SP ENERGY NETWORKS

Managing Director of Transmission

Report for the year 2011

Introduction

(1) Special Condition D of SP Transmission's licence requires it to appoint a Managing Director of Transmission (MDT) to be responsible for the conduct of the transmission business.

(2) SP Transmission Ltd (SPT) is required to arrange for the MDT to be provided with the services of persons, premises, systems and other resources as may be reasonably required by the MDT for the efficient and effective management and operation of the transmission business in accordance with SPT's statutory duties and licence obligations.

(3) The above licence condition also requires that the MDT provide an annual report to the Directors of the licensee regarding the provision of resources referred to above in respect of the previous calendar year. The report is also to state the opinion of the MDT as to whether adequate arrangements have been made to enable SPT to comply with its obligations in the ensuing year. It should also describe the differences between the provision of resources in that year and in the previous year, and the reason for these differences.

Arrangements for Provision of Resources in 2011

(4) The Energy Networks division of ScottishPower is responsible for the management and operation of the three GB licensed networks in the group. Two of these licensees - SP Transmission Ltd and SP Distribution Ltd - hold Transmission and Distribution licences respectively for Central and Southern Scotland. SP Manweb plc holds the distribution licence for Merseyside and North Wales. SP Power Systems Ltd ('PowerSystems') is the ScottishPower subsidiary that provides network management and operational services to these licence holders.

(5) Within the structure described above, PowerSystems provides services to SP Transmission under a Service Agreement. This sets out the network investment and operational services that PowerSystems is required to provide. These include an annually updated investment plan approved by SP Transmission, and service targets that PowerSystems is expected to meet.

(6) The Service Agreement includes a requirement that PowerSystems carry out its functions in accordance with relevant statutory and licence obligations. SP Transmission has step-in rights in the event of default or material breach by PowerSystems.

(7) SP Transmission has been given a General Consent by Ofgem under Condition B3 of its Licence in relation to the contracting out of operational control of network assets to an affiliated company. In accordance with the terms of that consent, the Service Agreement with PowerSystems includes a covenant that PowerSystems will refrain from any action that is likely to cause SP Transmission to breach its statutory or licence requirements, and that it will provide information required by SP Transmission to monitor PowersSystems' performance or to meet requirements for information by the Authority.

(8) As referred to in the previous year's report, SP Transmission has an agreement in place with Iberdrola Engineering and Construction ("IEC") whereby IEC provides technical and management support for delivering the Transmission capital investment programme.

(9) PowerSystems, on behalf of SP Transmission, SP Distribution and SP Manweb, continues to hold accreditation to ISO 9001: Quality Management, ISO 14001: Environmental Management, BS OHSAS 18001: Occupational Health & Safety & BSI-PAS55: Asset Management. The accreditation provides assurance to stakeholders on the efficient and effective management of transmission and distribution assets.

(10) The following paragraphs provide a summary of key projects undertaken during 2011and the significant amount of pre-engineering and other preparatory works that are also being progressed to deliver the customer and strategic reinforcement requirements for 2020.

(11) In 2011 activity focused on development and construction works for the connection of numerous wind farm generation projects and associated reinforcement requirements. Two large windfarms - Clyde (North) and Whitelee Extension windfarms (c 621MW of new capacity) - were connected to the Transmission System in December 2011.

(12) The modernisation of the existing network continued with a range of projects across the main asset groups – switchgear, overhead lines and underground cables. In accordance with a key strategy agreed as part of Transmission Price Control Review 4 (TPCR4), SP Transmission will remove all poor condition/ performance gas compression cables by 2012/13. As part of this, the replacement of poor condition 275kV gas-compression cables between Kaimes/Whitehouse/Dewar Place and Ravenscraig-Wishaw was completed during 2011. The remaining circuit, in Glasgow, will be replaced as part of the Glasgow East Reinforcement project.

Adequacy of Provision for 2012

(13) In 2012, activity in Transmission continues to focus on the connection of numerous wind farm generation projects and associated reinforcement requirements as well as continuing with underlying asset replacement, mainly substations.

(14) Development and construction works will continue on c2GW of new wind farm capacity, including Fallago, Harestanes, Aikengall II, with expected substantive completion in the period leading up to 2016/17.

(15) ScottishPower, in accordance with its long-term plan agreed with stakeholders, continues to undertake a number of major projects that will enhance the capability and capacity of the transmission network. This includes key projects to facilitate the delivery of the Government's target for renewable generation in Scotland.

(16) In February 2012 National Grid and SP Transmission announced the award of a £1bn contract to Siemens and cable manufacturer Prysmian to build the first ever sub-sea electricity link between Scotland and England/Wales. The link will be the longest high capacity HVDC (High Voltage Direct Current) cable in the world. The major grid upgrade will increase the capacity of electricity flowing between England and Scotland by more than 2 Gigawatts (GW), allowing new renewable energy projects to be developed in Scotland that could power 3 million homes with clean energy and at the same time help meet Scottish & UK Government carbon reduction targets.

(17) Due to be operational by 2016, the 260 mile long high voltage cable link will run from Hunterston in Ayrshire to a landing point on the Wirral peninsula. Subject to planning approvals, this new link will be one of the first major upgrades to be delivered as part of ScottishPower's approved plans under the RIIO-T1 agreement.

(18) The announcement comes shortly after Ofgem's agreement to fast track SP Transmission's plans for transmission network upgrades between 2013 and 2021, with much of the pre-engineering, planning and preparatory works currently underway. The £2.6bn investment planned over this period will increase power transfer capacity from Scotland to England from 3.3GW to close to 7GW by 2021. The under-sea link is one of several strategic projects designed to transport more power from Scotland to England and complements existing reinforcement projects like the construction of a new 400kV double-circuit overhead link between Beauly (nr Inverness) and Denny (nr Falkirk). This circuit is necessary to increase power transfers to central Scotland, arising from new renewable generation in the north of Scotland.

(19) In December 2009, the Scottish Government granted S37 consent for the Beauly-Denny 400kV overhead line, subject to appropriate visual mitigation measures. Since then extensive liaison has taken place with the local community to develop visual mitigation measures in an attempt to fully comply with planning conditions attached to the S37 consent. This has taken considerable time and a submission was made to the Scottish Government in August 2011 with a large number of detailed proposals to satisfy the Stirling Visual Impact Mitigation Scheme (SVIMS). Following this submission Scottish Ministers requested that Stirling Council be given a period of 45 days to comment on SPT's proposals. This resulted in SPT attending Stirling Council's community consultation group on SVIMS before they submitted their comments to Scottish Ministers. Finally in December 2011, formal notice of consent for the Beauly-Denny project was provided to SPT by Scottish Ministers. A full tender and contract award assessment is currently ongoing with works on the scheme already commenced. It is expected that the overhead line will be completed by late 2015.

(20) SP Transmission has been making good progress with a project to increase reactive compensation in central Scotland to secure the network for increased power flows. Major construction works continue at Strathaven, Windyhill, Elvanfoot, Moffat and Longannet which will increase the power transfer capacity of the Scotland-England interconnector to 3.3GW (from 2.8GW) by 2013.

(21) Significant progress has been made on pre-engineering works for further two strategic reinforcement projects – both designed to strengthen the power links between West & East of Scotland and further increase the transport of power from Scotland to England. In the case of the second project, this will be the first use of series compensation on overhead lines in the UK. The projects are scheduled to commence construction in 2012/13 and are planned to complete in 2015/16. Once operational they will take the power transfer capability between Scotland and England up to 4.4GW.

(22) Whilst there has been significant construction activity associated with new renewable generation activity there has also been significant reinforcement works being undertaken to improve security of supply to existing customers. An increase in underlying electricity demand in and around the west of Glasgow has necessitated the establishment of a new Grid Supply Point near Glasgow city centre. A site has been chosen at the existing Energy Networks' depot at St Vincent Crescent - construction work continues and ScottishPower are on schedule for completion during 2013.

(23) There is a forecast increase in electricity demand in the east of Glasgow due to the 2014 Commonwealth Games. As a result reinforcement works are taking place around Dalmarnock grid supply site to increase capacity and improve security of supply as this area of Glasgow undergoes extensive redevelopment. The Glasgow Gateway project to develop a smart grid has developed through discussions with the Commonwealth Games committee and Glasgow City Council.

(24) During the year a number of modernisation projects are being undertaken to maintain or improve security of supply for customers. This includes asset replacement activity at Dewar Place, White House & Clyde's Mill, Telford Road and Coylton substations, which are all undergoing major refurbishment works. These works will be substantively complete during 2012. Other transformer/ switchgear asset modernisation works, driven by condition, are in progress at Govan, Bonnybridge and Drumchapel with anticipated completion during 2013.

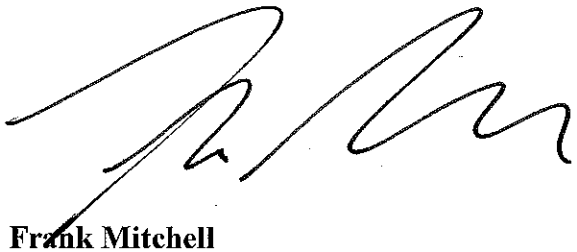
(25) In accordance with the company's asset strategy, refurbishment work was undertaken to improve the asset condition of a number of 400kV, 275kV and 132kV overhead line routes. A major refurbishment of XF route (Neilston to Windyhill) is ongoing with a scheduled completion during 2012.

(26) The annual maintenance programme, which ensures that the network continues to operate efficiently and with a high degree of reliability, continues to be delivered in accordance with policy.

(27) Capital expenditure is forecast to increase over the next few years as significant investment is undertaken to accommodate new connections. As previously mentioned, forecasts also include the construction of the West Coast HVDC link which will be a significant investment. The company will continue to borrow to finance these activities as forecast investment will be in excess of net cash inflow from operating activities for the year ended 2012. This will be financed either through loans from the parent company or debt issued directly by the company. As noted in last year's report, Iberdrola S.A. has provided legally enforceable undertakings to SP Transmission as required by the latter's licence, for example that it will refrain from

any action that would then be likely to cause the licensee to breach any of its statutory or licence obligations.

(28) In view of the arrangements described above, and the resources made available, I am satisfied that adequate arrangements have been made in order to as far as possible secure compliance with statutory and licence obligations in the year 2012.



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