(100.0)**	(94.7)
Accretion of convertible debt component (note 21)	**(3.6)**	–
Less: interest capitalised	**8.3**	3.4
Notional interest arising on discounted provisions	**(4.3)**	(3.0)
Finance costs excluding movement on financing derivatives	**(210.8)**	(188.1)
Movement on financing derivatives (note 29)	**(43.5)**	–
Total finance costs	**(254.3)**	(188.1)
Net finance costs	**(89.4)**	(61.3)

(i) Included within other interest receivable are credits from jointly controlled entities of £39.2m (2005 – £11.5m), including £28.8m in respect of loan stock interest receivable from Scotia Gas Networks plc (2005 – £nil).

Notes on the Financial Statements Continued

for the year ended 31 March 2006

6. NET FINANCE COSTS Continued

Adjusted net finance costs are arrived at after the following adjustments:

	2006 £m	2005 £m
Net finance costs	(89.4)	(61.3)
(add)/less:		
Share of interest from jointly controlled entities and associates	(97.3)	(17.2)
Accretion of convertible debt component (note 21)	3.6	–
Movement on financing derivatives (note 29)	43.5	–
Return on pension scheme assets (note 27)	(115.7)	(107.1)
Interest on pension scheme liabilities (note 27)	100.0	94.7
Adjusted net finance costs	(155.3)	(90.9)

7. TAXATION

Analysis of charge recognised in the income statement:

	Before Exceptional items and certain re-measurements £m	Exceptional items and certain re-measurements £m	2006 £m	Before Exceptional items and certain re-measurements £m	Exceptional items and certain re-measurements £m	2005 £m
Current tax						
UK corporation tax	218.1	27.6	245.7	176.1	33.3	209.4
Adjustments in respect of previous years	(0.4)	–	(0.4)	(4.0)	–	(4.0)
Total current tax	217.7	27.6	245.3	172.1	33.3	205.4
Deferred tax						
Current year	14.6	(17.3)	(2.7)	30.2	(12.8)	17.4
Adjustments in respect of previous years	12.0	–	12.0	6.7	–	6.7
Total deferred tax	26.6	(17.3)	9.3	36.9	(12.8)	24.1
Total taxation charge	244.3	10.3	254.6	209.0	20.5	229.5

The charge for the year can be reconciled to the profit per the income statement as follows:

	2006 £m	2006 %	2005 £m	2005 %
Profit before tax	896.9		789.3	
Less: share of results of associates and jointly controlled entities	(43.6)		(40.6)	
Group profit before tax	853.3		748.7	
Tax on profit on ordinary activities at standard UK corporation tax rate of 30% (2005 – 30%)	256.0	30.0	224.6	30.0
Tax effect of:				
Expenses not deductible for tax purposes	0.7	0.1	3.6	0.5
Non taxable income	(4.8)	(0.6)	–	–
Adjustments to tax charge in respect of previous years	11.6	1.3	2.7	0.4
Consortium relief not paid for	(8.6)	(1.0)	–	–
Utilisation of tax losses	(0.3)	–	–	–
Advance corporation tax	–	–	(1.4)	(0.2)
Group tax charge and effective rate	254.6	29.8	229.5	30.7

The adjusted current tax charge is arrived at after the following adjustments:

	2006 £m	2006 %	2005 £m	2005 %
Total taxation charge	254.6	28.3	229.5	29.1
Effect of adjusting items (see below)	–	1.5	–	2.8
Total taxation charge on adjusted basis	254.6	29.8	229.5	31.9
(add)/less:				
Share of current tax from jointly controlled entities and associates	13.8	1.6	9.9	1.4
Exceptional items	(27.6)	(3.2)	(20.5)	(2.9)
Tax on movement on derivatives	17.3	2.0	–	–
Deferred tax (including share of jointly controlled entities)	(26.6)	(3.2)	(36.9)	(5.1)
Adjusted current tax charge and effective rate	231.5	27.0	182.0	25.3

7. TAXATION Continued

The adjusted effective rate is based on adjusted profit before tax being:

	2006 £m	2005 £m
Profit before tax	**896.9**	789.3
(add)/less:		
Exceptional items and certain re-measurements	**(55.4)**	(65.8)
Share of tax from jointly controlled entities and associates	**28.8**	8.6
Accretion of convertible debt component (note 21)	**3.6**	–
Return on pension scheme assets (note 27)	**(115.7)**	(107.1)
Interest on pension scheme liabilities (note 27)	**100.0**	94.7
Adjusted profit before tax	**858.2**	719.7

Deferred tax recognised directly in equity

	2006	2005
Relating to:		
Pension scheme actuarial movements	**(4.2)**	(5.5)
Cash flow hedge movements	**(5.1)**	–
	(9.3)	(5.5)

8. DIVIDENDS

	2006 £m	2005 £m
Amounts recognised as distributions from equity:		
Final dividend for the previous year of 30.3p (2005 – 26.4p) per share	**260.0**	226.1
Interim dividend for the current year of 13.8p (2005 – 12.2p) per share	**118.8**	104.7
	378.8	330.8
Proposed final dividend for the current year of 32.7p (2005 – 30.3p) per share	**281.3**	260.0

The proposed final dividend is subject to approval by shareholders at the Annual General Meeting and has not been included as a liability in these financial statements. The final dividend paid, £260.0m (30.3p, 2005 – 26.4p), was declared on 17 May 2005, approved at the Annual General Meeting on 28 July 2005 and was paid to shareholders on 23 September 2005. An interim dividend, £118.8m (13.8p, 2005 – 12.2p), was paid on 24 March 2006.

9. EARNINGS PER SHARE

Basic earnings per share
The calculation of basic earnings per share at 31 March 2006 is based on the net profit attributable to equity shareholders and a weighted average number of ordinary shares outstanding during the year ended 31 March 2006. All earnings are from continuing operations.

Adjusted earnings per share
Adjusted earnings per share has been calculated by excluding the charge for deferred tax, net finance income relating to pensions, items disclosed as exceptional, and the impact of IAS 32 and IAS 39.

	Year ended 31 March 2006 Earnings £m	Year ended 31 March 2006 Earnings per share pence	Year ended 31 March 2005 Earnings £m	Year ended 31 March 2005 Earnings per share pence
Basic	**642.3**	**74.7**	559.9	65.3
Exceptional items and certain re-measurements (note 4)	**(45.1)**	**(5.2)**	(45.3)	(5.3)
Basic excluding exceptional items and certain re-measurements	**597.2**	**69.5**	514.6	60.0
Adjusted for:				
Deferred tax (note 7)	**26.6**	**3.1**	36.9	4.3
Deferred tax from share of jointly controlled entities results	**15.0**	**1.7**	(1.3)	(0.1)
Return on pension scheme assets (note 27)	**(115.7)**	**(13.4)**	(107.1)	(12.4)
Interest on pension scheme liabilities (note 27)	**100.0**	**11.6**	94.7	11.0
Accretion of convertible debt component (note 6)	**3.6**	**0.4**	–	–
Adjusted	**626.7**	**72.9**	537.8	62.8

Basic	**642.3**	**74.7**	559.9	65.3
Convertible debt interest (net of tax) (note 21)	**10.5**	**1.2**	3.3	0.4
Dilutive effect of convertible debt	**–**	**(3.0)**	–	(1.2)
Diluted	**652.8**	**72.9**	563.2	64.5
Exceptional items and certain re-measurements	**(45.1)**	**(5.0)**	(45.3)	(5.2)
Diluted excluding exceptional items and certain re-measurements	**607.7**	**67.9**	517.9	59.3

The weighted average number of shares used in each calculation is as follows:

	31March 2006 Number of shares (millions)	31 March 2005 Number of shares (millions)
For basic and adjusted earnings per share	**859.5**	857.2
Effect of exercise of share options	**1.7**	1.9
	861.2	859.1
Effect of dilutive convertible debt	**33.3**	14.2
For diluted earnings per share	**894.5**	873.3

10. INTANGIBLE ASSETS

Consolidated

	Goodwill £m	Allowances and Certificates (i) £m	Development Expenditure (ii) £m	Brands (iii) £m	Other intangibles (iv) £m	Total £m
Cost:						
At 1 April 2004	274.0	44.0	–	–	11.4	329.4
Additions	–	94.0	–	–	2.3	96.3
Acquisitions (note 14)	18.6	–	–	9.0	1.1	28.7
Disposals	–	(44.0)	–	–	–	(44.0)
At 31 March 2005	292.6	94.0	–	9.0	14.8	410.4
Additions	–	389.6	–	–	1.2	390.8
Acquisitions (note 14)	0.8	–	1.4	–	–	2.2
Disposals	–	(198.9)	–	–	–	(198.9)
At 31 March 2006	**293.4**	**284.7**	**1.4**	**9.0**	**16.0**	**604.5**
Aggregate amortisation and impairment:						
At 1 April 2004	–	–	–	–	(6.5)	(6.5)
Charge for year	–	–	–	(0.8)	(2.7)	(3.5)
At 31 March 2005	–	–	–	(0.8)	(9.2)	(10.0)
Charge for year	–	–	–	(0.9)	(3.0)	(3.9)
At 31 March 2006	**–**	**–**	**–**	**(1.7)**	**(12.2)**	**(13.9)**
Carrying amount:						
At 31 March 2006	**293.4**	**284.7**	**1.4**	**7.3**	**3.8**	**590.6**
At 31 March 2005	292.6	94.0	–	8.2	5.6	400.4
At 1 April 2004	274.0	44.0	–	–	4.9	322.9

(i) **Allowances and Certificates**
Allowances and Certificates consist of granted or purchased carbon emissions allowances and generated or purchased renewable obligations certificates (ROCs).

(ii) **Development expenditure**
Development costs relate to the design, construction and testing of renewable generation devices which the Group believes will generate probable future economic benefits.

(iii) **Brands**
Included within brands is the Atlantic brand, acquired on the acquisition of Atlantic Electric and Gas Limited (in administrative receivership) during the year ended 31 March 2005 (note 14). The Group have assessed the economic life of the Atlantic brand to be 10 years and the brand is being amortised over this period.

(iv) **Other intangible assets**
Included within other intangible assets are application software licence fees, software development work, software upgrades and purchased PC software packages. These assets are amortised over 5 years.

The Company does not hold intangible assets.

10. INTANGIBLE ASSETS Continued

Impairment testing of Goodwill:

Goodwill description	Cash-generating unit	2006 £m	2005 £m
Swalec	Generation and Supply (i)	**187.0**	187.0
Hornsea	SSE Hornsea Limited (ii)	**56.2**	56.2
Medway	Generation and Supply (i)	**22.2**	22.2
Neos	Neos Networks Limited (iii)	**7.8**	7.8
Connect South West	Southern Electric Contracting Ltd (iv)	**0.8**	0.8
Eastern Contracting	Southern Electric Contracting Ltd (iv)	**0.9**	0.9
Fiddler's Ferry and Ferrybridge	Generation and Supply (i)	**17.7**	17.7
Harrison Smith (Batley)	Southern Electric Contracting Ltd (iv)	**0.8**	–
		293.4	292.6

Impairment review on goodwill balances

Goodwill is tested annually for impairment. The impairment test involves determining the cash generating unit to which the goodwill belongs and thereafter estimating the recoverable amount of the cash generating unit, which is the higher of fair value less costs to sell or the value in use. Value in use calculations have been used to determine the recoverable amounts for the cash generating units noted above. These are based on five-year projected cash flows extracted from the corporate business model which has been approved by the Executive and the Board. Discount rates in the range of 9.5% to 10.5% on a pre-tax basis have been applied to those cash flows. The key assumptions applied in determining the recoverable amounts for the cash generating units are as follows:

(i) Generation and Supply
The impairment test on the carrying value of goodwill relating to Swalec, Medway and Fiddler's Ferry / Ferrybridge is based on an assessment of the recoverable amount of the Generation and Supply business segment. This segment is managed as an integrated business at gross margin for all aspects of the generation and supply of electricity, and the sale of gas. In projecting the gross margin for the business, factors such as market demand, market share and forward wholesale energy prices are considered. Management believes that the assumed margins are reasonably achievable. The specific goodwill balances relate to the following acquisitions: Swalec was acquired in 2001 and is a supply business serving, primarily, South Wales; Medway, a gas-fired power station, was acquired after the acquisition of the remaining 62.5% shareholding in the power station in November 2003; the Fiddler's Ferry and Ferrybridge coal-fired power stations, were acquired in July 2004.

(ii) SSE Hornsea Limited
The impairment test on the carrying value of goodwill associated with Hornsea has been carried out based on the recoverable amount of SSE Hornsea Limited. This is based on projected cash flows which include management estimates of projected demand for gas storage, injection and withdrawal tariffs and wholesale gas prices. Management believes that the assumed margins are reasonably achievable.

(iii) Neos Networks Limited
The impairment test on the carrying value of goodwill associated with Neos has been carried out based on the recoverable amount of Neos Networks Limited. This is based on projected cash flows which include management estimates of sales growth in the range of 10-20%. Management believes that the assumed margins are reasonably achievable.

(iv) Southern Electric Contracting Limited
The impairment test on the carrying value of goodwill related to the acquisitions of Eastern Contracting and Connect South West were based on cash flow projections of the acquiring subsidiary entity, Southern Electric Contracting, which has successfully integrated these businesses into its operations. Management believes that the assumed margins included in the projections are reasonably achievable.

Scotia Gas Networks investment in gas distribution networks
The Group's share of Scotia Gas Networks' investment in the gas distribution networks includes an amount of acquired goodwill. In testing this acquired goodwill for impairment, management believe that both the fair value less costs to sell of the business and the value in use of the cash generating unit support the carrying value of goodwill inherent in the Group's financial statements.

Summary

In all cases, management conclude that the projected future cash flows are sufficient to support the carrying value of the recognised goodwill and the other cash generating unit assets. Management believe that while cash flow projections are subject to inherent uncertainty, any reasonably possible changes to the key assumptions utilised in assessing recoverable amounts would not cause the carrying amounts to exceed the recoverable amounts of the cash generating units identified.

Goodwill is allocated to the following business segments:

	2006 £m	2005 £m
Energy Systems	**–**	–
Generation and Supply	**226.9**	226.9
Other businesses	**66.5**	65.7
	293.4	292.6

11. PROPERTY, PLANT AND EQUIPMENT

Consolidated

	Generation and gas storage assets £m	Land and Buildings £m	Network assets £m	Vehicles and miscellaneous Equipment £m	Total £m
Cost:					
At 1 April 2004	2,154.2	82.9	3,959.8	227.1	6,424.0
Additions	179.0	0.7	192.0	11.8	383.5
Acquired (note 14)	131.5	–	–	0.4	131.9
Disposals (iv)	(12.1)	(3.1)	(6.3)	(16.0)	(37.5)
Reclassification (i)	10.6	–	–	–	10.6
At 31 March 2005	2,463.2	80.5	4,145.5	223.3	6,912.5
Additions	**276.4**	**14.8**	**193.8**	**17.1**	**502.1**
Acquired (note 14)	**–**	**–**	**–**	**0.1**	**0.1**
Revised decommissioning provision (ii)	**(14.2)**	**–**	**–**	**–**	**(14.2)**
Reclassification (i)	**–**	**–**	**(2.5)**	**–**	**(2.5)**
Disposals (iv)	**(34.9)**	**(0.1)**	**(0.4)**	**(15.6)**	**(51.0)**
Disposal of subsidiary (note 14)	**–**	**–**	**–**	**(2.4)**	**(2.4)**
At 31 March 2006	**2,690.5**	**95.2**	**4,336.4**	**222.5**	**7,344.6**
Depreciation:					
At 1 April 2004	577.0	18.4	1,501.8	184.3	2,281.5
Charge for the year	89.7	1.8	108.6	9.5	209.6
Impairment charge (iii)	61.0	–	–	–	61.0
Disposals (iv)	(3.4)	(0.4)	(6.2)	(15.7)	(25.7)
At 31 March 2005	724.3	19.8	1,604.2	178.1	2,526.4
Charge for the year	**74.7**	**1.8**	**111.1**	**12.5**	**200.1**
Reclassification (i)	**–**	**–**	**(0.6)**	**–**	**(0.6)**
Disposals (iv)	**(10.7)**	**(0.1)**	**(0.1)**	**(15.3)**	**(26.2)**
Disposal of subsidiary (note 14)	**–**	**–**	**–**	**(1.7)**	**(1.7)**
At 31 March 2006	**788.3**	**21.5**	**1,714.6**	**173.6**	**2,698.0**
Net book value					
At 31 March 2006	**1,902.2**	**73.7**	**2,621.8**	**48.9**	**4,646.6**
At 31 March 2005	1,738.9	60.7	2,541.3	45.2	4,386.1
At 1 April 2004	1,577.2	64.5	2,458.0	42.8	4,142.5

(i) The reclassification in the year ended 31 March 2005 relates to capital spares purchased on full acquisition of Medway Power Limited which were previously classified as stock. The reclassification in the year ended 31 March 2006 relates to telecoms fibre that was transferred to stock in the year.

(ii) The net book value of generation and gas storage assets includes decommissioning costs with a net book value of £18.0m (2005 – £32.5m). The value of the decommissioning assets at Fiddler's Ferry and Ferrybridge have been reassessed following the Group's decision to invest in flue gas desulphurisation plant at these stations, which is expected to extend the useful lives of the stations by between 15 and 20 years. Accordingly, this change in the timing of the expected decommissioning expenditure has been adjusted out of the carrying value of the asset.

(iii) The impairment charge in the year ended 31 March 2005 related to Peterhead power station and is disclosed separately in the income statement (note 4).

(iv) Assets disposed includes those assets which have been replaced after damage or obsolescence in the year.

Land is predominantly heritable or freehold. The net book value of other land and buildings includes freehold £32.0m (2005 – £18.8m). Generation assets comprise generating stations and related plant and machinery and include all hydro civil assets.

Cumulative interest capitalised for the Group, included in the cost of tangible fixed assets amounts to £31.2m (2005 – £22.9m).

At the balance sheet date, the cumulative amounts capitalised in respect of assets in the course of construction were as follows:

	2006 £m	2005 £m
Generation and gas storage assets	**355.2**	187.8
Transmission and distribution assets	**27.0**	11.0
	382.2	198.8

Included within the assets in the course of construction is the Group's share of expenditure on the Aldbrough gas storage facility and the Beatrice offshore wind farm projects which are managed under joint participation agreements.

11. PROPERTY, PLANT AND EQUIPMENT Continued

Included within property, plant and equipment are the following assets held under finance leases:

	Network assets £m	Vehicles and miscellaneous equipment £m	Total £m
Cost			
At 31 March 2005 and 31 March 2006	**5.1**	**7.0**	**12.1**
Depreciation			
At 1 April 2004	3.7	5.2	8.9
Charge for the year	0.3	0.3	0.6
At 1 April 2005	4.0	5.5	9.5
Charge for the year	0.3	0.3	0.6
At 31 March 2006	**4.3**	**5.8**	**10.1**
Net book value			
At 31 March 2006	**0.8**	**1.2**	**2.0**
At 1 April 2005	1.1	1.5	2.6
At 1 April 2004	1.4	1.8	3.2

The Company does not hold any property, plant or equipment.

12. INVESTMENT IN ASSOCIATES AND JOINT VENTURES

	Jointly controlled entities		Associates		
	Shareholder Investment £m	Loans £m	Shareholder Investment £m	Loans £m	Total £m
Consolidated					
Share of net assets / cost					
At 1 April 2004	50.6	125.1	10.6	10.1	**196.4**
Additions					
Increase in shareholder loans	–	1.0	–	–	**1.0**
Repayment of shareholder loans	–	(10.8)	–	(2.7)	**(13.5)**
Dividends received	(10.5)	–	(2.0)	–	**(12.5)**
Share of post tax profit excluding exceptional items	13.5	–	11.5	–	**25.0**
Share of post tax exceptional items	–	–	15.6	–	**15.6**
At 31 March 2005	53.6	115.3	35.7	7.4	**212.0**
Adoption of IAS 39	–	–	–	–	**–**
At 1 April 2005	53.6	115.3	35.7	7.4	**212.0**
Increase in equity investment	–	0.3	14.7	–	**15.0**
Change in designation of investment (i)	–	(1.4)	–	–	**(1.4)**
Increase in shareholder loans	–	–	–	0.7	**0.7**
Repayment of shareholder loans	–	(10.8)	–	(7.3)	**(18.1)**
Dividends received	(8.0)	–	–	–	**(8.0)**
Share of post tax profit excluding exceptional items	16.8	–	19.4	–	**36.2**
Share of post tax exceptional items	–	–	11.7	–	**11.7**
	62.4	**103.4**	**81.5**	**0.8**	**248.1**
Scotia Gas Networks plc (ii)					
Initial investment (note 14)	213.9	270.0	–	–	**483.9**
Increase in equity investment	21.1	–	–	–	**21.1**
	235.0	270.0	–	–	**505.0**
Increase in shareholder loans	–	16.9	–	–	**16.9**
Share of profit excluding movement on derivatives	4.8	–	–	–	**4.8**
Share of movement on derivatives (net of tax)	(9.1)	–	–	–	**(9.1)**
Opening financial derivative liability (net of tax)	(62.6)	–	–	–	**(62.6)**
	168.1	**286.9**	**–**	**–**	**455.0**
At 31 March 2006	**230.5**	**390.3**	**81.5**	**0.8**	**703.1**

12. INVESTMENT IN ASSOCIATES AND JOINT VENTURES Continued

	Joint Ventures Investment £m	Joint Ventures Shareholder Loans £m	Total £m
Company			
Share of net assets / cost			
At 31 March 2005	–	–	**–**
Adoption of IAS 39	–	–	**–**
At 1 April 2005	–	–	**–**
Scotia Gas Networks plc (ii)			
Initial investment (note 14)	213.9	270.0	**483.9**
Increase in equity investment	21.1	–	**21.1**
Increase in shareholder loans	–	16.9	**16.9**
At 31 March 2006	**235.0**	**286.9**	**521.9**

(i) The Group's interest in Renewable Technology Ventures Limited was increased from 50% to 100% on 27 January 2006 (note 13).

(ii) The investment in Scotia Gas Networks is disclosed separately to aid understanding of the Group's financial performance.

Prior to the investment in Scotia Gas Networks (note 14), the Company did not have any investments in joint ventures or associates.

Details of the principal jointly controlled entities, operations and associates are as follows:

	Country of Incorporation	31 March 2006 Holding %	31 March 2005 Holding %	Principal Activity
Jointly Controlled Entities				
PriDE (South East Regional Prime) Limited (ii)	England and Wales	**50**	50	Defence estates contractor
Seabank Power Limited (iii)	England and Wales	**50**	50	Electricity generation
Scotia Gas Networks (v)	England and Wales	**50**	50	Investment in gas networks
Jointly Controlled Operations				
Aldbrough	Unincorporated	**50**	50	Development of gas storage facility
Beatrice	Unincorporated	**50**	50	Development of offshore wind farm facility
Associates				
Barking Power Limited (i)	England and Wales	**30**	22	Electricity generation
Derwent Co-generation Limited (i)	England and Wales	**49.5**	49.5	Electricity generation
Scottish Electricity Settlements Limited (iv)	Scotland	**50**	50	Electricity settlement systems

The above companies' shares consist of ordinary shares only. All companies operate in Great Britain and Ireland. Seabank Power Limited has an accounting period ending on 31 December. All other companies have accounting periods ending on 31 March.

(i) Shares held by SSE Generation Limited
(ii) Shares held by SSE Contracting
(iii) Shares held by SSE Seabank Investments Limited
(iv) Shares held by S+S Limited
(v) Shares held by Scottish and Southern Energy plc

The Group's investment in Barking Power Limited was increased from 22.05% to 30.4% on 13 January 2006. Scottish Electricity Settlements Limited is in the process of being voluntarily wound-up.

The details of the Group's share of Scotia Gas Networks plc's acquisition of the Scotland and the South of England gas distribution networks are included in note 14. The material significance of this investment warrants separate disclosure from other jointly controlled entities. Accordingly, the post-acquisition result from the Group's share of these businesses is included in the segmental analysis of Group operating profit (note 2).

Operating profit in the Scotia Gas Networks Group was £205.4m and the profit before tax and movements on financial derivatives was £39.6m. After losses on financial derivatives (being £18.2m, after tax) and tax charged (£30.0m), the Scotia Gas Networks plc Group loss was £8.6m. As an investor, Scottish and Southern Energy plc recovered £28.8m of this in relation to loan stock interest payable to the Group.

12. INVESTMENT IN ASSOCIATES AND JOINT VENTURES Continued

The financial statements of Scotia Gas Networks plc can be summarised as follows (100%):

	Assets £m	Liabilities £m	Revenues £m	Loss after tax and movement on derivatives £m
31 March 2006				
Scotia Gas Networks plc	4,564.8	4,228.9	523.1	8.6

13. SUBSIDIARY UNDERTAKINGS

Details of the principal subsidiary undertakings are as follows:

	Country of Incorporation	2006 Holding %	2005 Holding %	Principal Activity
Subsidiary undertakings				
SSE Services plc (i)	England and Wales	**100**	100	Finance and IT support services
SSE Energy Supply Limited (i)	England and Wales	**100**	100	Electricity supply
SSE Retail Limited (i)	Scotland	**100**	100	Electrical appliance sales and servicing
SSE Telecommunications Limited (i)	Scotland	**100**	100	Telecommunication services
SSE Generation Limited (i)	England and Wales	**100**	100	Electricity generation
SSE Insurance Limited (i)	Isle of Man	**100**	100	Insurance services
SSE Stock Limited (i)	Scotland	**100**	100	Holds inventory for Group companies
Tay Valley Lighting (Stoke on Trent) Limited (i)	England and Wales	**50**	50	Contracting services
Tay Valley Lighting (Newcastle and North Tyneside) Limited – (i)	England and Wales	**50**	50	Contracting services
Tay Valley Lighting (Leeds City Council) Limited – (i)	England and Wales	**50**	–	Contracting services
Medway Power Limited (ii)	England and Wales	**100**	100	Electricity generation
SSE Medway Operations Limited (ii)	England and Wales	**100**	100	Maintenance contractor
Keadby Generation Limited (ii)	England and Wales	**100**	100	Electricity generation
Renewable Technology Ventures Limited (ii)	Scotland	**100**	50	Renewable generation development
Scottish Hydro-Electric Transmission Limited (iii)	Scotland	**100**	100	Transmission of electricity
Scottish Hydro-Electric Power Distribution Limited (iii)	Scotland	**100**	100	Distribution of electricity
Southern Electric Power Distribution plc (iii)	England and Wales	**100**	100	Distribution of electricity
S+S Limited (iii)	Scotland	**100**	100	Electricity connections
Southern Electric Contracting Limited (iv)	England and Wales	**100**	100	Electrical contractor
SSE Utility Services plc (iv)	England and Wales	**100**	100	Utility contractor
Southern Electric Gas Limited (v)	England and Wales	**100**	100	Gas supply
SSE Hornsea Limited (v)	England and Wales	**100**	100	Gas storage
SSE Freight Limited (v)	England and Wales	**100**	100	Vessel chartering
Neos Networks Limited (vi)	England and Wales	**100**	100	Telecommunication services

The above companies' shares consist of ordinary shares only. All companies operate in Great Britain and Ireland except for SSE Insurance Limited which operates in the Isle of Man. All companies have accounting periods ending on 31 March. The Group acquired the remaining shares in Renewable Technology Ventures Limited, previously a jointly controlled entity, in the year to 31 March 2006.

A full list of Group companies will be included in the company's annual return and the shares are held by:

(i) Scottish and Southern Energy plc
(ii) Shares held by SSE Generation Limited.
(iii) Shares held by SSE Power Distribution Limited.
(iv) Shares held by SSE Contracting Limited.
(v) Shares held by SSE Energy Supply Limited.
(vi) Shares held by SSE Telecommunications Limited.

The Company's investment in subsidiaries at 31 March is £777.9m (1 April 2004 and 31 March 2005 – £777.9m).

13. SUBSIDIARY UNDERTAKINGS Continued

Service concession arrangements

In 50:50 partnership with Royal Bank Leasing Limited, the Group has established three companies to provide street lighting services to councils under the Private Finance Initiative (PFI). These services are thereafter sub-contracted to Southern Electric Contracting Limited, a wholly owned subsidiary. The companies established are as follows:

Company	Council
Tay Valley Lighting (Stoke on Trent) Limited	Stoke-on-Trent
Tay Valley Lighting (Newcastle and North Tyneside) Limited	Newcastle and North Tyneside
Tay Valley Lighting (Leeds City Council) Limited	Leeds City Council

Under SIC-12 Consolidation – Special Purpose Entities, these companies are categorised as subsidiaries and are accounted for accordingly. The debt associated with these companies is non-recourse to the Group. The arrangements for all three companies are materially similar.

Characteristics of the arrangements

Description
The contracts are 25-year arrangements to replace aging street-lighting stock and to subsequently maintain the new assets throughout each Councils' areas.

Significant terms
The cash flows under the PFI arrangements come from the unitary charge for these services paid by the Councils. The unitary charge can only be adjusted if performance under the contract falls below the required standards. Any significant change to the services proposed by either party is subject to a formal change procedure and agreement to such a change is required by the other party.

Nature and extent of rights and obligations
The assets are part of the public highway and ownership of the assets remains with the Councils. The Tay Valley Lighting companies are licenced to replace and maintain the assets for the period of the contract. This obligation is passed down to Southern Electric Contracting Limited through the operating sub-contract. Any failure to provide the services to the required standards will result in financial penalties which are taken from the unitary charge.

The companies have 25-year contracts with no extension options. Termination during this period can be initiated through a number of routes including service provider default, force majeure or the event of a risk becoming uninsurable, authority default, voluntary authority termination, or termination for a prohibited act or breach of refinancing provisions. In all cases, a formula exists for calculating compensation payments to the service provider.

Throughout the contract period there are a number of circumstances under which the companies could potentially be required to provide additional services:

(i) Changes in the law
If circumstances arise where by a change in legislation would mean a change in the way the services are to be provided the companies would be liable for part of the cost of this change. This liability is capped.

(ii) Final survey
The Councils have the ability to deduct 20% of the unitary charge in the last two years if an independent survey indicates the assets are unlikely to have a 5-year residual life.

The Group's exposure to unforeseen obligations is insured.

14. ACQUISITIONS AND DISPOSALS

i. Acquisitions

(a) The acquisition of Gas Distribution Networks by Scotia Gas Networks plc
At 1 June 2005, Scotia Gas Networks plc, an entity of which the Group holds 50%, acquired the Scotland and the South of England gas distribution networks from National Grid Transco plc.

The total value of the acquired businesses after finalisation of the completion process was £3,217.8m. The transaction was initially funded by non-recourse borrowings with the balance being funded by the shareholders. The Group's share of the initial transaction cost at 1 June 2005 was £483.9m which consisted of £270.0m of subordinated loans and £213.9m of equity funding. The non-recourse funding of this transaction was replaced by the issue of listed debt by the distribution network entities of £2,219.8m on 21 October 2005.

At 31 March 2006, the Group, through Scotia Gas Networks plc, had invested £521.9m in the gas distribution networks, consisting of £270.0m of subordinated loans, £235.0m of equity funding and £16.9m of capitalised interest. The subsequent increase to the capital invested in the Scotia Gas Networks group is highlighted in note 12.

The Group's investment in Scotia Gas Networks plc at 31 March 2006 is £455.0m consisting of the £521.9m invested less the opening liability on financing derivatives (£62.6m, see below) and the loss after interest, tax and movement on derivatives (£4.3m, see note 12). In the 10 months from acquisition, the Group's share of the results of Scotia Gas Networks plc, a jointly controlled entity, contributed £102.7m to the Group's underlying operating profit (note 2) and £48.6m after interest (excluding loan stock interest payable and financing derivatives). The Group's share of the mark-to-market impact of the financial derivatives held by the Scotia Gas Networks' companies is included in notes 12 and 29.

Scotia Gas Networks plc entered into a contingent interest rate swap on 30 August 2004 subject to the acquisition of the gas networks in Scotland and the south of England being completed. From 1 April 2005, 50% of the fair value of the swap has been reflected in the Group's accounts including the Group's share of the fair value loss on financing derivatives up to 1 June 2005, when the transaction to acquire the distribution networks was concluded. Since 1 June 2005, the Group's share of this loss has been reflected as part of the share of losses on financing derivatives within the results of Scotia Gas Networks plc. On 21 October 2005, the formerly contingent swap was closed off by the issue of a new 'mirror' swap, both of which are marked to market under IAS 39. The issue of the listed debt at 21 October 2005 was achieved at the same time as entering a number of interest rate and currency swaps, all of which are designated as being effective hedges. From 1 June 2005, the Group's share of movements on financing derivatives is a charge of £13.0m (£9.1m net of tax).

The investment in the jointly controlled entity is accounted for using the equity method.

The acquisition of the Scotland and the South of England gas distribution networks by Scotia Gas Networks plc at 1 June 2005 can be represented as follows:

	Carrying Value of acquired entities £m	Fair Value adjustments on acquisition £m	Accounting policy alignments £m	Fair Value of acquired entities £m
Property, plant and equipment	3,117.8	31.9	–	**3,149.7**
Net current liabilities	(76.6)	39.6	–	**(37.0)**
Retirement benefit obligations	(60.9)	5.9	–	**(55.0)**
Deferred tax	(271.0)	176.6	(667.9)	**(762.3)**
Other provisions	(30.3)	(15.7)	–	**(46.0)**
Net assets	2,679.0	238.3	(667.9)	**2,249.4**
Goodwill (i)	401.0	(100.5)	667.9	**968.4**
	3,080.0	137.8	–	**3,217.8**
Satisfied by cash:				
Bank facility				**2,250.0**
Equity investment by shareholders				**967.8**
				3,217.8
The Group's share of the equity investment (50%)				**483.9**
Represented by:				
Share capital				**213.9**
Loan Stock				**270.0**
				483.9

The fair value adjustments reflect the assessment of fair value based on the regulatory value of the businesses and the fair value of current liabilities and provisions including the deferred tax liability. The accounting policy adjustments reflect the adoption of Group policies on deferred taxation. The adjustments have been made effective at the date of acquisition and the subsequent movements in deferred taxation have been recognised in the current year.

(i) Goodwill has been subject to impairment test review (note 10).

14. ACQUISITIONS AND DISPOSALS Continued

i. Acquisitions Continued

(b) Other acquisitions in the financial year
On 27 January 2006, SSE Generation Limited acquired the remaining 50% of the share capital of Renewable Technology Ventures Limited, a company which was previously a joint venture with The Weir Group plc. On 9 February 2006, Southern Electric Contracting Limited acquired 100% of the equity of Harrison Smith (Batley) Limited.

The fair value of net assets acquired was £0.4m and the combined consideration was £1.2m. Accordingly, goodwill on acquisition of £0.8m was recognised on these combinations. Consideration was £0.8m cash and £0.4m deferred consideration. The net cash outflow was £0.6m, being the £0.8m cash consideration less £0.2m of acquired cash.

ii. Acquisitions in the previous financial year

The fair values of the assets and liabilities of the following acquisitions made during the year ended 31 March 2005 and the consideration paid or due are shown below:

(i) Fiddler's Ferry and Ferrybridge (FFF)
On 30 July 2004, Keadby Generation Limited acquired from AEP Energy Services UK Limited the Fiddler's Ferry and Ferrybridge power stations, associated coal stocks, fuel in transit and contracts to supply fuel for a consideration of £259.3m.

(ii) Atlantic Electric & Gas
On 28 April 2004, SSE Energy Supply Limited acquired the assets and ongoing business of Atlantic Electric & Gas Limited (in administrative receivership) from the Receivers, KPMG LLP, for a consideration of £85.2m.

(iii) Eastern Contracting
On 12 January 2005, Southern Electric Contracting Limited acquired the assets and ongoing business of part of Alfred McAlpine Utility Services SE Limited from Alfred McAlpine for a consideration of £2.0m.

The book values and final fair values of the assets and liabilities acquired were as follows:

	Carrying Value of net assets acquired £m	Revaluation and accounting policy alignment £m	Fair value £m
Intangible assets	8.4	1.7	10.1
Property, plant and equipment	70.3	61.6	131.9
Inventories	67.9	40.3	108.2
Other current assets	192.7	(34.9)	157.8
Current liabilities	(1.8)	–	(1.8)
Provisions	–	(46.2)	(46.2)
Deferred taxation	–	(6.1)	(6.1)
Retirement benefit obligations	–	(26.0)	(26.0)
Net assets	**337.5**	**(9.6)**	**327.9**
Goodwill			**18.6**
Total consideration			**346.5**

The revaluation and accounting policy alignment adjustments reflect the recognition of decommissioning costs, the net liabilities of the pension scheme acquired, the result of the independent valuation of coal stocks, an estimate of the fair value of the station assets, the adoption of IFRS, adjustments to work-in-progress, recognition of provisions on acquired contracts and the revaluation of working capital and intangible assets acquired. The consideration of £346.5m included £7.5m of deferred consideration which was not part of the cash outflow of £339.0m.

14. ACQUISITIONS AND DISPOSALS Continued

iii. Disposals

Thermal Transfer Limited

The Group disposed of its shareholding in Thermal Transfer Limited on 31 March 2006 for a consideration of £21.5m, net of costs of disposal, resulting in a gain on disposal of £18.6m. The assets and liabilities sold and the consideration received can be stated as follows:

	£m
Property, plant and equipment	0.7
Stock and work-in-progress	2.6
Trade and other receivables	11.8
Cash and cash equivalents	2.7
Trade and other payables	(14.5)
Deferred tax liabilities	(0.4)
Net assets disposed of	**2.9**
Gain on disposal	**18.6**
Net consideration	**21.5**

The proceeds of disposal have constituted £20.0m cash and £1.5m of deferred consideration, net of disposal costs. The net cash inflow associated with the disposal in the year is £17.3m (£20.0m consideration received less £2.7m cash and cash equivalents).

15. INVENTORIES

	Consolidated	
	2006 £m	2005 £m
Fuel and consumables	**153.9**	121.3
Work in progress	**15.1**	17.0
Goods for resale	**2.6**	3.1
Less: provisions held	**(7.4)**	(7.3)
	164.2	134.1

The Company does not hold any inventories.

16. TRADE AND OTHER RECEIVABLES

	Consolidated		Company	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Current assets				
Amounts owed by subsidiary undertakings	**–**	–	**1,079.8**	629.9
Trade receivables	**1,254.6**	747.1	**2.3**	–
Other receivables	**69.2**	55.0	**1.0**	7.5
Prepayments and accrued income	**339.1**	271.6	**–**	–
	1,662.9	1,073.7	**1,083.1**	637.4
Non-current assets				
Amounts owed by subsidiary undertakings	**–**	–	**1,794.3**	2,197.0
	1,662.9	1,073.7	**2,877.4**	2,834.4

17. CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Bank balances	**17.6**	13.7	**15.3**	0.5
Call deposits	**32.3**	218.5	**10.4**	199.1
Cash and cash equivalents	**49.9**	232.2	**25.7**	199.6

Cash and cash equivalents (which are presented as a single class of assets on the face of the balance sheet) comprise cash at bank and short term highly liquid investments with a maturity of three months or less.

	Consolidated		Company	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Cash and cash equivalents (from above)	**49.9**	232.2	**25.7**	199.6
Bank overdraft (note 21)	**(6.1)**	(4.4)	**–**	(2.1)
Cash and cash equivalents in the statement of cash flows	**43.8**	227.8	**25.7**	197.5

18. TRADE AND OTHER PAYABLES

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Current liabilities				
Amounts due to subsidiary undertakings	–	–	1,896.9	1,791.6
Payments received in advance	20.3	20.4	–	–
Trade payables	1,311.2	862.0	–	–
Taxation and social security	11.4	32.1	–	–
Other creditors	74.2	96.5	3.6	57.8
Accruals and deferred income	417.5	350.0	–	–
	1,834.6	1,361.0	1,900.5	1,849.4
Non-current liabilities				
Accruals and deferred income	396.7	266.3	–	–
	2,231.3	1,627.3	1,900.5	1,849.4

19. CURRENT TAX LIABILITIES

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Corporation tax	165.4	138.0	18.1	10.4

20. CONSTRUCTION CONTRACTS

	2006 £m	2005 £m
Contracts in progress at balance sheet date:		
Amounts due from contract customers included in trade and other receivables (note 16)	27.2	28.2
Amounts due to contract customers included in trade and other payables (note 18)	(17.9)	(19.4)
Contract costs incurred plus recognised profits less recognised losses to date	126.1	154.3
Less: Progress billings	(130.7)	(160.5)
	(4.6)	(6.2)

At 31 March 2006, retentions held by customers for contract work amounted to £1.4m (2005 – £1.1m). Advances received from customers for contract work amounted to £5.5m (2005 – £2.7m).

At 31 March 2006, amounts of £nil (2005 – £nil) included in trade and other receivables and arising from construction contracts are due for settlement after more than 12 months.

The Company does not hold any construction contracts.

21. LOANS AND OTHER BORROWINGS

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Current				
Bank overdraft	6.1	4.4	–	2.1
Other short-term loans	410.7	24.5	384.8	–
Obligations under finance leases	0.5	0.5	–	–
	417.3	29.4	384.8	2.1

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Non current				
Loans including convertible debt	1,796.5	1,652.1	576.3	742.4
Obligations under finance leases	1.1	1.5	–	–
Amounts owed to subsidiary undertakings	–	–	240.2	240.2
	1,797.6	1,653.6	816.5	982.6

21. LOANS AND OTHER BORROWINGS Continued

i. Borrowings

Borrowing facilities
The Group has an established €1.5bn Euro commercial paper programme (paper can be issued in a range of currencies and swapped into Sterling). The Group has £650.0m (2005 – £650.0m) of committed credit facilities in place, maturing in 2009. These provide a back-up facility to the commercial paper programmes and at 31 March 2006 there was no draw down of these facilities.

Analysis of Borrowings

	Weighted average interest rate (viii) 2006	Weighted average interest rate (viii) 2005	2006 £m	2005 £m
Current				
Bank Overdrafts (i)	5.50%	5.75%	6.1	4.4
Other short-term loans – amortising (ii)	7.69%	7.68%	19.6	18.0
Other short-term loans – non-amortising (iii)	4.52%	–	234.7	–
Non-recourse funding (iv)	6.44%	6.44%	6.5	6.5
7.875% Eurobond repayable on 26 March 2007	7.88%	–	149.9	–
Total Current	5.92%	7.10%	416.8	28.9
Non-Current				
Between two and five years				
Loans – amortising (ii)	7.60%	7.71%	78.0	89.9
Loans – non-amortising (v)	6.25%	6.83%	25.1	25.0
US $100m repayable on 1 May 2007 (vi)	7.78%	7.78%	61.5	61.5
7.875% Eurobond repayable on 26 March 2007	–	7.88%	–	149.8
3.75% Convertible bond repayable 29 October 2009 (vii)	3.75%	3.75%	280.8	297.4
Non-recourse funding (iv)	6.44%	6.44%	19.7	11.5
	5.18%	5.84%	465.1	635.1
Over five years				
Loans – amortising (ii)	6.27%	6.36%	13.7	21.5
Loans – non-amortising (v)	5.12%	5.16%	350.0	350.0
5.875% Eurobond repayable on 26 September 2022	5.88%	5.86%	295.5	295.2
5.50% Eurobond repayable on 19 June 2032	5.50%	5.50%	350.3	350.3
4.625% Eurobond repayable on 20 February 2037	4.63%	–	323.3	
	5.28%	5.30%	1,332.8	1,017.0
Fair value adjustment (note 29)	–	–	(1.4)	–
	5.28%	5.30%	1,331.4	1,017.0
Total Non Current	5.25%	5.47%	1,796.5	1,652.1
Total	5.38%	5.49%	2,213.3	1,681.0

(i) Bank overdrafts are repayable on demand.

(ii) Balances under amortising loans are adjusted for capital repayments or drawings in the financial year. These are held with the European Investment Bank (EIB) in a combination of fixed and floating rates.

(iii) Balances include commercial paper and cash advances.

(iv) The Tay Valley Lighting companies formed under 50:50 partnership with Royal Bank Leasing Limited to provide street-lighting services are categorised as subsidiaries under SIC-12 (note 13). The debt held by these companies is included on consolidation but is non-recourse to the Group.

(v) The floating rate European Investment Bank advances are reset quarterly at a rate normally less than three month LIBOR. Other loans include a mixture of fixed and floating debt repayable between 2007 and 2014.

21. LOANS AND OTHER BORROWINGS Continued

i. Borrowings Continued

(vi) The US $100m loan has been swapped into Sterling with £60.0m being fixed at an effective rate of 7.78%.

(vii) The liability component of the convertible bond is presented separately under IAS 32. As permitted by the transition provisions of IFRS 1, the comparative at 31 March 2005 has not been similarly disclosed.

(viii) The weighted average interest rates are as noted. The weighted average interest rate for the Group (including swaps) for the year ended 31 March 2006 was 5.42% (2005 – 5.91%).

Convertible bond
The convertible bond was issued on 26 October 2004 in exchange for £300.0m in cash. The bond entitles holders to convert the bond into ordinary shares at any time up to 24 October 2009 at the applicable conversion share price of £9.00 per ordinary share at the date of issue. The conversion price is subject to adjustment in certain circumstances set out in the offering circular including payment of dividends greater than amounts set out in the circular, capital restructuring and change of control. Conversion is at the option of the bond holder.

Prior to 1 April 2005, the bond has been treated wholly as a borrowing as permitted by the transition exemptions available under IFRS 1. From 1 April 2005, the net proceeds received from the issue of the bond have been split between a liability element and an equity component, the liability element representing the fair value at the inception of the embedded option to convert the liability into equity of the Group.

	At 31 March 2006 £m	At 1 April 2005 £m	At 31 March 2005 £m
Nominal value of issue of convertible bond	**300.0**	300.0	300.0
Costs of issue (i)	**(2.0)**	(2.6)	(2.6)
Net proceeds of convertible bond issued	**298.0**	297.4	297.4
Equity component (net of deferred tax)	**(14.6)**	(14.6)	
Deferred tax on temporary differences	**(6.2)**	(6.2)	
Interest charged (ii)	**15.0**	–	
Interest paid	**(11.4)**	–	
Accretion of debt component	**3.6**	–	
Liability component	**280.8**	276.6	

(i) The costs of issue of the bond are amortised over the term of the bond.

(ii) Interest is charged by applying an effective interest rate of 5.35% to the liability component for the twelve month period from adoption of IAS 32.

For the purpose of diluted Earnings per Share (EPS) convertible bond interest of £15.0m (2005 – £3.3m) is added back to earnings and the number of potential ordinary shares to be issued includes the following in respect of this bond:

	2006 Number of shares	2005 Number of shares
Weighted average number of shares	**33,333,333**	14,246,575

ii. Finance lease liabilities

Future finance lease commitments are as follows:

	Minimum lease payments		**Present Value of minimum lease payments**	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Amounts payable:				
Within one year	**0.5**	0.5	**0.5**	0.5
Between one and five years	**1.0**	1.5	**0.8**	1.1
After five years	**0.7**	0.8	**0.3**	0.4
	2.2	2.8	**1.6**	2.0
Less: future finance charge	**(0.6)**	(0.8)		
Present value of lease obligations	**1.6**	2.0		

The average lease term is 13 to 14 years. For the year ended 31 March 2006, the average effective borrowing rate was 8% (2005 – 8%). Interest rates are fixed at the contract date. All leases, held by the Group's telecoms businesses, are on a fixed repayment basis and no arrangements have been entered into for contingent rental payments. The fair value of the Group's lease obligations approximates their carrying amount. The Group's obligations under finance leases are secured by the lessors' rights over the leased assets. The Company does not have any obligations under finance leases.

Notes on the Financial Statements Continued

for the year ended 31 March 2006

22. DEFERRED TAXATION

The following are the deferred tax liabilities and assets recognised by the Group and movements thereon during the current and prior reporting periods:

	Accelerated capital allowances £m	Fair value gains / (losses) on derivatives £m	Convertible bond equity component £m	Retirement benefit obligations £m	Share based payments £m	Other £m	Total £m
Consolidated							
At 1 April 2004	859.1	–	–	(58.7)	(0.5)	(34.2)	**765.7**
Acquisition	27.2	–	–	(7.8)	–	(13.3)	**6.1**
Charge / (credit) to Income Statement	9.6	–	–	3.7	(0.9)	11.7	**24.1**
Charge / (credit) to equity	–	–	–	(5.5)	–	–	**(5.5)**
At 31 March 2005	895.9	–	–	(68.3)	(1.4)	(35.8)	**790.4**
Cumulative adoption of IAS 39 and IAS 32 (i)	–	9.6	6.2	–	–	–	**15.8**
At 1 April 2005	895.9	9.6	6.2	(68.3)	(1.4)	(35.8)	**806.2**
Charge / (credit) to Income Statement (ii)	1.8	(17.4)	(1.1)	14.4	–	11.6	**9.3**
Charge / (credit) to equity	–	(5.1)	–	(4.2)	–	–	**(9.3)**
Transfer to Scotia Gas Networks (iii)	–	26.9	–	–	–	–	**26.9**
At 31 March 2006	**897.7**	**14.0**	**5.1**	**(58.1)**	**(1.4)**	**(24.2)**	**833.1**

	Accelerated capital allowances £m	Fair value gains / (losses) on derivatives £m	Convertible bond equity component £m	Retirement benefit obligations £m	Share based payments £m	Other £m	Total £m
Company							
At 1 April 2004	–	–	–	22.6	–	–	**22.6**
Charge / (credit) to Income Statement	–	–	–	5.2	–	(1.4)	**3.8**
Charge / (credit) to equity	–	–	–	1.9	–	–	**1.9**
At 31 March 2005	–	–	–	29.7	–	(1.4)	**28.3**
Cumulative adoption of IAS 39 and IAS 32 (i)	–	(13.1)	6.2	–	–	–	**(6.9)**
At 1 April 2005	–	(13.1)	6.2	29.7	–	(1.4)	**21.4**
Charge / (credit) to Income Statement	–	2.7	(1.1)	6.1	–	0.4	**8.1**
Charge / (credit) to equity	–	4.1	–	(8.7)	–	–	**(4.6)**
At 31 March 2006	**–**	**(6.3)**	**5.1**	**27.1**	**–**	**(1.0)**	**24.9**

22. DEFERRED TAXATION Continued

(i) As permitted by the transition provisions of IFRS 1, the Group has adopted IAS 39 from 1 April 2005. As a result, the associated deferred taxation on the financial instruments recognised is highlighted in this note.

(ii) Includes movement relating to the Scotia Gas Networks plc swap from 1 April 2005 to 31 May 2005 (note 14).

(iii) Being transfer of deferred tax asset relating to financing derivatives at 1 June 2005 on completion of acquisition of gas distribution networks.

Certain deferred tax assets and liabilities have been offset. The following is an analysis of the deferred tax balances (after offset) for financial reporting purposes:

	Consolidated		Company	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Deferred tax liabilities	**919.1**	888.3	**24.9**	28.3
Deferred tax assets	**86.0**	97.9	**–**	–
Net deferred tax liabilities	**833.1**	790.4	**24.9**	28.3

At the balance sheet date, the Group has unused tax losses of £40.6m (2005 – £40.9m) available for offset against future profits.

At the balance sheet date, the aggregate amount of temporary differences associated with undistributed earnings of subsidiaries for which deferred tax liabilities have not been recognised was £2.3m (2005 – £2.5m). No liability has been recognised in respect of these differences because the Group is in a position to control the timing of the reversal of the temporary differences and it is probable that such differences will not reverse in the foreseeable future.

Temporary differences arising in connection with interests in associates and jointly controlled entities are recorded as part of the Group's share of investment in those entities. The aggregate amount of these is £11.1m (2005 – £1.3m).

23. PROVISIONS

	Onerous energy contracts (i) £m	Decommissioning (ii) £m	Other (iii) £m	Total £m
Consolidated				
At 1 April 2004	66.4	3.0	26.6	**96.0**
Acquired in the year	12.8	32.4	1.0	**46.2**
Charged in the year	1.3	1.7	–	**3.0**
Utilised during the year	–	–	(5.0)	**(5.0)**
Reversed during the year	(27.1)	–	(1.8)	**(28.9)**
At 1 April 2005	53.4	37.1	20.8	**111.3**
Acquired in the year	–	–	0.2	**0.2**
Charged in the year	2.5	1.8	2.4	**6.7**
Revised decommissioning provision	–	(14.2)	–	**(14.2)**
Utilised during the year	(17.3)	–	(4.3)	**(21.6)**
Disposal in the year	–	–	(0.6)	**(0.6)**
At 31 March 2006	**38.6**	**24.7**	**18.5**	**81.8**
At 31 March 2006				
Non-current	38.6	24.7	15.7	**79.0**
Current	–	–	2.8	**2.8**
	38.6	**24.7**	**18.5**	**81.8**
At 31 March 2005				
Non-current	38.6	37.1	15.3	**91.0**
Current	14.8	–	5.5	**20.3**
	53.4	**37.1**	**20.8**	**111.3**

(i) The onerous energy contracts provision relates to future losses on purchase contracts designated as own use under IAS 39. These losses will be incurred over a maximum period to 2011 when the contracts terminate.

(ii) Provision has been made for the estimated net present cost of decommissioning certain generation and gas storage assets. The estimate is based on a forecast of clean-up costs at the time of decommissioning discounted for the time value of money. The timing of costs provided is dependent on the lives of the facilities. The provision held in respect of the decommissioning assets at Fiddler's Ferry and Ferrybridge has been reassessed following the Group's decision to invest in flue gas desulphurisation plant at these stations, which is expected to extend the useful lives of the stations by between 15 and 20 years. Accordingly, this change in the timing of the expected decommissioning expenditure has been reflected in the carrying value of the provision.

(iii) Other provisions include balances held in relation to restructuring, insurance and warranty claims. In addition, the Group has an unapproved, unfunded retirement benefit provision for pensions for certain directors and former directors and employees.

The Company does not hold provisions.

Notes on the Financial Statements Continued

for the year ended 31 March 2006

24. SHARE CAPITAL

	Number (millions)	£m
Equity: Ordinary shares of 50p each:	1,200.0	600.0
Authorised:		
At 31 March 2006 and 1 April 2005		
Allotted, called up and fully paid:		
At 1 April 2004	857.5	428.7
Issue of shares (i)	1.3	0.7
At 31 March 2005	**858.8**	**429.4**
Issue of shares (i)	1.5	0.8
At 31 March 2006	**860.3**	**430.2**

(i) The Company issued 1,455,451 (2005 – 1,331,156) shares during the year under the savings-related share option schemes, and discretionary share option schemes for a consideration of £9.9m (2005 – £9.7m).

During the year, the Company purchased 940,323 shares (2005 – 381,373) for a consideration of £9.5m (2005 – £2.8m) to be held in trust for the benefit of employee share schemes. At 31 March 2006, the Trust held 1,530,082 shares (2005 – 696,477) which had a market value of £17.3m.

The Company has one class of ordinary share which carries no right to fixed income. The holders of ordinary shares are entitled to receive dividends as declared and are entitled to one vote per share at meetings of the Company.

25. RESERVES

	Share premium account £m	Capital redemption reserve £m	Equity reserve £m	Retained earnings £m	Hedge reserve £m	Total £m
Consolidated						
Reconciliation of movement in reserves						
At 1 April 2004	72.6	13.7	–	1,122.9	–	**1,209.2**
Profit for the year	–	–	–	559.8	–	**559.8**
Premium on issue of shares	9.0	–	–	–	–	**9.0**
Actuarial losses on retirement benefit schemes	–	–	–	(12.7)	–	**(12.7)**
Dividends to shareholders	–	–	–	(330.8)	–	**(330.8)**
Credit in respect of employee share awards	–	–	–	1.6	–	**1.6**
Investment in own shares	–	–	–	(2.8)	–	**(2.8)**
At 31 March 2005	81.6	13.7	–	1,338.0	–	**1,433.3**
Cumulative adoption of IAS 32 and 39	–	–	14.6	3.9	18.3	**36.8**
At 1 April 2005	81.6	13.7	14.6	1,341.9	18.3	**1,470.1**
Profit for the year	–	–	–	642.3	–	**642.3**
Effective portion of changes in fair value of cash flow hedges	–	–	–	–	(11.7)	**(11.7)**
Premium on issue of shares	9.1	–	–	–	–	**9.1**
Actuarial losses on retirement benefit schemes (net of tax)	–	–	–	(9.9)	–	**(9.9)**
Dividends to shareholders	–	–	–	(378.8)	–	**(378.8)**
Credit in respect of employee share awards	–	–	–	4.0	–	**4.0**
Investment in own shares	–	–	–	(9.5)	–	**(9.5)**
Other movements	–	–	–	(0.4)	–	**(0.4)**
At 31 March 2006	**90.7**	**13.7**	**14.6**	**1,589.6**	**6.6**	**1,715.2**

25. RESERVES

	Share premium account £m	Capital redemption reserve £m	Equity reserve £m	Retained earnings £m	Hedge reserve £m	Total £m
Company						
Reconciliation of movement in reserves						
At 1 April 2004	72.6	13.7	–	725.9	–	**812.2**
Profit for the year	–	–	–	119.1	–	**119.1**
Premium on issue of shares	9.0	–	–	–	–	**9.0**
Actuarial losses on retirement benefit schemes	–	–	–	(0.9)	–	**(0.9)**
Dividends to shareholders	–	–	–	(330.8)	–	**(330.8)**
At 31 March 2005	81.6	13.7	–	513.3	–	**608.6**
Cumulative adoption of IAS 32 and 39	–	–	14.6	(11.8)	(6.7)	**(3.9)**
At 1 April 2005	81.6	13.7	14.6	501.5	(6.7)	**604.7**
Profit for the year	–	–	–	472.7	–	**472.7**
Effective portion of changes in fair value of cash flow hedges	–	–	–	–	9.8	**9.8**
Premium on issue of shares	9.1	–	–	–	–	**9.1**
Actuarial losses on retirement benefit schemes	–	–	–	(20.3)	–	**(20.3)**
Dividends to shareholders	–	–	–	(378.8)	–	**(378.8)**
At 31 March 2006	**90.7**	**13.7**	**14.6**	**575.1**	**3.1**	**697.2**

The profit for the year attributable to shareholders dealt with in the financial statements of the Company was £472.7m (2005 – £119.1m, restated).

As allowed by section 230 of the Companies Act 1985, the Company has not presented its own income statement.

The hedge reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedge derivative instruments related to hedged transactions that have not yet occurred.

On adoption of IAS 32, the convertible bond has been split into an equity component, which is disclosed as the equity reserve, and a debt component, which is recorded as part of non-current loans and borrowings (note 21).

26. MINORITY INTERESTS

	Equity £m
At 1 April 2004	(0.3)
Share of loss on ordinary activities after taxation	(0.1)
At 31 March 2005	(0.4)
Minority interest acquired in year	0.4
At 31 March 2006	**–**

27. RETIREMENT BENEFIT OBLIGATIONS

Defined Benefit Schemes

The Group has two (2005 – three) funded final salary pension schemes which provide defined benefits based on final pensionable pay. The schemes are subject to independent valuations at least every three years. The future benefit obligations are valued by actuarial methods on the basis of an appropriate assessment of the relevant parameters.

On 1 February 2006, the third group scheme, Keadby Generation Limited (KGL) a group within the Electricity Supply Pension Scheme (ESPS), which was acquired at July 2004 as part of the acquisition of the Fiddler's Ferry and Ferrybridge power stations, became part of the Southern Electric group of the ESPS. This reduced the number of defined benefit schemes from three to two.

On 12 January 2005, the Group also acquired a part of the business of Alfred McAlpine referred to as Eastern Contracting. The liabilities under the associated pension scheme and the agreed asset values were part of the valuation of the Southern Electric scheme from that point.

The Group also has an unapproved unfunded retirement benefit plan and a personal pension scheme. The personal pension scheme is a money purchase scheme whereby the Group matches the members' contributions up to a maximum of 6% of salary. The scheme is managed by Friends Provident.

Pension summary:

	Scheme type	Net actuarial gain/ (loss) recognised in respect of the pension asset in the SoRIE 2006 £m	2005 £m	Net pension (liability) / asset 2006 £m	2005 £m
Scottish Hydro Electric (Company)	Defined benefit	**(29.0)**	6.2	**90.2**	98.9
Southern Electric (incorporating KGL)	Defined benefit	**14.9**	(24.5)	**(284.0)**	(326.5)
		(14.1)	(18.3)	**(193.8)**	(227.6)

The individual pension scheme details based on the latest formal actuarial valuations are as follows:

	Scottish Hydro-Electric	Southern Electric	KGL
Latest formal actuarial valuation	31 March 2003	31 March 2004	31 March 2004
Valuation carried out by	Hymans Robertson	Hewitt, Bacon & Woodrow	Hewitt, Bacon & Woodrow
Value of assets based on valuation	£614.0m	£770.5m	£46.4m
Value of liabilities based on valuation	£658.0m	£1,046.0m	£60.1m
Valuation method adopted	Projected Unit	Projected Unit	Projected Unit
Average investment rate of return	5.3%	6.0%	6.5%
Average salary increase	4.8%	4.9%	3.9%
Average pension increase	2.5%	3.0%	2.8%
Value of fund assets/accrued benefits	93.3%	73.7%	77.2%

An actuarial valuation of the Scottish Hydro-Electric Pension Scheme as at 31 March 2006 is currently in progress. All schemes have been updated to 31 March 2006 by qualified independent actuaries. The valuations have been prepared for the purposes of meeting the requirements of IAS 19. The major assumptions used by the actuaries were:

	At 31 March 2006	At 31 March 2005
Rate of increase in pensionable salaries	**4.4%**	4.3%
Rate of increase in pension payments	**2.9%**	2.8%
Discount rate	**4.9%**	5.4%
Inflation rate	**2.9%**	2.8%

The assumptions relating to longevity underlying the pension liabilities at 31 March 2006 are based on standard actuarial mortality tables, and include an allowance for future improvements in longevity. The assumptions equivalent to future longevity for members in normal health at age 65 are as follows:

	At 31 March 2006 Male	At 31 March 2006 Female	At 31 March 2005 Male	At 31 March 2005 Female
Currently aged 65	**20**	**23**	18	22
Currently aged 45	**21**	**24**	19	23

27. RETIREMENT BENEFIT OBLIGATIONS Continued

Valuation of combined Pension Schemes

	Consolidated				Company			
	Long-term rate of return expected at 31 March 2006 %	Value at 31 March 2006 £m	Long-term rate of return expected at 31 March 2005 %	Value at 31 March 2005 £m	Long-term rate of return expected at 31 March 2006 %	Value at 31 March 2006 £m	Long-term rate of return expected at 31 March 2005 %	Value at 31 March 2005 £m
Equities	**7.7**	**1,258.5**	8.2	1,025.7	7.7	**645.2**	8.2	510.7
Government bonds	**4.2**	**321.8**	4.7	172.2	4.2	**115.7**	4.7	101.2
Corporate bonds	**4.9**	**211.4**	5.4	301.2	4.9	**88.9**	5.4	84.2
Other investments	**5.0**	**225.6**	5.3	152.2	5.0	**106.0**	5.6	89.7
Total fair value of plan assets		**2,017.3**		1,651.3		**955.8**		785.8
Present value of defined benefit obligation		**(2,211.1)**		(1,878.9)		**(865.6)**		(686.9)
(Defecit)/surplus in the scheme		**(193.8)**		(227.6)		**90.2**		98.9
Deferred tax thereon		**58.1**		68.3		**(27.1)**		(29.7)
Net pension (liability)/asset		**(135.7)**		(159.3)		**63.1**		69.2

Movements in the defined benefit obligation during the year:

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
At 1 April	**(1,878.9)**	(1,691.5)	**(686.9)**	(658.5)
Movements in the year:				
Service costs	**(22.9)**	(20.9)	**(8.0)**	(7.9)
Member contributions	**(7.7)**	(6.7)	**(2.8)**	(2.7)
Benefits paid	**86.1**	81.3	**32.6**	31.3
Interest on pension scheme liabilities	**(100.0)**	(94.7)	**(36.5)**	(35.7)
Losses on curtailments	**(0.6)**	(1.0)	**(0.2)**	–
Actuarial losses	**(287.1)**	(72.4)	**(163.8)**	(13.4)
Liabilities assumed on business combinations	**–**	(73.0)	**–**	–
At 31 March	**(2,211.1)**	(1,878.9)	**(865.6)**	(686.9)

Movements in scheme assets during the year:

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
At 1 April	**1,651.3**	1,495.8	**785.8**	733.8
Movements in the year:				
Expected return on pension scheme assets	**115.7**	107.1	**55.8**	52.1
Assets distributed on settlement	**(86.1)**	(81.3)	**(32.6)**	(31.3)
Employer contributions	**55.7**	21.9	**9.2**	8.9
Member contributions	**7.7**	6.7	**2.8**	2.7
Assets acquired in business combinations	**–**	47.0	**–**	–
Actuarial gains	**273.0**	54.1	**134.8**	19.6
At 31 March	**2,017.3**	1,651.3	**955.8**	785.8

Charges / (credits) recognised:

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Current service cost (charged to operating profit)	**22.9**	20.9	**8.0**	7.9
Losses on curtailment (charged to restructuring provision)	**0.6**	1.0	**0.2**	–
	23.5	21.9	**8.2**	7.9
Charged/(credited) to finance costs:				
Expected return on pension scheme assets	**(115.7)**	(107.1)	**(55.8)**	(52.1)
Interest on pension scheme liabilities	**100.0**	94.7	**36.5**	35.7
	(15.7)	(12.4)	**(19.3)**	(16.4)

27. RETIREMENT BENEFIT OBLIGATIONS Continued

History of experience gains and losses

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Total actuarial (losses) and gains recognised in Statement of Recognised Income and Expense before adjustment for taxation	**(14.1)**	(18.3)	**(29.0)**	6.2
Experience gains and losses on scheme liabilities	**(123.3)**	(38.0)	**–**	–

Defined contribution scheme

The total contribution paid by the Group to defined contribution schemes was £2.3m (2005 – £2.1m).

Unapproved, unfunded retirement benefit (UURB) pension costs

The provision made in the year for the UURB was £2.6m (2005 – £1.4m). This is included in other provisions (note 23).

Balance sheet disclosure

The net pension (deficit) / surplus have been offset in this note. The following is an analysis of the retirement benefit obligations and assets for financial reporting purposes:

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Retirement benefit obligations	**(284.0)**	(326.5)	**–**	–
Retirement benefit assets	**90.2**	98.9	**90.2**	98.9
	(193.8)	(227.6)	**90.2**	98.9

Staff costs analysis

The pension costs in note 5 can be analysed thus:

	2006 £m	2005 £m
Service costs	**22.9**	20.9
Defined contribution scheme payments	**2.3**	2.1
	25.2	23.0

28. EMPLOYEE SHARE-BASED PAYMENTS

The Scottish and Southern Energy Group operates a number of share schemes for the benefit of its employees. Details of these schemes are as follows:

(i) Discretionary share option scheme

In the past, the Company operated this scheme, under which senior executives and staff were awarded share options. The options granted to the senior executives from 1996 were subject to the performance criterion of normalised earnings per share over a three-year period showing average compound annual growth rate of at least 2% above the increase in the UK retail price index for that year. This criterion was met and any remaining discretionary share options are now exercisable. This scheme has now ended and no options have been granted under this scheme since 1998.

(ii) Savings-related share option schemes ('Sharesave')

This scheme gives employees the option to purchase shares in the Company at a discounted market price, subject to the employees remaining in employment for the term of the agreement. Employees may opt to save between £5 and £250 per month for a period of three or five years. At the end of this period, the employees have six months to exercise their options by using the cash saved (including a bonus equivalent to interest). If the option is not exercised, the funds may be withdrawn by the employee and the option expires.

(iii) Share Incentive Plan (SIP)

This scheme allows employees the opportunity to purchase shares in the Company on a monthly basis. Employees may nominate an amount between £10 and £125 to be deducted from their gross salary. This is then used to purchase shares ('Partnership' shares) in the market on the final business day of each month. These shares are then held in trust for a period of five years, at which point they are transferred at no further cost to the employee. These shares may be withdrawn at any point during the five years, but tax and national insurance would then be payable on any amounts withdrawn.

In addition to the shares purchased on behalf of the employee, the Company will also match the purchase up to a maximum of five shares ('Matching' shares) per month. Again these shares are held in trust for the five years until they are transferred to the employee. If an employee leaves during the first three years, or removes his/her 'partnership' shares, these 'matching' shares are forfeited.

In addition, at 31 March 2005 the company made a special award of 50 free shares to all employees in employment at both 31 March and 20 August 2005 in recognition of their contribution to the success of the company. Under the arrangements for the award, the shares will be held in trust for five years, at which point they will be transferred to the employees at no cost to the employee. These shares may be withdrawn at any point during years four and five, but tax and national insurance would then be payable on any amounts withdrawn.

(iv) Deferred bonus scheme

This scheme applies to senior managers and executive directors. Those eligible are awarded an amount equal to their cash bonus for the period which is adjusted by a multiplier of between 0.7 and 1.35 depending on three factors, namely: relative performance in terms of Total Shareholder Return (TSR) over a three-year period compared to the FTSE100; safety; and relative performance in terms of customer complaints (as recorded by energywatch). This amount is then used to purchase shares in the market which are held in trust on behalf of the employee for a period of three-years, at which point the employee is entitled to exercise the award. In addition to shares purchased using the adjusted bonus award, additional shares will also be purchased using any dividends received on the shares held by the trust. If the employee resigns, they lose all outstanding awards.

As allowed by IFRS 2, only options granted since 7 November 2002, which were unvested at 1 January 2005, have been included.

28. EMPLOYEE SHARE-BASED PAYMENTS Continued

Details used in the calculation of these costs are as follows:

(i) Discretionary share option scheme

Date of grant	Number at 31 March 2006	Price (pence)	Date from which exercisable	Expiry date
December 1996	**59,500**	315	December 1999	December 2006
June 1998	**10,000**	547	June 2001	June 2008
July 1998	**204,800**	547	July 2001	July 2008

No additional costs were expensed in relation to this scheme as no options have been granted after 7 November 2002.

(ii) Savings-related share option scheme

Consolidated

Date of grant		25 July 2003		16 July 2004		14 July 2005	
		2006	2005	**2006**	2005	**2006**	2005
Outstanding at the start of the year	Shares	**1,535,702**	1,645,220	**951,823**	–	**–**	–
	Price	**562**	562	**622**	–	**–**	–
Granted	Shares	**–**	–	**–**	986,379	**1,678,450**	–
	Price	**–**	–	**–**	622	**886**	–
Forfeited	Shares	**(59,602)**	(104,453)	**(42,932)**	(34,284)	**(46,961)**	–
	Price	**562**	562	**622**	622	**886**	–
Exercised	Shares	**(6,166)**	(5,065)	**(848)**	(272)	**(95)**	–
	Price	**998**	722	**986**	822	**1,001**	–
Outstanding at the end of the year	Shares	**1,469,934**	1,535,702	**908,043**	951,823	**1,631,394**	–
	Price	**562**	562	**622**	622	**886**	–

Of the outstanding options at the end of the year, none were exercisable.

Company

Date of grant		25 July 2003		16 July 2004		14 July 2005	
		2006	2005	**2006**	2005	**2006**	2005
Outstanding at the start of the year	Shares	**1,700**	1,700	**2,287**	–	**–**	–
	Price	**562**	562	**622**	–	**–**	–
Granted	Shares	**–**	–	**–**	2,287	**3,655**	–
	Price	**–**	–	**–**	622	**886**	–
Outstanding at the end of the year	Shares	**1,700**	1,700	**2,287**	2,287	**3,655**	–
	Price	**562**	562	**622**	622	**886**	–

No options were forfeited or exercised in the year. Of the outstanding options at the end of the year, none were exercisable.

The fair value of these options at the grant date, calculated using the Black-Scholes model, and the assumptions made in that model are as follows:

	July 2003		July 2004		July 2005	
	3 Year	5 Year	3 Year	5 Year	3 Year	5 Year
Price	659p	667p	730p	739p	1,012p	1,023p
Expected volatility	17%	17%	17%	17%	15%	15%
Risk free rate	4.7%	4.8%	4.7%	4.8%	4.1%	4.2%
Expected dividends	4.6%	4.6%	4.6%	4.6%	4.2%	4.2%
Term of the option	3 yrs	5 yrs	3 yrs	5 yrs	3 yrs	5 yrs
Underlying price at grant date	630p	630p	699p	699p	967p	967p
Strike price	562p	562p	622p	622p	886p	886p

Expected price volatility was determined by calculating the historical volatility of the Group's share price over the previous 12 months.

28. EMPLOYEE SHARE-BASED PAYMENTS Continued

(ii) Savings-related share option scheme Continued

In addition to the sharesave schemes detailed above, at 31 March 2006 there were outstanding options under the 2001 sharesave issue. Since the shares under this scheme were granted prior to 7 November 2002, they have not been included as permitted by the transitional rules under IFRS 1. However, at 31 March 2006, the outstanding options are as follows:

Date of grant	Number at 31 March 2006	Price (pence)	Date from which exercisable	Expiry date
October 2001	874,128	566	December 2006	May 2007

(iii) Share Incentive Plan

	Consolidated				Company			
	2006		2005		2006		2005	
	Shares	Weighted average price (pence)	Shares	Weighted average price (pence)	Shares	Weighted average price (pence)	Shares	Weighted average price (pence)
Outstanding at start of year	290,258	729	135,407	632	460	731	300	632
Granted during the year	255,993	1,028	164,043	803	240	1,025	275	797
Forfeited during the year	(13,958)	729	(6,485)	632	–	–	–	–
Exercised during the year	(5,056)	1,066	(2,707)	805	–	–	(115)	882
Expired during the year	–	–	–	–	–	–	–	–
Outstanding at end of year	527,237	874	290,258	729	700	832	460	731

Of the outstanding shares at the end of the year, none were realisable.

Shares purchased under this scheme prior to 7 November 2002 have not been included as permitted by the transitional rules under IFRS 1.

Free shares

	Consolidated				Company			
	2006		2005		2006		2005	
	Shares	Weighted average price (pence)	Shares	Weighted average price (pence)	Shares	Weighted average price (pence)	Shares	Weighted average price (pence)
Outstanding at start of year	–	–	–	–	–	–	–	–
Granted during the year	502,550	965	–	–	200	965	–	–
Forfeited during the year	(20,000)	965	–	–	–	–	–	–
Exercised during the year	(5,100)	1,073	–	–	–	–	–	–
Expired during the year	–	–	–	–	–	–	–	–
Outstanding at end of year	477,450	965	–	–	200	965	–	–

Of the outstanding shares at the end of the year, none were realisable.

(iv) Deferred bonus scheme

	Consolidated				Company			
	2006		2005		2006		2005	
	Shares	Price (pence)	Shares	Price (pence)	Shares	Price (pence)	Shares	Price (pence)
Outstanding at start of year	406,219	660	191,000	626	207,185	657	95,578	626
Granted during the year	181,780	1,009	217,330	685	95,958	1,009	111,607	685
Forfeited during the year	(3,816)	1,061	(1,255)	823	–	–	–	–
Exercised during the year	(58,788)	988	(856)	687	(37,008)	989	–	–
Expired during the year	–	–	–	–	–	–	–	–
Outstanding at end of year	525,395	860	406,219	660	266,135	784	207,185	657

Of the outstanding options at the end of the year, none were exercisable.

Shares purchased under this scheme prior to 7 November 2002 have not been included as permitted by the transitional rules under IFRS 1.

29. FINANCIAL INSTRUMENTS

The Group and the Company adopted IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* from 1 April 2005. No comparative information has been presented under these standards for the year ended 31 March 2005, in accordance with the transition provisions of IFRS 1. The comparative figures have been prepared in accordance with FRS 4 *Capital Instruments* and FRS 13 *Derivatives and other financial instruments: disclosures*.

Exposure to commodity price and volume risk, counterparty credit risk, interest rate risk, currency risk and liquidity risk arises in the normal course of the Group's business. Derivative financial instruments are entered into to hedge exposure to risk. The objectives and policies for holding or issuing financial instruments and similar contracts, and the strategies for achieving those objectives that have been followed during the year are explained below. The Risk Committee, a standing committee of the Board comprising three executive directors and senior managers from the Generation and Supply and Finance functions, oversees the control of these activities. This committee is discussed further in the Directors' Report.

The Group's Treasury function is responsible for managing the banking and liquidity requirements of the Group, risk management relating to interest rate and foreign exchange exposures, and for managing the credit risk relating to the banking counterparties with which it transacts. The department's operations are governed by policies determined by the Board and any breaches of these policies are reported to the Risk Committee and Audit Committee.

(i) Risk

Counterparty credit risk and liquidity risk
Credit risk arising from the Group's normal commercial operations is controlled by individual business units operating in accordance with group policies and procedures. Generally, individual business units enter into contracts or agreements with counterparties having investment grade credit ratings only, or where suitable collateral or other security has been provided. Counterparty credit validation is undertaken prior to contractual commitment.

Credit risk management for the Group's regulated businesses is performed in accordance with industry standards as set out by the Regulator and is controlled by the individual business units. The Group's greatest credit risks lie with the non-regulated operations of the Generation and Supply business and the activities carried out by the Group's Treasury function, for which specific credit risk controls that match the risk profile of those activities, are applied.

Liquidity risk, the risk that the Group will have insufficient funds to meet liabilities, is managed by the Group's Treasury function.

Generation and Supply
Exposure to credit risk in the supply of electricity and gas arises from the potential of a customer defaulting on their invoiced payables. The financial strength and creditworthiness of business customers is assessed before commencing, and during, their contract of supply. Domestic customers' creditworthiness is reviewed from a variety of internal and external information.

Exposure to credit risk in the procurement of wholesale energy and fuel is managed by reference to agreed transaction credit limits which are determined by whether the counterparty:

(i) holds an investment grade credit rating; or

(ii) can be assessed as adequately credit worthy in accordance with internal credit rules using information from other external credit agencies; or

(iii) can provide a guarantee from an investment grade rated entity or post suitable collateral or provide other acceptable assurances in accordance with group procedures where they have failed to meet the above conditions; or

(iv) can be allocated a non-standard credit limit approved by the Risk Committee within its authorised limits as delegated by the Group Board.

Credit support clauses or side agreements are typically included or entered into to protect the Group against counterparty failure or non-delivery. Within the Generation and Supply business, increasing volumes of commodity derivative products are now traded through cleared exchanges to further mitigate credit risk. Such exchanges are subject to strict regulation by the UK Financial Services Authority (FSA) and participants in these exchanges are obliged to meet rigorous capital adequacy requirements.

Individual counterparty credit exposures are monitored by category of credit risk and are subject to approved limits. At 31 March 2006, the Group had pledged £100m of cash collateral and letters of credit and had received £660m of cash collateral and letters of credit principally to reduce exposures on commodity price risk.

Treasury
In relation to the Group's liquidity risk, the Group's relationship banks (defined as those banks who support the company's financing activities through their ongoing participation in the committed lending facilities that are maintained by the Group), are each allocated financial limits, subject to the maintenance of a minimum credit rating of "A" or equivalent allocated by a recognised major ratings group. In respect of short-term cash management, counterparties are subject to review and approval according to defined criteria.

Bank credit exposures, which are monitored and reported on daily, are calculated on a formulaic, risk-weighted basis. Any issues relating to these credit exposures are presented for discussion and review by the Risk Committee.

The Group has no significant concentration of credit risk, with exposure spread over a large number of counterparties and customers.

29. FINANCIAL INSTRUMENTS Continued

(i) Risk Continued

Energy commodity price risk
The Group's Generation and Supply business faces exposure to energy commodity price movements as part of its normal course of business. This arises from the Group's requirement to source gas or electricity to supply customers, or to procure fuel to produce electricity from its generation assets.

The Group's strategy is to procure gas, electricity and fuel through longer term contracts including forwards and futures contracts and financial instruments which will reduce the volume required to be procured in the short-term market. Alternatively, reduced retail sales activity may be seen as an appropriate strategy in times of rising commodity prices. The contracts entered into are done so primarily for own use or hedging purposes and not for trading purposes.

The capacity to generate electricity beyond the level currently committed to existing customers is also recognised as an exposure to volatile wholesale electricity prices.

The resulting energy commodity price risk is quantified by the use of a Value at Risk (VaR) model which provides an estimate of the potential change to the Group's forecast profits over a given period and to a given confidence level. The calculated financial risk is controlled through the imposition of a number of risk limits approved by the Risk Committee.

Energy volume risk
Inherently linked to the Group's energy commodity price risk is the Group's energy volume risk. This risk arises from the requirement to match volumes of procured gas, electricity and power station fuel with demand for gas and electricity by its customers, which can vary from expectations and result in a requirement to close the resulting positions at unfavourable prices. This risk is managed through the ability to increase or decrease energy production either in the form of flexible purchase contracts or assets such as pumped storage generating plant, flexible hydro generating plant, standby oil plant and gas storage.

The Group has assessed its portfolio of sources of production and supply and has been able to identify contracts which are held for own use (which are not accounted for as financial derivatives) and those which are held to manage commodity price and volume risk. Certain physical contracts are treated as the hedging instrument in documented cash flow hedging relationships where the hedged item is the forecast future purchase requirement to meet production or customer demand.

Currency risk
In addition to spot purchases of foreign currency, the Group uses forward contracts, swaps and options to manage its exposures to foreign exchange risk. All such exposures are transactional in nature, and relate primarily to procurement contracts, commodity purchasing and related freight requirements, commodity hedging, long term plant servicing and maintenance agreements, and the purchase and sale of carbon emission certificates. Significant exposures are reported to, and discussed by, the Risk Committee on an ongoing basis and additionally form part of the bi-annual Treasury report to the Audit Committee.

At the balance sheet date, the total nominal value of outstanding forward foreign exchange contracts that the Group has committed to is:

	2006 £m	2005 £m
Forward foreign exchange contracts	**777.1**	521.8

The Group has no subsidiaries outside the UK and therefore has minimal exposure to currency translation risk arising from operations outside the UK.

Interest rate risk
Interest rate risk derives from the Group's exposure to changes in value of an asset or liability or future cash flows through changes in interest rates.

The Group's policy is to manage this risk by stipulating that a minimum of 50% of Group borrowings be subject to fixed rates of interest, either directly through the debt instruments themselves or through the use of derivative financial instruments. Such instruments include interest rate swaps and options, forward rate agreements and, in the case of debt raised in currencies other than sterling, cross currency swaps.

Although interest rate derivatives are primarily used to hedge risk relating to current borrowings, under certain circumstances they may also be used to hedge future borrowings. Any such pre-hedging is unwound at the time of pricing the underlying debt, either through cash settlement on a net present value basis or by transacting offsetting trades. The floating rate borrowings mainly comprise commercial paper issued at interest rates less than LIBOR and cash advances from the European Investment Bank (EIB).

29. FINANCIAL INSTRUMENTS Continued

(i) Risk Continued

Effective interest rate analysis

In respect of income earning financial assets and interest bearing financial liabilities, the following table indicates their effective interest rates as at the balance sheet date and the periods in which they mature:

At 31 March 2006	Effective interest rate %	Total £m	Within 1 year £m	1-2 years £m	2-5 years £m	More than 5 years £m
Cash and cash equivalents	**4.22%**	**(34.4)**	(34.4)	–	–	–
Bank overdrafts	**5.50%**	**6.1**	6.1	–	–	–
Long term bonds	**5.77%**	**1,186.5**	150.0	61.5	–	975.0
Other bank loans – fixed	**6.33%**	**336.3**	19.6	46.4	56.6	213.7
Other bank loans – floating	**4.52%**	**385.0**	235.0	–	–	150.0
Interest rate swaps – fixed	**5.81%**	**340.0**	–	–	75.0	265.0
Interest rate swaps – floating	**4.69%**	**325.0**	125.0	200.0	–	–
Convertible debt	**3.75%**	**300.0**	–	–	300.0	–
Finance lease obligations	**8.00%**	**1.6**	0.5	–	0.8	0.3
Non-recourse borrowings	**6.44%**	**26.2**	6.5	6.5	13.2	–

(ii) Fair Values

The fair values of the Group's financial assets and financial derivatives and the carrying amounts in the Group's consolidated balance sheet are analysed below. Balances included in the analysis of primary financial assets and liabilities include cash and cash equivalents, loans and borrowings, trade and other receivables, trade and other payables and provisions, all of which are disclosed separately. Own use commodity contracts are not considered to be financial instruments.

Summary fair values

The fair values of the primary financial assets and liabilities together with their carrying values are as follows:

	2006 Carrying Value £m	2006 Fair Value £m
Financial Assets		
Trade and other receivables	**1,672.3**	**1,672.3**
Cash and cash equivalents	**2.1**	**2.1**
Other financial assets (i)	**32.3**	**32.3**
Financial Liabilities		
Trade and other payables	**(2,231.3)**	**(2,231.3)**
Provisions	**(81.8)**	**(81.8)**
Bank loans and overdrafts (ii)	**(726.8)**	**(747.7)**
Long-term bonds (iii)	**(1,180.5)**	**(1,232.0)**
Convertible bond (iii)	**(280.8)**	**(389.4)**
Non-recourse borrowings	**(26.2)**	**(26.2)**
Obligations under Finance Leases	**(1.6)**	**(1.6)**

(i) Represents carrying value of equity in unlisted investments, included at fair value.

(ii) Fair value of overdrafts is equivalent to carrying value due to short-term maturity.

(iii) Fair values have been determined with reference to closing market prices.

Unless otherwise stated, carrying value approximates fair value.

29. FINANCIAL INSTRUMENTS Continued

(ii) Fair Values Continued

Financial derivative instruments – disclosure
For disclosure purposes, derivative financial instruments are classified into two categories, operating derivatives and financing derivatives. Operating derivatives include all qualifying commodity contracts including those for electricity, gas, oil, coal and carbon. Financing derivatives include all fair value and cash flow interest rate hedges, non-hedge accounted mark to market (MTM) interest rate derivatives, cash flow foreign exchange hedges and non-hedge MTM accounted foreign exchange contracts. Non-hedge accounted contracts are treated as held for trading MTM. The carrying value is the same as the fair value for all instruments. All balances are stated gross of associated deferred taxation.

	At 1 April 2005 £m	Movement in the year: Income Statement (ii) £m	Movement in the year: Hedge Reserve (ii) £m	At 31 March Transfer (i) £m	2006 £m
Operating derivatives					
Cash flow hedges – commodity (iii)	49.2	–	(32.4)	–	**16.8**
MTM – commodity (iii)	80.9	(14.4)	–	–	**66.5**
	130.1	(14.4)	(32.4)	–	**83.3**
Financing derivatives					
Cash flow hedges – interest rate (iv)	(13.2)	(0.1)	1.5	–	**(11.8)**
Fair value hedges – interest rate (iv)	(3.8)	2.3	–	–	**(1.5)**
MTM – interest rate (iv)	(74.6)	(47.8)	–	89.5	**(32.9)**
Cash flow hedges – currency (v)	(9.6)	–	14.0	–	**4.4**
MTM – currency (v)	(1.0)	4.6	–	–	**3.6**
	(102.2)	(41.0)	15.5	89.5	**(38.2)**
Financial assets / (liabilities)	**27.9**	**(55.4)**	**(16.9)**	**89.5**	**45.1**
Hedged items (vi)					
Loans and borrowings (note 21)	3.9	(2.5)	–	–	**1.4**
Net balance sheet	**31.8**	**(57.9)**	**(16.9)**	**89.5**	**46.5**

The net movement reflected in the Income Statement can be analysed thus:

	2006 £m
Operating derivatives	
Total result on operating derivatives (vii)	**176.1**
Less: amounts settled in the year (viii)	**(190.5)**
Movement in unrealised derivatives	**(14.4)**
Financing derivatives (and hedged items)	
Total result on operating derivatives (vii)	**(47.3)**
Less: amounts settled in the year (viii)	**3.8**
Movement in unrealised derivatives	**(43.5)**
Total	**(57.9)**

(i) Represents previously contingent interest rate swap held and entered into by Scotia Gas Networks plc and transferred at date of acquisition of the gas distribution networks at 1 June 2005 to the investment in the jointly controlled entity (note 14).

(ii) Gains or losses transferred to the hedge reserve represent amounts in respect of mark-to-market movements on effective cash flow hedge relationships which have not matured. Where hedge accounting is discontinued, any cumulative gain or loss on the hedging instrument previously recognised in equity remains in equity until the forecast transaction occurs. If the transaction is no longer expected to occur, the cumulative gain or loss recognised in equity is recognised in the income statement. The movement on the hedge reserve in the year includes the impact of a transfer of an ineffective, loss-making cash flow hedge item to the income statement. See note (v) for policy basis.

(iii) These fair values represent the contracts which have not been designated as own use purchase contracts in line with the provisions of IAS 39. The fair values at the balance sheet date represent the unrealised gains and losses from holding commodity contracts for future delivery. These fair values are subject to change in commodity market prices. The method of determining fair value is described in 'basis of determining fair value' below.

(iv) The interest rate derivative instruments outstanding at the balance sheet date had remaining lives of between nine months and 31 years and fixed rates of interest payable ranging from 4.01% to 8.22%. The gross fair value of these instruments was a £46.2m liability. The method of determining fair value is described in 'basis of determining fair value' below.

29. FINANCIAL INSTRUMENTS Continued

(ii) Fair Values Continued

Financial derivative instruments – disclosure Continued

(v) At 31 March 2006, the fair value of the Group's currency derivatives is estimated to be approximately £8.0m. This amount is based on market values of equivalent instruments at the balance sheet dates. The method of determining fair value is described in 'basis of determining fair value' below. For both (iv) and (v), the effective portion of the fair value movement of qualifying cash flow hedges is recorded in the hedge reserve. If the hedged asset or liability no longer exists or the forecast transaction is no longer expected to occur, the previously deferred amount in equity is recycled to the income statement.

(vi) The fair value adjustments to loans and borrowings designated as the hedged item in effective fair value hedge relationships are analysed. This provides a full analysis of the impact of the adoption of IAS 39 in the financial year. This is reflected in note 21 to these financial statements.

(vii) Total result on derivatives (operating or financial) in the income statement represents amounts in respect of realised gains or losses on derivatives, mark-to-market movements on effective fair value hedge relationships which have not matured, mark-to-market movements on other derivatives held or acquired during the year and mark-to-market movements on the ineffective portion of cash flow hedge relationships which have not matured.

(viii) Amounts settled in the year represent the unwind of opening unrealised financial derivative assets or liabilities which have matured or been delivered in the financial year and other derivatives transacted in the year which have matured or been delivered.

The net financial assets / (liabilities) have been offset in this note. The following is an analysis of these items for financial reporting purposes.

	Consolidated 2006 £m	Consolidated 2005 £m	Company 2006 £m	Company 2005 £m
Financial Assets				
Non-current	**24.8**	–	**–**	–
Current	**157.6**	–	**–**	–
	182.4	–	**–**	–
Financial liabilities				
Non-current	**(77.5)**	–	**(20.9)**	–
Current	**(59.8)**	–	**–**	–
	(137.3)	–	**(20.9)**	–
Loans (note 21)	**1.4**	–	**–**	–
	46.5	–	**(20.9)**	–

Basis of determining fair value

Closing rate market values have been used to determine the fair values of the interest rate and foreign currency contracts and denominated long-term fixed rate debt. Commodity contracts fair values are based on published price quotations where liquid markets exist and on future price forecasts where markets are illiquid. The estimates applied reflect the management's best estimates of these factors.

(iii) Comparatives for the year to 31 March 2005

As set out in the accounting policies on page 53, the financial information provided in respect of financial instruments as at 31 March 2005 is based on the Group's policies under FRS 4 and does not take into account the requirements of IAS 32 and IAS 39.

Interest rate profile

At 31 March 2005, the Group had fixed interest investments of £218.5m which were part of the financing activities of the Group. After taking into account interest rate swaps and currency swaps, the interest rate profile of the Group's total borrowings was as follows:

	Borrowings			Fixed rate borrowings	
	Total £m	Floating rate £m	Fixed rate £m	Weighted average interest rate %	Weighted average period for which rate is fixed Years
31 March 2005	1,681.0	40.9	1,640.1	5.71	12.81

29. FINANCIAL INSTRUMENTS Continued

(iii) Comparatives for the year to 31 March 2005 Continued

The floating rate borrowings mainly comprise commercial paper bearing interest rates less than LIBOR at the date of issue and cash advances from the European Investment Bank.

Fair values
Set out below is a comparison of book values and fair values of the Group's other financial assets and liabilities:

	2005 Book value £m	2005 Fair value £m
Primary financial instruments held or issued to finance the Group's operations		
Short-term borrowings	22.4	24.6
Long-term borrowings	1,640.6	1,706.7
Short-term deposits	218.5	218.5
Derivative financial instruments held to manage the interest rate and currency profile		
Interest rate swaps and options	–	(31.1)
Cross currency swaps	–	(5.5)
Foreign exchange swaps and forward contracts	–	(10.9)
Oil and coal swaps	–	82.7

Market values have been used to determine the fair values of the interest rate swaps and options, foreign currency contracts, oil price contracts and Sterling denominated long-term fixed rate debt. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

30. RELATED PARTY TRANSACTIONS

The following transactions took place during the year between the Group and entities which are related to the Group but which are not members of the Group. Related parties are defined as those in which the Group has control, joint control or significant influence over.

	Sale of goods and services 2006 £m	Purchase of goods and services 2006 £m	Other Transactions 2006 £m	Sale of goods and services 2005 £m	Purchase of goods and services 2005 £m	Other Transactions 2005 £m
Jointly controlled entities:						
Seabank Power Limited	19.9	(70.9)	17.9	13.5	(108.5)	21.4
PriDE (South East Regional Prime) Limited	19.2	–	0.1	0.5	–	–
Scotia Gas Networks plc	52.3	(62.1)	30.3	–	–	–
Associates:						
Scottish Electricity Settlements Limited	0.1	0.2	0.5	0.4	(2.7)	0.6
Barking Power Limited	–	(125.9)	–	1.3	(105.7)	–
Derwent Co-generation Limited	32.5	(68.5)	–	24.2	(52.4)	–

The transactions with Seabank Power Limited, Barking Power Limited and Derwent Co-generation Limited relate to the contracts for the provision of energy or the tolling of energy under power purchase arrangements. PriDE (South East Regional Prime) Limited operates a long-term contract with Defence Estates for management of MoD facilities in the South East of England. All operational activities are sub-contracted to the ventures partners including Southern Electric Contracting Limited. Scotia Gas Networks plc has operated the gas distribution networks in Scotland and the south of England from 1 June 2005. The Group's gas supply activity incurs gas distribution charges while the Group also provides services to Scotia Gas Networks in the form of a management service agreement for corporate services, stock procurement services and the provision of the capital expenditure on the development of front office management information systems. Scottish Electricity Settlements Limited previously operated the settlement systems for the Scottish electricity market prior to the opening of BETTA and the other transactions represent the interest paid on the loans provided to the company. Sales of goods to related parties were made at an arms length price.

for the year ended 31 March 2006

30. RELATED PARTY TRANSACTIONS Continued

The balances outstanding with related parties at 31 March were as follows:

Consolidated

	Amounts owed by related parties 2006 £m	Amounts owed by related parties 2005 £m	Amounts owed to related parties 2006 £m	Amounts owed to related parties 2005 £m
Jointly controlled entities:				
Seabank Power Limited	**133.8**	118.4	**36.2**	30.6
PriDE (South East Regional Prime) Limited	**6.5**	0.9	**–**	–
Scotia Gas Networks plc	**299.8**	–	**0.3**	–
Associates:				
Scottish Electricity Settlements Limited	**–**	7.4	**–**	0.6
Barking Power Limited	**3.8**	1.5	**13.2**	13.4
Derwent Co-generation Limited	**0.6**	0.7	**8.0**	4.8

The amounts outstanding are unsecured and will be settled in cash. No guarantees have been given or received. No provisions have been made for doubtful debts in respect of the amounts owed by related parties. Aggregate capital loans to jointly controlled entities and associates are shown in note 12.

During the year, the Company entered into the following transactions with its subsidiaries (note 13):

Company

	2006 £m	2005 £m
Loans granted to subsidiaries	**–**	33.1
Loans repaid by subsidiaries	**425.0**	–
Interest charged to subsidiaries	**86.6**	85.7
Sale of goods	**–**	–
Purchase of goods	**–**	–
Balances outstanding at 31 March:		
Loan balances outstanding at the year end	**858.1**	1,283.1

Remuneration of key management personnel

The remuneration of the Directors, who are the key management personnel of the Group, is set out below in aggregate.

	2006 £m	2005 £m
Short-term employment benefits	**2.9**	2.7

In addition, the key management personnel receive share based remuneration, details of which can be found in note 28. The aggregate key management remuneration in 2005 included remuneration of a former Executive Director who retired on 31 March 2005.

Further information about the remuneration of individual Directors is provided in the audited part of the Remuneration Report.
The key management personnel are employed by the Company.

31. COMMITMENTS AND CONTINGENCIES

i. Capital commitments

	2006 £m	2005 £m
Capital expenditure:		
Contracted for but not provided	**637.1**	230.6

ii. Operating lease commitments

a) Leases as lessee:

	2006 £m	2005 £m
Amount included in the income statement relating to the current year leasing arrangements	**14.3**	14.5

At the balance sheet date, the Group had outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows:

	2006 £m	2005 £m
Power purchase agreements		
Within one year	**158.4**	157.1
In second to fifth years inclusive	**479.6**	570.1
After five years	**67.8**	135.7
	705.8	862.9
Other leases		
Within one year	**8.3**	9.6
In second to fifth years inclusive	**16.5**	19.5
After five years	**28.5**	30.8
	53.3	59.9
Total		
Within one year	**166.7**	166.7
In second to fifth years inclusive	**496.1**	589.6
After five years	**96.3**	166.5
	759.1	922.8

The average lease is over 12 years.

Included in the above operating leases are obligations under power purchase agreements with various power generating companies including certain related parties (note 30). Each arrangement was assessed in accordance with IFRIC 4 *Determining whether an Arrangement contains a Lease*, and IAS 17 *Leases*, and while all were deemed to meet the definition of a lease none were deemed to qualify as finance leases.

b) Leases as lessor:

The Group leases out a number of combined heat and power plants under operating leases. The leases typically run for a period of 15 years, with an average of 10 years to run, with an option to renew the lease after that date. None of the leases include contingent rentals.

The Group leases out certain plant, property and equipment under operating leases. The future minimum lease payments under non-cancellable leases are as follows:

	2006 £m	2005 £m
Within one year	**0.3**	0.3
In second to fifth years inclusive	**1.0**	1.0
After five years	**1.2**	1.5
	2.5	2.8

During the year ended 31 March 2006 £0.3m was recognised as rental income in the income statement (2005 – £0.3m). Lease payments are straight line over the term of the lease.

The Company has no lease commitments.

31. COMMITMENTS AND CONTINGENCIES

iii. Guarantees and indemnities

Scottish and Southern Energy plc has provided guarantees on behalf of subsidiary and associated undertakings as follows:

	2006 £m	2005 £m
Bank borrowing	**63.6**	79.0
Performance of contracts	**370.6**	307.4
Purchase of gas	**120.5**	175.5

In addition, unlimited guarantees have been provided on behalf of subsidiary undertakings in relation to five contracts in respect of performance of work and any liabilities arising. Southern Electric Power Distribution plc and the Company have provided guarantees to the Southern Group of the ESPS in respect of the funding required by the scheme.

The Company has not adopted amendments to IAS 39 and IFRS 4 in relation to financial guarantee contracts which will apply for periods commencing on or after 1 April 2006. Where the Company enters into financial guarantee contracts to guarantee the indebtedness of other companies within its Group, the Company considers these to be insurance arrangements, and accounts for them as such. In this respect, the Company treats the guarantee contract as a contingent liability until such time as it becomes probable that the Company will be required to make a payment under the guarantee. The Company does not expect the amendments to have any impact on the financial statements for the period commencing 1 April 2006.

32. ANALYSIS OF NET DEBT

	At 1 April 2005 (after IAS 32) £m	Decrease in cash and cash equivalents £m	(Increase)/ decrease in debt £m	At 31 March 2006 £m
Cash and cash equivalents (note 17)	232.2	(182.3)	–	**49.9**
Bank overdraft (i)	(4.4)	(1.7)	–	**(6.1)**
	227.8	(184.0)	–	**43.8**
Loans and borrowings (ii)	(1,660.2)	–	(554.5)	**(2,214.7)**
Finance lease creditors (note 21)	(2.0)	–	0.4	**(1.6)**
Bank overdrafts (i)	4.4	–	1.7	**6.1**
	(1,657.8)	–	(552.4)	**(2,210.2)**
Net debt	(1,430.0)	(184.0)	(552.4)	**(2,166.4)**

(i) Bank overdrafts are reported on the balance sheet as part of current loans and borrowings. For cash flow purposes, these have been included as cash and cash equivalents.

(ii) The opening loans and borrowings are restated for £20.8m relating to the equity component of the convertible bond (note 21). The closing loans and borrowings are adjusted for £1.4m relating to fair value adjustments to borrowings (note 21).

33. EXPLANATION OF TRANSITION TO IFRS

Reconciliation of previously reported financial statements under UK GAAP to IFRS.

The Group and Company have prepared the financial statements under IFRS. The UK GAAP to IFRS reconciliation of the statements listed below are included in the following pages:

- Income statement for the year to 31 March 2005 (Group only), and
- The balance sheets at I April 2004 and 31 March 2005.

An explanation of the reclassification and re-measurements applied on adoption of IFRS follows on pages 98 to 99.

In addition to these changes, the Group has adopted IAS 32 and IAS 39 prospectively from 1 April 2005. Details of the impact of adoption at that date are included on pages 99 and 100.

Reconciliation of the Group profit and loss account under UK GAAP to the group income statement under IFRS for the year to 31 March 2005.

Consolidated

	UK GAAP £m	IAS 12 Deferred tax £m	IFRS 2 Share-based payments £m	IAS 16 PPE £m	IAS 19 Pensions £m	IAS 38 Intangibles £m	IAS 36 Goodwill £m	IAS 28 and 31 £m	Reclass-ification £m	IFRS £m
Group and share of jointly controlled entities	7,482.8							(58.2)		7,424.6
Jointly controlled entities	(58.2)							58.2		–
Revenue	7,424.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7,424.6
Cost of sales before exceptional item	(6,256.1)			(1.1)						(6,257.2)
Exceptional item	(61.0)									(61.0)
Cost of sales	(6,317.1)			(1.1)						(6,318.2)
Gross profit	**1,107.5**	**0.0**	**0.0**	**(1.1)**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1,106.4**
Distribution and administrative costs	(429.0)		6.4			(0.4)	15.4			(407.6)
Exceptional item	111.2									111.2
Operating profit before jointly controlled entities and associates	**789.7**	**0.0**	**6.4**	**(1.1)**	**0.0**	**(0.4)**	**15.4**	**0.0**	**0.0**	**810.0**
Jointly controlled entities and associates										
Share of operating profit before exceptionals	50.8									50.8
Exceptional item	22.3									22.3
Share of interest	–							(17.2)		(17.2)
Share of tax before exceptional item	–							(8.6)		(8.6)
Tax on exceptional item	–							(6.7)		(6.7)
Share of jointly controlled entities and associates	**73.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**(32.5)**	**0.0**	**40.6**
Operating profit	**862.8**	**0.0**	**6.4**	**(1.1)**	**0.0**	**(0.4)**	**15.4**	**(32.5)**	**0.0**	**850.6**
Net finance costs	(73.7)								12.4	(61.3)
Interest:										
Jointly controlled entities and associates	(17.2)							17.2		–
Other finance income	13.4				(1.0)				(12.4)	–
Profit before taxation	**785.3**	**0.0**	**6.4**	**(1.1)**	**(1.0)**	**(0.4)**	**15.4**	**(15.3)**	**0.0**	**789.3**
Taxation excluding impact of exceptional items	(215.0)	(2.6)						8.6		(209.0)
Tax impact of exceptional items	(27.2)							6.7		(20.5)
Income tax expense	(242.2)	(2.6)						15.3		(229.5)
Profit after taxation	**543.1**	**(2.6)**	**6.4**	**(1.1)**	**(1.0)**	**(0.4)**	**15.4**	**0.0**	**0.0**	**559.8**
Equity minority interests in subsidiary undertakings	0.1									0.1
Profit for the financial year	**543.2**	**(2.6)**	**6.4**	**(1.1)**	**(1.0)**	**(0.4)**	**15.4**	**0.0**	**0.0**	**559.9**

33. EXPLANATION OF TRANSITION TO IFRS Continued

Reconciliation of the Group balance sheet under UK GAAP to IFRS as at 1 April 2004

Consolidated

	UK GAAP £m	IFRS Reclass-ifications £m	IAS 12 Deferred Tax £m	IAS 10 Dividends £m	IFRS 2 Share-based payments £m	IAS 16 PPE £m	IAS 19 Pensions £m	IAS 38 Intangibles £m	IAS 31 JVs £m	IFRS £m
Assets										
Intangible assets										
– goodwill	274.0									274.0
– other intangible assets	–							48.9		48.9
Property, plant and equipment	4,139.1					3.4				4,142.5
Investments	197.0								(0.4)	196.6
Retirement benefit asset	–						75.3			75.3
Deferred tax asset	–						81.3			81.3
Non-current assets	4,610.1	0.0	0.0	0.0	0.0	3.4	156.6	48.9	(0.4)	4,818.6
Current assets										
Inventories	46.0									46.0
Trade and other receivables	736.9				(0.1)					736.8
Current asset investments	21.8	(21.8)								–
Cash and cash equivalents	6.5	21.8								28.3
Current assets	811.2	0.0	0.0	0.0	(0.1)	0.0	0.0	0.0	0.0	811.1
Total assets	**5,421.3**	**0.0**	**0.0**	**0.0**	**(0.1)**	**3.4**	**156.6**	**48.9**	**(0.4)**	**5,629.7**
Liabilities										
Loans and other borrowings	–	(82.4)								(82.4)
Trade and other payables	(1,307.8)	167.8		226.1				(44.0)		(957.9)
Current tax liabilities	–	(85.4)								(85.4)
Current liabilities	(1,307.8)	0.0	0.0	226.1	0.0	0.0	0.0	(44.0)	0.0	(1,125.7)
Non-Current liabilities										
Loans and other borrowings	(1,363.0)									(1,363.0)
Deferred tax liabilities	(512.7)		(311.8)				(22.6)			(847.1)
Provisions	(96.0)									(96.0)
Trade and other payables	(289.3)									(289.3)
Retirement benefit obligations	(124.4)						(146.6)			(271.0)
Non-current liabilities	(2,385.4)	0.0	(311.8)	0.0	0.0	0.0	(169.2)	0.0	0.0	(2,866.4)
Total liabilities	**(3,693.2)**	**0.0**	**(311.8)**	**226.1**	**0.0**	**0.0**	**(169.2)**	**(44.0)**	**0.0**	**(3,992.1)**
Net assets	**1,728.1**	**0.0**	**(311.8)**	**226.1**	**(0.1)**	**3.4**	**(12.6)**	**4.9**	**(0.4)**	**1,637.6**
Equity										
Share capital	428.7									428.7
Share premium	72.6									72.6
Capital redemption reserve	13.7									13.7
Retained earnings	1,213.4		(311.8)	226.1	(0.1)	3.4	(12.6)	4.9	(0.4)	1,122.9
Equity attributable to equity holders of the Group	1,728.4	0.0	(311.8)	226.1	(0.1)	3.4	(12.6)	4.9	(0.4)	1,637.9
Minority interest	(0.3)									(0.3)
Total equity	**1,728.1**	**0.0**	**(311.8)**	**226.1**	**(0.1)**	**3.4**	**(12.6)**	**4.9**	**(0.4)**	**1,637.6**

33. EXPLANATION OF TRANSITION TO IFRS Continued

Reconciliation of the Group balance sheet under UK GAAP to IFRS as at 31 March 2005

Consolidated

	UK GAAP £m	IFRS Reclass-ifications £m	IAS 12 Deferred Tax £m	IAS 10 Dividends £m	IFRS 2 Share-based payments £m	IAS 16 PPE £m	IAS 19 Pensions £m	IAS 38 Intangibles £m	IFRS 3 Goodwill £m	Acq-uisitions £m	IFRS 3 IAS 31 JVs £m	IFRS £m
Assets												
Intangible assets												
– goodwill	260.6								15.4	17.7		293.7
– other intangible assets	8.2							98.5				106.7
Property, plant and equipment	4,383.8					2.3						4,386.1
Investments	213.8										(0.4)	213.4
Retirement benefit asset	–						98.9					98.9
Deferred tax asset	–						97.9					97.9
Non-current assets	4,866.4	0.0	0.0	0.0	0.0	2.3	196.8	98.5	15.4	17.7	(0.4)	5,196.7
Current assets												
Inventories	134.1											134.1
Trade and other receivables	1,073.7											1,073.7
Current asset investments	218.5	(218.5)										–
Cash and cash equivalents	13.7	218.5										232.2
Current assets	1,440.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1,440.0
Total assets	**6,306.4**	**0.0**	**0.0**	**0.0**	**0.0**	**2.3**	**196.8**	**98.5**	**15.4**	**17.7**	**(0.4)**	**6,636.7**
Liabilities												
Loans and other borrowings	–	(29.4)										(29.4)
Trade and other payables	(1,700.8)	168.7		260.0	5.1			(94.0)				(1,361.0)
Current tax liabilities	–	(138.0)										(138.0)
Provisions	–	(20.3)										(20.3)
Current liabilities	(1,700.8)	(19.0)	0.0	260.0	5.1	0.0	0.0	(94.0)	0.0	0.0	0.0	(1,548.7)
Non-Current liabilities												
Loans and other borrowings	(1,918.4)	264.8										(1,653.6)
Deferred tax liabilities	(530.4)	0.2	(310.7)				(29.7)			(17.7)		(888.3)
Provisions	(111.3)	20.3										(91.0)
Trade and other payables	–	(266.3)										(266.3)
Retirement benefit obligations	(143.6)						(182.9)					(326.5)
Non-current liabilities	(2,703.7)	19.0	(310.7)	0.0	0.0	0.0	(212.6)	0.0	0.0	(17.7)	0.0	(3,225.7)
Total liabilities	**(4,404.5)**	**0.0**	**(310.7)**	**260.0**	**5.1**	**0.0**	**(212.6)**	**(94.0)**	**0.0**	**(17.7)**	**0.0**	**(4,774.4)**
Net assets	**1,901.9**	**0.0**	**(310.7)**	**260.0**	**5.1**	**2.3**	**(15.8)**	**4.5**	**15.4**	**0.0**	**(0.4)**	**1,862.3**
Equity												
Share capital	429.4											429.4
Share premium	81.6											81.6
Capital redemption reserve	13.7											13.7
Retained earnings	1,377.6		(310.7)	260.0	5.1	2.3	(15.8)	4.5	15.4		(0.4)	1,338.0
Equity attributable to equity holders of the Group	1,902.3	0.0	(310.7)	260.0	5.1	2.3	(15.8)	4.5	15.4	0.0	(0.4)	1,862.7
Minority interest	(0.4)											(0.4)
Total equity	**1,901.9**	**0.0**	**(310.7)**	**260.0**	**5.1**	**2.3**	**(15.8)**	**4.5**	**15.4**	**0.0**	**(0.4)**	**1,862.3**

Notes on the Financial Statements Continued

for the year ended 31 March 2006

33. EXPLANATION OF TRANSITION TO IFRS Continued

Reconciliation of the Company balance sheet under UK GAAP to IFRS as at 1 April 2004

Company

	UK GAAP £m	IFRS Reclassifications £m	IAS 10 Dividends £m	IAS 19 Pensions £m	IFRS £m
Assets					
Intangible assets					
– goodwill	–				–
– other intangible assets	–				–
Property, plant and equipment	–				–
Investments in subsidiaries	777.9				777.9
Amounts owed by Group companies	–	2,207.8			2,207.8
Retirement benefit asset	52.7			22.6	75.3
Non-current assets	–	2,207.8	0.0	22.6	3,061.0
Current assets					
Trade and other receivables	27.9				27.9
Amounts owed by Group companies	2,725.5	(2,207.8)	(79.5)		438.2
Current asset investments	8.6	(8.6)			–
Cash and cash equivalents	0.4	8.6			9.0
Current assets	2,762.4	(2,207.8)	(79.5)	0.0	475.1
Total assets	**3,593.0**	**0.0**	**(79.5)**	**22.6**	**3,536.1**
Liabilities					
Loans and other borrowings	(62.2)				(62.2)
Trade and other payables	(283.0)		226.1		(56.9)
Amounts owed to Group companies	(1,456.2)				(1,456.2)
Current tax liabilities	(12.5)				(12.5)
Current liabilities	(1,813.9)	0.0	226.1	0.0	(1,587.8)
Non-Current liabilities					
Loans and other borrowings	(444.6)				(444.6)
Due to Group companies	(240.2)				(240.2)
Deferred tax liabilities	–			(22.6)	(22.6)
Retirement benefit obligations	–				–
Non-current liabilities	(684.8)	0.0	0.0	(22.6)	(707.4)
Total liabilities	**(2,498.7)**	**0.0**	**226.1**	**(22.6)**	**(2,295.2)**
Net assets	**1,094.3**	**0.0**	**146.6**	**0.0**	**1,240.9**
Equity					
Share capital	428.7				428.7
Share premium	72.6				72.6
Capital redemption reserve	13.7				13.7
Retained earnings	579.3		146.6		725.9
Equity attributable to equity holders of the Group	1,094.3	0.0	146.6	0.0	1,240.9
Minority interest	–				–
Total equity	**1,094.3**	**0.0**	**146.6**	**0.0**	**1,240.9**

33. EXPLANATION OF TRANSITION TO IFRS Continued

Reconciliation of the Company balance sheet under UK GAAP to IFRS as at 31 March 2005

Company

	UK GAAP £m	IFRS Reclassifications £m	IAS 12 Deferred Tax £m	IAS 10 Dividends £m	IAS 19 Pensions £m	IFRS £m
Assets						
Intangible assets						
– goodwill	–					–
– other intangible assets	–					–
Property, plant and equipment	–					–
Investments in subsidiaries	777.9					777.9
Amounts owed by Group companies	–	2,197.0				2,197.0
Retirement benefit asset	70.9				28.0	98.9
Non-current assets	848.8	2,197.0	0.0	0.0	28.0	3,073.8
Current assets						
Trade and other receivables	7.5					7.5
Amounts owed by Group companies	3,084.9	(2,197.0)		(258.0)		629.9
Deferred tax asset	1.3	(1.3)				–
Current asset investments	199.1	(199.1)				–
Cash and cash equivalents	0.5	199.1				199.6
Current assets	3,293.3	(2,198.3)	0.0	(258.0)	0.0	837.0
Total assets	**4,142.1**	**(1.3)**	**0.0**	**(258.0)**	**28.0**	**3,910.8**
Liabilities						
Loans and other borrowings	(2.1)					(2.1)
Trade and other payables	(317.8)			260.0		(57.8)
Amounts owed to Group companies	(1,791.6)					(1,791.6)
Current tax liabilities	(10.4)					(10.4)
Current liabilities	(2,121.9)	0.0	0.0	260.0	0.0	(1,861.9)
Non-Current liabilities						
Loans and other borrowings	(742.4)					(742.4)
Due to Group companies	(240.2)					(240.2)
Deferred tax liabilities	–	1.3	0.1		(29.7)	(28.3)
Retirement benefit obligations	–					–
Non-current liabilities	(982.6)	1.3	0.1	0.0	(29.7)	(1,010.9)
Total liabilities	**(3,104.5)**	**1.3**	**0.1**	**260.0**	**(29.7)**	**(2,872.8)**
Net assets	**1,037.6**	**0.0**	**0.1**	**2.0**	**(1.7)**	**1,038.0**
Equity						
Share capital	429.4					429.4
Share premium	81.6					81.6
Capital redemption reserve	13.7					13.7
Retained earnings	512.9		0.1	2.0	(1.7)	513.3
Equity attributable to equity holders of the Group	1,037.6	0.0	0.1	2.0	(1.7)	1,038.0
Minority interest	–					–
Total equity	**1,037.6**	**0.0**	**0.1**	**2.0**	**(1.7)**	**1,038.0**

33. EXPLANATION OF TRANSITION TO IFRS Continued

Certain income statement and balance sheet items, previously reported under UK GAAP, have been reclassified to comply with the Group's format for reporting under adopted IFRS.

In addition to this, certain other balances have been re-measured by applying the Group's new accounting policies in accordance with adopted IFRS from 1 April 2004. A description of these accounting changes and their impact on the restated financial statements at 31 March 2005 follows.

Note that, as permitted, IAS 32 and IAS 39 have not been applied to these restatements and instead have been applied from 1 April 2005. Details on this are included at note 29.

(i) Deferred tax

Under UK GAAP, deferred tax is provided on timing differences whereas, under IAS 12 *Income Taxes*, provision must be made based on temporary differences between carrying values and the related tax base of assets and liabilities, except in certain circumstances.

Under UK GAAP, the Group's policy was to recognise deferred tax on a discounted basis. Under adopted IFRS, discounting is not permitted and the deferred tax provision has been restated accordingly.

The impact of these changes has been to reduce net assets at 31 March 2005 by £310.7m. Consequently, an additional charge of £2.6m, for the year to 31 March 2005, has been reflected in the income statements.

(ii) Current dividend

Previously, proposed dividends were recognised in the year in which the profits to which they relate were earned. IAS 10 *Events after the Balance Sheet Date* requires that dividends should not be accrued until the date at which they are declared. As the Company normally declares its final dividend after its results are approved by its Board, final dividends are not accrued at the year end.

Consequently, this has the effect of increasing opening net assets at 1 April 2004 by £226.1m and closing net assets at 31 March 2005 by £260.0m.

(iii) Share based payments

Under UK GAAP, Inland Revenue-approved "save as you earn schemes", such as SSE's sharesave scheme, did not result in a charge being taken to the profit and loss account. Other employee share schemes were accounted for on an intrinsic value basis. Under IFRS 2 *Share based payments*, all grants of equity instruments are required to be measured at fair value, with an appropriate charge being made to the income statement in the appropriate accounting period.

SSE has elected to adopt the provisions of IFRS 1 which allow first time adopters to apply the rules of IFRS 2 only to options granted after 7 November 2002 and which had not vested by 1 January 2005.

The Group's employee share schemes have been accounted for in accordance with IFRS 2. The impact of this is a credit to the Income Statement of £6.4m, for the year to 31 March 2005.

(iv) Property, plant and equipment

The main change for the Group from the adoption of IAS 16 *Property, Plant and Equipment* relates to the hydro generation infrastructure network.

Under UK GAAP, the hydro generation infrastructure network, including the dams, tunnels and other hydro civil engineering structures, was considered to have an indefinite life and was not subject to depreciation. Expenditure to maintain the hydro generation civil infrastructure was dealt with using the renewals accounting provisions of FRS 15 *Tangible Fixed Assets*.

Under IAS 16 *Property, Plant and Equipment*, renewals accounting is prohibited and all items of property, plant and equipment should be subject to depreciation, with the exception of land. As a result all aspects of accounting for these assets and expenditures have been amended to be compliant with IFRS.

Consequently, the Group identified the carrying value of the Hydro Civil Assets acquired in 1990 on privatisation and rolled this balance forward for additions and depreciation based on a useful economic life of 100 years. The overall effect is to increase net assets by £3.4m at 1 April 2004, the date of transition, with an additional net charge of £1.1m in the year ended 31 March 2005 being recognised. Qualifying expenditure on these assets will be capitalised and depreciated over the useful life of the assets.

(v) Retirement benefits

Under UK GAAP, the Group fully adopted FRS 17 *Retirement Benefits* in 2002. The Group's revised policy is to account for retirement and other benefits in accordance with the revised version of IAS 19 Employee Benefits. The method of accounting for pension scheme assets and liabilities, actuarial gains and losses and income and charges associated with such schemes under IAS 19 is very similar to FRS 17 but some notable differences exist.

The main re-measurement change under IAS 19 is the requirement for scheme assets to be valued at a bid price rather than a mid market valuation. The effect of this change is the net asset balances at 31 March 2005 is lower by £15.8m.

33. EXPLANATION OF TRANSITION TO IFRS Continued

In addition to this, surpluses or deficits on the Group's schemes are reported gross on the face of the Balance Sheet rather than net of deferred tax, as is the practice under UK GAAP.

(vi) Intangible assets

Under IAS 38 *Intangible Assets*, the Group has reclassified the software licence and development costs incurred since 1 April 2000, which had been expensed under UK GAAP, as Intangible Assets. The Group's policy for amortisation of these assets is to amortise these over a period of 5 years. As a result, net assets at 31 March 2005 have been increased by £4.5m.

The Group has revised its method of recording the assets and liabilities created under the Renewable Obligations Certificates (ROCs) scheme. Self-generated ROCs are recorded at market value and purchased ROCs are recognised at cost within intangible assets. The liability under the renewables obligation is recognised based on electricity supplied to customers, the percentages set by the regulator and the prevailing market price. The impact of this change is to increase both intangible assets and current liabilities by £94.0m at 31 March 2005. The accoounting for the underlying transaction remains unaffected by this disclosure change.

(vii) Business combinations

Under UK GAAP, goodwill is amortised over its estimated useful economic life. Under adopted IFRS, this is prohibited by IFRS 3 *Business Combinations* which instead requires an annual impairment review in accordance with IAS 36 *Impairment of Assets* to be carried out.

At the transition date of 1 April 2004, the net balance of goodwill recognised under UK GAAP has been carried forward. This balance will thereafter be subject to an impairment review which will be carried out on at least an annual basis. The goodwill amortisation charge under UK GAAP for the year ended 31 March 2005 of £15.4m, has been reversed in the Income Statement.

In addition to this, the acquisition accounting methodology for the purchase of Fiddler's Ferry and Ferrybridge has been reassessed under IFRS 3. This has had the effect of increasing the deferred tax provision required by £17.7m and, consequently, creating goodwill on acquisition of the same amount.

(viii) Associates and jointly controlled entities

Under UK GAAP, the Group's share of the operating profit, interest and taxation of associates and jointly controlled entities have been reported separately on the face of the profit and loss account.

Under adopted IFRS, the Group's share of profit after tax for its associates and jointly controlled entities is reported as a single line item within operating profit. To aid comparison and understanding of the Group's results, the Group discloses such additional information required to allow continued reporting of operating profit inclusive of the operating profit from associates and jointly controlled entities.

In addition to this, an adjustment in relation to deferred taxation under IAS 12 requires a £0.4m reduction to the opening carrying value of investments in jointly controlled entities.

(ix) Other accounting policies

All other accounting policies which have not been specifically disclosed in this document have not changed significantly from previous policies under UK GAAP.

Company

The adopted IFRS policies of the Company are identical to those of the Group, where applicable. The income statement profit for the year to 31 March 2005 can be reconciled as follows:

	Income Statement £m
UK GAAP profit after tax for the financial year ended 31 March 2005	297.4
Add/(less):	–
Internal dividends received in cash (from prior year)	79.5
Internal dividends accrued (not received)	(257.8)
Adopted IFRS profit after tax for the financial year ended 31 March 2005	119.1

34. IAS 39 AND IAS 32: NOTES TO THE CONVERSION

In accordance with IFRS 1, the balance sheet at 31 March 2005 and the income statement for the year ended 31 March 2005 have not been restated to reflect the adoption of IAS 39 and IAS 32.

The principal effect of the adoption of these standards at 1 April 2005 is to record certain derivative financial instruments in the balance sheet at their fair value.

Operating derivatives

IAS 39 does not apply to commodity contracts that are held for the Group's 'own use' requirements, although the definition of 'own use' is narrow. Such contracts continue to be accounted for under accruals accounting.

Outwith the exemption for own use contracts, all derivatives must be recognised at fair value with changes in value being recognised in the income statement, with the exception of contracts which qualify for cash flow hedge accounting treatment.

34. IAS 39 AND IAS 32: NOTES TO THE CONVERSION Continued

Under cash flow hedge accounting, movements on the effective portion of the hedge are recognised through a special hedge reserve, while any ineffectiveness is taken to the income statement. The impact of this is to minimise the impact of fair value movements to the income statement and, hence, reduce potential volatility.

The fair values applied to the contracts which require to be so treated are based on forward price curves generated from a combination of published market data and, for periods where such data is not available, internal valuation techniques. The values attributed to the balance sheet are based on the present value of the differences between contract prices and these forward curves.

The financial impact of this approach before associated deferred tax has been to increase opening net assets at 1 April 2005 by £130.1m, comprising £49.2m credited to the hedge reserve and £80.9m credited to retained earnings.

Financing derivatives
IAS 39 also applies to the treatment of the Group's loans, borrowings and derivatives.

Under IAS 39, loans and borrowings are carried at amortised cost. However, derivatives are recognised separately on the balance sheet at fair value with movements in those fair values being reflected through the income statement.

Qualifying interest rate derivatives are accounted for under 'cash flow' hedging rules, as described above, or under 'fair value' hedge accounting rules. 'Fair value' hedge accounting requires both the fair value of the hedged item and the hedging instrument to be recognised on the balance sheet, with movements on both being recognised through the income statement. Furthermore, certain foreign exchange transactions are accounted for under the 'cash flow' hedge accounting rules previously described.

The financial impact of this approach before associated deferred tax has been to reduce opening net assets at 1 April 2005 by £43.6m, comprising £23.0m debited to the hedge reserve and £20.6m debited to retained earnings.

Convertible debt
Under UK GAAP, the Group's convertible debt was accounted for as part of net debt and was shown as a liability on the balance sheet.

Under IAS 32, this compound instrument is required to be split into its debt and equity elements, with the debt element being measured at fair value at inception. This will increase interest charged to the income statement over the term of the debt and has the impact of increasing net assets, by reducing borrowings, and increasing shareholder's equity, by £14.6m at 1 April 2005.

Scotia Gas Networks
The impact of the Group's share of the contingent interest rate swap held by Scotia Gas Networks plc, of which the Group owns 50%, has been recognised at 1 April 2005.

The purchase by Scotia Gas Networks plc of gas networks in Scotland and the south of England from National Grid Transco completed at 1 June 2005. However, at 1 April 2005 the acquisition of the operating companies remained contingent on final approval by Ofgem and the Health and Safety Executive. As a result, at that date, the interest rate swap was contingent on the success of the consortium's proposed purchase.

The Group's share of this contingent swap was £54.7m 'out of the money' before tax at the date of conversion. The swap does not qualify for hedge accounting and must therefore be marked to market through the income statement.

Summary
The impact of these adjustments to the balance sheet at 1 April 2005 can be summarised as follows:

At 1 April 2005	Operating Derivatives £m	Financing Derivatives £m	Scotia Gas Networks £m	Convertible Debt £m	Total £m
IAS 39 asset / (liability)	130.1	(43.6)	(54.7)	–	31.8
Deferred tax liability / (asset)	(39.1)	13.1	16.4	(6.2)	(15.8)
Borrowings	–	–	–	20.8	20.8
Total net assets / (liability)	**91.0**	**(30.5)**	**(38.3)**	**14.6**	**36.8**
Fair value deferred in hedge reserves	34.4	(16.1)	–	–	18.3
Fair value deferred in retained earnings	56.6	(14.4)	(38.3)	–	3.9
Shareholders' equity	–	–	–	14.6	14.6
Shareholders' funds	**91.0**	**(30.5)**	**(38.3)**	**14.6**	**36.8**

Notice of meeting

NOTICE IS HEREBY GIVEN that the SEVENTEENTH ANNUAL GENERAL MEETING of Scottish and Southern Energy plc will be held at the Bournemouth International Centre, Exeter Road, Bournemouth, BH2 5BH on Thursday, 27 July 2006 at 12 noon for the following purposes:

To consider and, if thought fit, pass the following resolutions, of which resolutions 1 to 9 and 12 will be proposed as ordinary resolutions, and resolutions 10 and 11 will be proposed as special resolutions:

Resolution 1
to receive the Financial Statements and the Reports of the Directors and the auditors for the financial year ended 31 March 2006.

Resolution 2
to approve the Remuneration Report of the Board for the financial year ended 31 March 2006.

Resolution 3
to declare a final dividend for the year ended 31 March 2006 of 32.7 pence per ordinary share.

Resolution 4
to re-elect Gregor Alexander as a Director of the company.

Resolution 5
to re-elect David Payne as a Director of the company.

Resolution 6
to re-elect Susan Rice as a Director of the company.

Resolution 7
that KPMG Audit Plc be appointed auditor of the company to hold office from the conclusion of this meeting until the conclusion of the next general meeting at which Financial Statements are laid before the company.

Resolution 8
that the Directors be authorised to determine the auditor's remuneration.

Resolution 9
that the Directors be and they are hereby generally and unconditionally authorised for the purposes of section 80 of the Companies Act 1985 to exercise the powers of the company to allot relevant securities (as defined within that section) up to an aggregate nominal amount of £143,380,318, provided that this authority shall expire on the conclusion of the next Annual General Meeting of the company after the passing of this resolution unless previously renewed, varied or revoked by the company in general meeting save that the company may before such expiry make an offer or agreement which would or might require relevant securities to be allotted after such expiry and the Directors may allot relevant securities in pursuance of such offer or agreement notwithstanding that the authority conferred hereby has expired.

Resolution 10
that subject to the passing of resolution 9 above the Directors be and they are hereby empowered pursuant to section 95 of the Companies Act 1985 (the 'Act') to allot 'equity securities' (as defined in section 94 of the Act) wholly for cash pursuant to the authority conferred by resolution 9 above as if section 89(1) of the Act did not apply to any such allotment, provided that this power shall be limited to the allotment of equity securities:

(a) in connection with an offer of such securities by way of rights to holders of ordinary shares in proportion (as nearly as may be practicable) to their respective holdings of such shares, but subject to such exclusions or other arrangements as the Directors may deem necessary or expedient in relation to fractional entitlements or any legal or practical problems under the laws of any territory, or the requirements of any regulatory body or stock exchange; and

(b) otherwise than pursuant to sub-paragraph (a) above up to an aggregate nominal amount of £21,507,047;

and shall expire on the conclusion of the next Annual General Meeting of the company after the passing of this resolution save that the company may before such expiry make an offer or agreement which would or might require equity securities to be allotted after such expiry and the Directors may allot equity securities in pursuance of any such offer or agreement notwithstanding that the power conferred hereby has expired.

This power applies in relation to a sale of shares which is an allotment of equity securities by virtue of section 94(3A) of the Act as if in the first paragraph of this resolution the words 'subject to the passing of resolution 9 above' and 'pursuant to the authority conferred by resolution 9 above' were omitted.

Resolution 11
that, pursuant to Article 12 of the Articles of Association, the company be and is generally and unconditionally authorised for the purposes of section 166 of the Companies Act 1985 (the 'Act') to make one or more market purchases (within the meaning of section 163(3) of the Act) on the London Stock Exchange of ordinary shares of 50p each in the capital of the company provided that:

(i) the maximum number of ordinary shares authorised to be purchased is 86,028,191 representing 10% of the company's issued ordinary share capital;

(ii) the minimum price which may be paid for such shares is 50p per share which amount shall be exclusive of expenses;

(iii) the maximum price which may be paid for an ordinary share shall not be more than 5% above the average of the middle market quotations for an ordinary share as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the date on which the ordinary share is purchased;

(iv) unless previously renewed, varied or revoked, the authority hereby conferred shall expire on the conclusion of the company's next Annual General Meeting or 15 months from the date of passing of this resolution, if earlier; and

(v) the company may make a contract or contracts to purchase ordinary shares under the authority hereby conferred prior to the expiry of such authority which will or may be executed wholly or partly after the expiry of such authority and may make a purchase of ordinary shares in pursuance of any such contract or contracts.

Resolution 12
that the Scottish and Southern Energy plc Performance Share Plan (the PSP), the principal terms of which are summarised in Note 7 to this Notice of Meeting, be approved and the Directors be authorised to do all acts and things as they may consider necessary or expedient to give effect to the PSP.

By order of the Board
Vincent Donnelly
Company Secretary
30 May 2006

Registered Office:
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Notes

1. Only holders of ordinary shares on the register at 11.00pm on 25 July 2006 may attend and vote in respect of the number of shares registered in their name at that time. A shareholder of the company is entitled to appoint one or more proxies to attend and, on a poll, vote instead of him or her. A proxy need not be a shareholder. A Proxy Form is enclosed with this Notice. The Proxy Form, duly completed and signed, together with any power of attorney or other authority under which it is signed or a notarially certified copy thereof, must reach the registrar of the company, Computershare Investor Services PLC, The Pavilions, Bridgwater Road, Bristol BS13 8FB, not later than 12 noon on 25 July 2006.

   Alternatively, you can submit your proxy vote electronically. Further information can be found in the Guidance Notes on the reverse of the Proxy Form.

2. The following documents will be available for inspection at the registered office of the company during normal business hours on any weekday (public holidays excepted) from the date of this Notice until the date of the Meeting and thereafter at the place of the Meeting from 11.45am until the conclusion of the Meeting;

(i) the register of Directors' share interests kept pursuant to section 325 of the Companies Act 1985;

(ii) the rules of the proposed Scottish and Southern Energy plc Performance Share Plan.

   Additionally, item (ii) above will also be available for inspection at the offices of Freshfields Bruckhaus Deringer, 65 Fleet Street, London EC4Y 1HS during normal business hours on any weekday (public holidays excepted) from the date of this notice until the date of the meeting.

3. The Audited Accounts are set out on pages 43 to 100; the Remuneration Report is set out on pages 36 to 41; details of the total dividend for this year are set out in the Directors' Report on page 28; Directors' biographical details are set out on pages 34 and 35; information on the Directors seeking re-election is set out on page 28; and explanations of resolutions 9 to 12 are set out below.

4. **Authority to Allot Shares – Resolution 9**
   This resolution renews the Directors' authority, under section 80 of the Companies Act 1985, to allot shares. The authority to allot is limited to shares with a nominal value of £143,380,318 representing one-third of the issued share capital as at 30 May 2006, the latest practicable date before the printing of the Notice of Meeting. This authority was last renewed at the Annual General Meeting in 2005. The authority, if renewed, will terminate at the conclusion of the 2007 Annual General Meeting. The Directors have no present intention of issuing any shares other than pursuant to existing rights under employee share schemes. Any allotment of shares would be offered to existing shareholders first, subject to the limited pre-emption disapplication contained in resolution 10. The authority is in line with current institutional shareholder guidelines.

5. **Disapplication of Pre-emption Rights – Special Resolution 10**
   Resolution 10 proposes as a special resolution to renew the Directors' authority, under section 89 of the Companies Act 1985, to allot shares for cash in certain circumstances otherwise than pro rata to all the shareholders. This authority, which was last renewed at the Annual General Meeting in 2005, gives the company greater flexibility in its financing arrangements.

   This resolution deals with the allotment of shares for cash under a rights issue, power to make adjustments to deal with overseas shareholders, fractions of shares and other such matters. It also permits the Directors to make additional issues of shares for cash up to £21,507,047 nominal share capital, representing five per cent of the issued share capital. This limit is in line with current institutional shareholder guidelines. There is no present intention of exercising this authority.

   For the purposes of this resolution, allotment of shares includes the sale of treasury shares – see the note to resolution 11 for further details.

6. **Purchase of Own Shares and Treasury Shares – Special Resolution 11**
   In certain circumstances it may be advantageous for the company to purchase its own ordinary shares, and resolution 11 will, if approved, renew the company's authority from shareholders to make such purchases until the Annual General Meeting in 2007 or 27 October 2007 whichever is the earlier. Purchases will only be made if the Directors believe that to do so would result in an increase in the Group's earnings per share and would be in the best interests of shareholders generally.

   The resolution (which will be proposed as a special resolution) specifies the maximum number of shares which may be acquired (10% of the company's issued share capital) and minimum and maximum prices at which they may be bought. There are options outstanding at the date of this report over 5.2 million ordinary shares, representing 0.6% of the issued share capital; if the authority given by resolution 11 were to be fully used, these options would represent 0.7% of the share capital in issue on that date.

   Any shares purchased in this way will either be cancelled (and the number of shares in issue reduced accordingly) or held in treasury under the Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003. Shares held in treasury may subsequently be sold for cash (within the limit of the shareholder pre-emption disapplication contained in resolution 10), cancelled, or used for the purposes of employee share schemes. Holding its own shares as treasury shares would give the company the ability to re-issue them quickly and cost effectively, and would provide the company with additional flexibility in the management of its capital base. The Directors believe that it is desirable for the company to have this flexibility. No dividends will be paid on shares whilst held in treasury and no voting rights will be exercisable in respect of treasury shares. Treasury shares transferred for the purposes of the company's employee share schemes will count towards the limits in those schemes on the number of new shares which may be issued.

   During the year no ordinary shares were purchased by the company. The company does not currently hold any treasury shares.

7. **Summary of the Scottish and Southern Energy plc Performance Share Plan (PSP) – Resolution 12**

   Eligibility and Grant Procedure
   Executive Directors and other senior executives will be invited to participate in the PSP at the discretion of the Remuneration Committee (the Committee). Awards can be granted within six weeks of any of the following: the Annual General Meeting approving the PSP; the announcement of the company's results for any period; or the occurrence of exceptional circumstances justifying the grant of awards. No payment is required for the grant of awards. No invitations to participate in the PSP may be made more than ten years following the date on which it is approved by shareholders.

   Value of Awards
   Award levels will be determined each year by the Committee. The Committee's intention is that annual awards will normally be made with a value of 100% of base salary.

Performance Measurement
The vesting of awards is dependent on the company's performance over a three year period, by reference to two separate performance measures. There will be no retesting of either performance measure.

The vesting of one-half of the award will depend on the company's total shareholder return (TSR) relative to the other companies included in the FTSE 100 index at the beginning of the performance period. TSR is a means of comparing companies' long-term share price performance, on the basis that dividends and distributions in respect of a company's shares are treated as reinvested at the date of payment. Each performance period will coincide with the financial years of the company commencing with the financial year in which the award is granted. For these purposes TSR performance of all relevant companies will be averaged over the 20 dealing days immediately before the start and end of the performance period.

Awards based on TSR will only vest if the Committee is also satisfied with the underlying financial performance of the company over the performance period.

The vesting of the remaining one-half of the award will depend on the company's earnings per share (EPS), measured in terms of the compound annual growth in EPS achieved over the performance period referred to above (adjusted in line with the UK retail price index) by comparison with the EPS of the financial year immediately preceding the performance period. EPS will be calculated before exceptional items, net finance income from pension assets (IAS 19), the impact of IAS 32 (apart from the accretion of convertible debt under IAS 32) and IAS 39 and deferred tax.

Vesting Schedule
The TSR element of the award will vest in full if the company's TSR is at or above the 75th percentile; 30% of this element will vest if the company's TSR is at the median; there will be straight line pro-rata vesting if the company's TSR falls between the median and the 75th percentile. No part of this element will vest if the company's TSR is below the median.

For awards made in 2006, the EPS element of the award will vest in full if the company's compound annual growth in EPS is equivalent to 8% per annum above the UK retail price index; 30% of this element will vest if compound annual growth in EPS is equivalent to 3% per annum above the UK retail price index; this element will vest on a straight line basis for compound annual growth in EPS between 3% and 8% above the UK retail price index. No part of this element will vest for compound annual growth in EPS below 3% above the UK retail price index. The Committee considers that these initial threshold and maximum vesting levels are suitably demanding targets having regard to the regulatory regime in which the company operates and on the basis of independent advice and have been set in the light of consensus expectations and the company's own forecasts.

The Committee may set different vesting levels in future years for the EPS and TSR elements, and may vary the EPS definition and the TSR comparator group in order to ensure that all targets remain stretching.

Cessation of Employment
Awards to executives who leave at any time prior to vesting will lapse unless they leave by reason of death, disability, or in other circumstances at the discretion of the Remuneration Committee.

Awards for good leavers will vest at the normal vesting date to the extent that the TSR and EPS performance conditions are met, but will normally be pro-rated on the basis of actual service within the three-year EPS performance period. Exceptionally (for example, if a participant is terminally ill), the Committee may release shares early having regard to performance achieved to the date of leaving. In appropriate cases, the Committee may moderate the application of the pro rata reduction if it considers that the participant's contribution to the business would not be properly recognised if the award was scaled down in the manner described above.

Change of Control
In the event of a change of control of the company, performance will be measured to the date of change of control and awards will vest to the extent that the EPS and TSR targets are met by that date. The Committee will have discretion, in relation to the EPS element, to adjust the vesting level if it considers that the performance conditions would have been met to a greater or lesser extent at the end of the full three-year performance period. The Committee will in normal circumstances scale down the vesting level of both elements having regard to the time that has elapsed between the grant of the award and the date of change of control, but will retain a limited discretion to modify pro-rating if it considers that the contribution of the management team to the creation of shareholder value during the performance period would not otherwise be properly recognised. The Committee will not use its discretion in such a way that unjustifiably large awards result.

Any internal reorganisation to create a new holding company will not result in the accelerated vesting of awards; they will be replaced by awards over shares in the new holding company unless the Committee determines otherwise.

Adjustment of Awards
Upon the vesting of an award, a participant will receive additional shares representing the gross value of dividends that would have been paid on those shares during the performance period and reinvested. The expected value of awards made on this basis will take into account a reasonable expectation of the value of dividends over the vesting period.

If there is a variation in the share capital of the company (including without limitation a capitalisation issue, rights or bonus issue or sub-division or consolidation of share capital, or a reduction of capital, or in the event of a demerger or payment of a special dividend), the shares under award may be adjusted to reflect that variation.

Rights Attaching to Shares
A participant will not have any voting or dividend rights prior to the vesting of the award. All shares allotted under the PSP will carry the same rights as any other issued ordinary shares in the company and application will be made for the shares to be listed by the UK Listing Authority and traded on the London Stock Exchange.

Benefits received under the PSP are not pensionable and may not be assigned or transferred except on a participant's death.

Alterations to the PSP
In addition to the Committee's powers to vary the EPS and TSR performance measures described above, it will have authority to amend the rules of the PSP, provided that no amendment to the advantage of participants or eligible employees may be made to provisions relating to the key features of the PSP without the prior approval of shareholders in general meeting unless the amendment is minor and made to benefit the administration of the PSP, to take account of a change in legislation or to obtain or maintain favourable tax, exchange control or regulatory treatment. Key features are: who can be a participant, the limits on the number of shares which can be issued under the PSP, the basis for determining a participant's entitlement to shares, and the terms on which they can be acquired, and the provisions relating to adjustments in the event of a variation in the company's share capital.

Limits on the Issue of Shares

The PSP will be subject to the limit that, in any ten-year period, not more than 10% of the issued ordinary share capital of the company from time to time may be issued or issuable under all the company's share plans. In addition, not more than 5% of the issued ordinary share capital of the company from time to time may be issued or issuable under the company's discretionary share plans in any ten-year period. The Committee will adopt appropriate policies to ensure that sufficient shares are available for these plans throughout the ten-year period, and may purchase shares in the market if desirable. The Committee may use treasury shares for the purposes of the PSP and transfers of such shares will count towards this percentage limit.

Where awards are granted over existing shares, these will be held in a discretionary employee benefit trust. The trust will also have the facility to subscribe for new shares within the limits referred above. The trust will not in any event hold more than 5% of the company's issued ordinary share capital.

Shareholder Information

Website
Shareholder Information
The company's website at scottish-southern.co.uk has a dedicated Investor Centre section where shareholders can find more information about the services available to them, download forms, view and update their shareholding online, manage their portfolio and view share price and dividend histories and trading graphs.

Voting Electronically
The website and the Guidance Notes on the reverse of the Proxy Form contain information on how shareholders can appoint their proxy electronically. Your on-line proxy can be checked and updated up until 12 noon on 25 July 2005.

Shareholder Enquiries
You can contact the registrar, Computershare Investor Services PLC ('Computershare'), by phoning the dedicated shareholder helpline on 0845 143 4005, or writing to them at: The Pavilions, Bridgwater Road, Bristol BS13 8FB.

Computershare deal with the following:

- Shareholding details
- Transferring shares
- Dividends
- Death of a shareholder
- Lost share certificates
- Merging duplicate share accounts
- eCommunication

Shareholder Services
Scottish and Southern Energy has a number of services including:

- Elect for eCommunications and have a tree planted
- Telephone, Internet and postal share dealings services with ShareGift option
- Merge duplicate share accounts and have a tree planted
- Dividend reinvestment plan

You can find further information on these services on the company's website at scottish-southern.co.uk>investor centre>shareholder services.

eCommunications Programme
Millions of annual reports are posted to shareholders each year, but now there is another way to receive this information which is better for the environment.

- Elect to receive your AGM documentation via an email advising of its availability on the company's website. You will need an internet enabled computer with Internet Explorer 5 or Netscape 4.
- In return, we will plant a tree in one of the Scottish and Southern Energy Woodlands.

Registering for the Programme
- Register your email address by visiting our website scottish-southern.co.uk>investor centre>shareholder services (you will need your Shareholder Reference Number).
- You will receive a confirmation email to which you must respond to complete the process.

Benefits of eCommunication
- You will receive email notification of the availability of the interim results and have access to all annual reports and company announcements.
- You can lodge your proxy appointment securely over the internet.
- You will save paper, help reforest areas of the UK and the tree planted may help reduce global warming gases.

Keep us Informed
Where delivery of an email fails, the company is required to recommence sending you paper copies of documents. You can help to avoid this by:

- Keeping the company informed of changes to your email address by visiting scottish-southern.co.uk>investor centre> shareholder service>eCommunications Programme and clicking on 'Click here' following the instructions under 'How to register'; and
- Regularly clearing out your in-box.

Duplicate Share Accounts
If you receive more than one annual report mailing, this may be due to you having more than one share account due to minor differences in your name and address details. You can merge duplicate share accounts by completing a Duplicate Share Account form. For a form call 0845 143 4005.

If you choose to merge duplicate share accounts, the company will plant a native species tree in one of the Scottish and Southern Energy Woodlands.

Dividend Reinvestment Plan (DRP)
The DRP is a simple and cost effective way to build your shareholding in the company by using cash dividends to buy additional shares. To join the DRP either download a Dividend Reinvestment Plan Mandate form and Terms and Conditions from scottish-southern.co.uk>investor centre>shareholder service>reinvestment or, telephone the Shareholder Helpline on 0845 143 4005 to request a form.

Investor Centre
The free online service, provided by the registrar, allows shareholders to manage their share portfolios. Shareholders can:

- View, update and calculate the market value of their shareholdings;
- Change address details and dividend payment instructions online; and
- View share price histories and trading graphs for listed companies.

To Register
Go to scottish-southern.co.uk, click on 'Investor Centre' in the left hand menu and follow the links to 'shareholder services'.

Financial Calendar
Annual General Meeting
27 July 2006

Ex dividend date
23 August 2006

Record date
25 August 2006

Final dividend payable
22 September 2006

Interim announcement
15 November 2006*

The Group's half-year results will be published on the company's website at scottish-southern.co.uk on 15 November* and in the Independent newspaper on 16 November*, and will detail the ex dividend and record dates for the interim dividend payable in March 2007. Paper copies of the half-year results are not distributed to individual shareholders, although shareholders who have elected for eCommunications do receive notification of the half-year results on the company's website.

* Provisional dates

Copy Reports
Copies of the following documents can be obtained, free of charge, from the Company Secretary, Scottish and Southern Energy plc, Inveralmond House, 200 Dunkeld Road, Perth PH1 3AQ or by accessing the company's website at scottish-southern.co.uk:

- Annual Report and Accounts 2006
- Annual Review 2006
- Corporate Responsibility Report 2006
- Corporate Profile 2006

Designed and produced by Tayburn Corporate

Glossary of Terms

Bar
Atmosphere pressure (approximately).

Barg
Measurement of pressure relative to atmospheric pressure.

BETTA
The British Electricity Trading and Transmission Arrangements – arrangements relating to the trading and transmission of electricity in Great Britain.

Biomass
Biomass is anything derived from plant or animal matter and includes agricultural and forestry wastes or residues and energy crops. It can be used for fuel directly by burning or by extraction of combustible oils.

Careline
A dedicated helpline staffed by advisers who give elderly customers, and those with disabilities extra help with their energy bills, advice on saving energy and other matters to do with gas and electricity, including security issues.

Charitable donations
Cash contributions made to UK-based charities and community organisations (excluding gifts in kind and community funds established for specific generation projects).

Carbon dioxide (CO_2)
One of the so-called 'greenhouse gasses' believed to contribute to global warming.

Contracting
SSE's business that offers mechanical and electrical engineering services.

Customer Minutes Lost (CMLs)
A measurement of the reliability of the electricity transmission and distribution networks calculated as the total of the number of minutes of each power interruption times the number of customers affected by each incident, divided by the total number of customers.

Dark fibre
Optical fibre which has yet to be used, ie the fibre is not yet connected to any device.

Distribution network
The network of high and low voltage overhead lines and underground cables distributing electricity to end users (customers), owned by the Distribution Network Operators (DNOs).

Distribution Network Operators (DNOs)
There are 14 Distribution Network Operators that operate across Great Britain, each owning a regional distribution network.

Distribution price controls
The regulatory mechanism set by Ofgem which determines the level of capital expenditure the electricity and gas distribution businesses are allowed to invest in their networks, and the revenue recoverable from customers.

energywatch
The independent gas and electricity watchdog set up in November 2000 through the Utility Act to protect and promote the interests of all gas and electricity consumers.

Energy Efficiency Commitment (EEC)
Domestic energy suppliers are given energy saving targets related to the size of their customer base. Energy Efficiency Commitment funding provides for energy efficiency improvements for householders. Half of all energy savings are to be achieved in properties occupied by members of a priority group – households in receipt of means-tested or disability-related benefits.

Energy Systems
The term used to cover the transmission and distribution of electricity and gas.

European Union Energy Trading Scheme (EU ETS)
A mechanism whereby the amount of emissions from installations such as power stations are capped. Savings on this cap can be sold, or excess emissions covered by purchasing surplus allowances from other installations.

Ethernet
A frame-based technology for Local Area Letworks (LANs) and Wide Area Networks (WANs) connecting computer systems to form a network.

Extra High Voltage (EHV)
Electricity distributed at voltages of 22,000 volts and above.

Flue Gas Desulphurisation (FGD)
In FGD processes, waste gases are treated with a chemical absorbent such as limestone to remove sulphur dioxide. The resulting slurry is then oxidised to calcium sulphate (gypsum) which can then be used in the building trade.

Gas storage
SSE's gas storage facilities consist of underground caverns created by dissolving large subterrannean salt deposits. Gas is pumped into the caverns under pressure and released into the gas network as required.

Gigawatt (GW)
1,000 megawatts (1,000,000,000 watts).

Gigawatt/hour (GWh)
1,000 megawatt/hours.

High Pressure (HP)
Gas distributed at pressures between 7 barg and 70 barg.

High Voltage (HV)
Electricity distributed at voltages between 1,000 volts and under 22,000 volts.

Hydro Benefit
Hydro Benefit was an arrangement which ensured that the high cost of distribution and transmission in the Scottish Hydro area was subsidised by hydro electric generation in the north of Scotland.

Innovation Funding Incentive (IFI) and Information and Incentive Project (IIP)
Schemes introduced by Ofgem to encourage electricity distribution businesses to deliver benefits to customers by identifying innovative ideas to improve efficiency and customer service.

Intermediate Pressure (IP)
Gas distributed at pressures between 2 barg and 7 barg.

Integrated Pollution Control (IPC) and Integrated Pollution Prevention and Control (IPPC)
Systems to control pollution from industry, enforced by the Environment Agency and Scottish Environmental Protection Agency.

JD Power
JD Power and Associates, a business unit of McGraw-Hill, is a global marketing information firm that conducts independent surveys of customer satisfaction, product quality and buyer behaviour.

Kilovolt (kV)
1,000 volts.

Kilowatt (kW)
1,000 watts.

Kilowatt/hour (kWh)
One unit of electricity.

Glossary of Terms Continued

Large Combustion Plant Directive (LCPD)
The Large Combustion Plant Directive applies to combustion plants with a thermal output of greater than 50 MW. It aims to reduce acidification, ground level ozone, and particles throughout Europe by controlling emissions of sulphur dioxide, nitrogen oxides, and dust (particulate matter) from large combustion plants such as power stations, petroleum refineries, steelworks, and other industrial processes running on solid, liquid, or gaseous fuel.

Liquefied Natural Gas (LNG)
Natural gas is cooled and stored or transported under pressure as liquefied natural gas in specialist tanks or vessels.

Low Pressure (LP)
Gas distributed at pressures up to 75mbarg.

Low Voltage (LV)
Electricity distributed at under 1,000 volts.

Megawatt (MW)
1,000 kilowatts, (1,000,000 watts).

Megawatt/hour (MWh)
1,000 units of electricity.

Merit order
The order of merit applied to generation plant which is determined by a combination of fuel cost and flexibility. 'Base load' comprises nuclear, gas and coal generation plant which is designed to operate continuously; mid-merit is coal, gas and hydro which is designed to operate for long periods; and peaking plant comprises gas, oil and specifically designed hydro that can be called on at short notice.

Micro generation
Small-scale generation supplying energy to a few or single premises, usually with the capability to export to the Grid surplus generation. Technologies include roof-top wind turbines and photovoltaic cells.

Millibarg (mbarg)
1,000th of a barg (approximately 1,000th of normal atmospheric pressure).

Nitrogen oxides (NO_X)
Toxic gasses produced by the combustion of carbon-based primary fuels by transport and in power stations (see also SO_2).

Office of Gas and Electricity Markets (Ofgem)
Ofgem is the regulator for Britain's gas and electricity industries. Its role is to promote choice and value for all customers.

PRiDE
A joint venture between Interserve Defence Limited (IDL) and Southern Electric Contracting (SEC), responsible, as the Prime Contractor, for the provision of estate management and construction services at over 100 MOD sites throughout the south east England.

Private Finance Initiative (PFI)
A system for providing capital assets for the provision of public services. Typically, the private sector designs, builds and maintains infrastructure and other capital assets and then operates those assets and contracts for a fee to the public sector.

Regulated Asset Value (RAV)
The value placed by Ofgem on the assets of the regulated. businesses (transmission, distribution and metering) which is used as the basis for calculating the income that is recoverable from customers.

Renewables Obligation Certificates (ROCs)
A system which encourages the development of renewable energy projects. An obligation is placed on suppliers to buy an increasing proportion of energy from renewable sources. If the suppliers do not meet this obligation, they are 'fined' and the proceeds distributed to the operators of renewable generation.

Run off
Water draining from hills within catchment areas into reservoirs supplying hydro electric schemes.

Scotia Gas Networks plc
The holding company, in which SSE has a 50% equity stake, for the two gas distribution networks acquired from National Grid Transco in 2005, Southern Gas Networks and Scotland Gas Networks.

Synchronous Digital Hierarchy leased lines (SDH)
A generic networking technology used to transport both voice and data traffic.

Solar photovoltaic cell
A device that converts light into electrical energy.

Sulphur dioxide (SO_2)
Toxic gasses produced by the combustion of carbon-based primary fuels by transport and in power stations (see also NOx).

Substation
Part of an electricity distribution or transmission system, where electricity is redirected and transformed from one voltage to another.

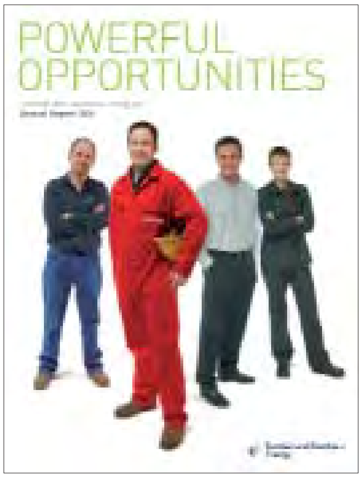
Terawatt/hour (TWh)
1,000 gigawatt/hours.

Thermal efficiency
A measurement of the effectiveness of converting primary fuels to electrical energy in power stations.

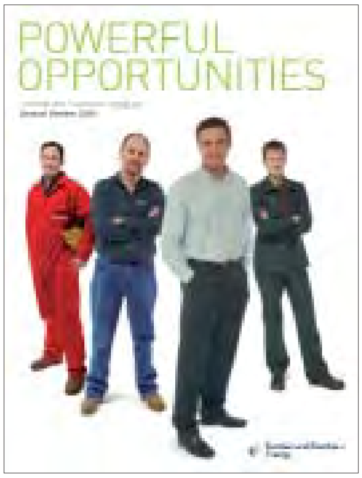
Transmission price controls
The regulatory mechanism set by Ofgem which determines the level of capital expenditure the electricity transmission business is allowed to invest in its network, and the revenue recoverable from customers.

Transmission system
The system on which electricity is transmitted at voltages of 132,000 volts and above in Scotland and 275,000 volts and above in England and Wales.

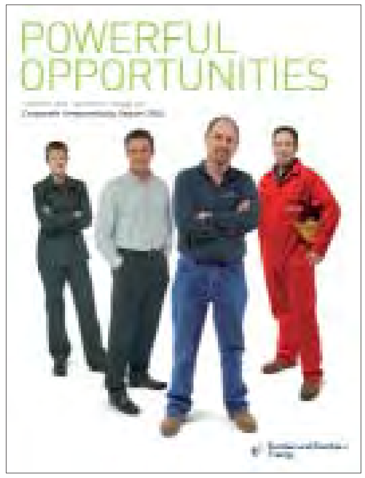
Unit of electricity
One unit of electricity equals one kilowatt/hour(kWh) i.e. 1,000 watts of electricity used continuously for one hour.



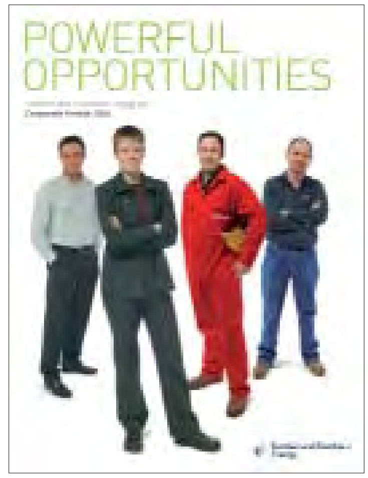
Annual Report 2006
During 2005/06 Scottish and Southern Energy continued its focus on delivering a strong operational performance and on securing value from its investment in new assets. This has enabled the company to deliver another set of very sound financial results and add to its well-established track record of sustained real growth in the dividend.



Annual Review 2006
Scottish and Southern Energy now has over 6.7 million customers, a net gain of 600,000 in 2005/06. It has the largest, non-nuclear generation fleet with a total capacity of over 10,000MW. SSE manages one electricity transmission system, two electricity distribution systems and two gas distribution systems, in all totalling over 200,000km.



Corporate Responsibility Report 2006
BiTC's Corporate Responsibility Index provides an authoritative benchmark for companies to evaluate their corporate responsibility management practice and performance in a range of environmental and social impact areas material to their business. In 2005, SSE's score was 97.5%, compared with 93.0% in the previous year. This placed SSE joint 7th in the Index, compared with joint 14th in the previous year, and made it the joint top-ranked company in its sector.



Corporate Profile 2006
Scottish and Southern Energy is one of the largest energy companies in the UK. It is involved in the transmission, distribution and supply of electricity; the storage, distribution and supply of gas; energy trading; electrical and utility contracting; energy services; and telecoms. On 31 March 2006 it was the 35th largest company in the FTSE 100.

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