3 June 2009

Scottish Water

Annual Report to Scottish Water Board Members and the Auditor General for Scotland

PRICEWATERHOUSECOOPERS

Contents

Abbreviations used throughout our report:

IAS	International Auditing Standards
IFRS	International Financial Reporting Standards
FRS	Financial Reporting Standards
SWBS	Scottish Water Business Stream
SWBSH	Scottish Water Business Stream Holdings
SWS	Scottish Water Solutions
SW Horizons	Scottish Water Horizons
SWHH	Scottish Water Horizons Holdings
WIC	Water Industry Commission
CMA	Central Market Agency
OPA	Overall Performance Assessment
RPI	Retail Price Index
OPEX	Operating Expenditure
CAPEX	Capital Expenditure

Executive Commentary

Introduction – Section 1

Our overall responsibility as external auditors of Scottish Water is to undertake our audit in accordance with the principles contained in the Audit Scotland Code of Audit Practice ("the Code") revised and published in March 2007.

We have a dual reporting responsibility for the audit: to the Board Members of Scottish Water and to the Auditor General for Scotland.

Audit Process and Independent Auditor opinions – Section 2

The financial statements of Scottish Water for the year ended 31 March 2009 have been prepared to comply with the Water Industry (Scotland) Act 2002 and UK Generally Accepted Accounting Principles ("GAAP").

We are pleased to report that our **true and fair opinion** and **regularity opinion** on the financial statements for the year ended 31 March 2009 is **unqualified.**

We also provide a view as to whether those parts of the Remuneration Report subject to audit have been properly prepared. Our opinion on the relevant parts of the **Remuneration Report is unqualified**. It should be noted that our audit opinion does not extend to other parts of the Annual Report.

The overall quality of the working papers and internal review processes undertaken by management in relation to the financial statements were of a high standard. We believe an effective working relationship exists between ourselves and your managers and staff and that an efficient audit process was achieved throughout the year.

In addition to the external audit of Scottish Water, we are also the appointed external auditor for:

Subsidiaries (part owned)	Joint Venture
• Scottish Water Business Stream (SWBS)	• Scottish Water Solutions (SWS)
Subsidiaries(100% owned)	
• Scottish Water Horizons • Scottish Water Business Stream Holdings (SWBSH) • Scottish Water Horizons Holdings	

The five organisations noted above produce separate statutory accounts, under the requirements of the Companies Act and are therefore subject to separate external audits. For all five organisations our audit opinions on their financial statements are **unqualified**.

Accounting Issues – Section 3

Wholesale Income Uncertainty Provision

From 1 April 2008 the supply of water to the non-domestic market was opened up to competition from other service providers. Scottish Water retained control over water infrastructure and wholesale water supply. Competing companies purchase water from Scottish Water on a wholesale basis and in turn sell water to their customers.

On opening up the market the Central Marketing Agency ("CMA") was established. The CMA is a company limited by guarantee, owned by its members. Scottish Water (the wholesale provider) and Scottish Water Business Stream are members, as well as other retailers that have entered the market.

The principal roles of the CMA are:

- Maintaining a record of all non-domestic customers and which provider serves each customer;
- Preparing billing information which is submitted to Scottish Water to bill individual providers;
- Calculating the charges owed to Scottish Water by each provider; and
- Calculating an estimated weighted average water cost (in units), in line with agreed pricing schedules.

Within the 2008/09 financial statements is a provision for £10.2 million classed as a "wholesale income uncertainty" provision. This provision is designed to recognise that certain wholesale income received by Scottish Water during the year may need to be refunded to the licensed retailers.

Management considers a wholesale provision necessary due to issues concerning the accuracy and completeness of CMA data, arising from incorrect calculations, estimated usages and vacant properties.

Of this £10.2 million provision, management has been able to provide specific examples and calculations to support a provision of around £5 million. However similar data could not be provided for the additional £5.2 million. In addition we have inspected a range of calculations suggesting no overall reliable estimate can be made. It is not possible to conclude with any reliability whether this provision will prove to be over or understated.

We acknowledge that Management has taken best efforts to calculate this provision. However based on this lack of reliability, the balance should more appropriately be disclosed as a contingency liability within the financial statements. The balance is below our overall materiality level and does not result in a qualification to our audit opinion. Management do not intend making any adjustment in the 2008/09 financial statements.

Management should continue (as they have been doing) to address their concerns with the CMA, working closely with the CMA to resolve quickly, the underlying data quality and reliability issues. The difficulties experienced by Scottish Water will become significantly greater should more of the non domestic market choose to receive their water from a licensed provider other than Scottish Water Business Stream. Scottish Water Business Stream is a wholly owned subsidiary of Scottish Water meaning its profits and results are consolidated with the Scottish Water Group Accounts. This would not be the case for other providers.

International Financial Reporting Standards

During 2008/09 Management prepared 1 April 2008 opening balances for Scottish Water under International Financial Reporting Standards ("IFRS"). The opening balances were reviewed for reasonableness by us in February 2009, based on Audit Scotland guidance. Good progress towards IFRS conversation was being made, although further work concerning PFI arrangements was needed.

The next step before introducing IFRS compliant financial statements in 2009/10 is for management to produce a full set of shadow IFRS statements for 2008/09. The deadline for completion of the shadow IFRS financial statements is November 2009.

Financial Performance 2008/09 – Section 4

The Scottish Water Group retained surplus for the year ended 31 March 2009 was £144.9 million compared to a surplus of £195.4 million for the year ended 31 March 2008. The £50.5 million movement arose from increased infrastructure depreciation charges, additional costs to achieve challenging leakage targets and tax rate changes.

The actual financial outturn for 2008/09 was materially in line with the budget.

Regulated operating costs were £0.3 million below budget; this was after absorbing increased expenditure to improve leakage performance, voluntary severance costs and increased levels of provisions associated with bad debt restructuring.

The Quality and Standards (Q&S) capital programmes 2 and 3 incurred gross expenditure of £686.6 million in 2008/09; this was within the planned expenditure range of £650 million - £690 million. This expenditure was £16.4 million greater than budget and as a result planned capital expenditure in 2009/10 has been reduced by £11.2 million.

The closing cash balance for the Scottish Water Group, as at 31 March 2009 was £75.2 million. An element of this balance will be utilised in 2009/10 to meet capital expenditure commitments.

Financial Forecast 2009/10 and Financial Pressures – Section 5

The approved Scottish Water budget for 2009/10 (including SWS but excluding all subsidiaries) anticipates total income of £1,062.7 million and a profit after taxation of £117.5 million.

Management considerations built into the 2009/10 budget are as follows:

- Income has been forecast based on agreed water charge increases and a prudent increase only in the customer base, reflecting the downturn in new housing developments.

- Operating expenditure has been calculated based on prior year expenditure levels, factoring in increases in expenditure where known. Operating expenditure efficiencies of £13 million are anticipated.

- Capital expenditure is budgeted at £680.5 million. Net borrowing of £250.5 million is required to achieve this level of capital expenditure. However borrowing limits set by Scottish Government cap borrowing at £181.8 million. The shortfall in funding will be met by utilising certain cash balances and an inter-company loan.

Financial pressures are anticipated to arise from the price determination for the next regulatory period (2010 – 2014), reduced levels of available borrowing, reducing collection rates for income and cost inflation which exceeds price increases, which are based on increases in the retail price index.

Continuing to deliver the challenging capital programme and meeting leakage targets will also bring additional pressures.

Key Performance Indicators

For 2009/10, it has been agreed with the Board that key performance indicators (KPIs) will be presented in two tiers:

Tier One	Financial indicators, leakage targets, cumulative output delivery, customer satisfaction, health and safety and overall OPA targets and score.
Tier Two	Individual performance indicators including OPA components, certain new measures in relation to wholesale activity, contribution to carbon footprint and total number of staff.

The key performance indicators set by Scottish Water have either been agreed with the regulators (reflected in the delivery plan) and/or within the final price determination for the 2006-2010 regulatory period.

The tier one indicators will continue to be monitored by the Board on a monthly basis, with action agreed where necessary to ensure Scottish Water stay on track to deliver the agreed targets.

Governance and Control

Systems reviewed during the course of our 2008/09 audit included: the Main Accounting System, Bank and Cash, Debtors, Creditors, Payroll, Asset Management and Information Technology (IT) General Controls. During the course of our work we did not identify any significant control weaknesses. A total of 3 recommendations were reported, which were in relation to potential improvements within the IT General Controls Environment. All findings were accepted by management and an action plan established. We will follow up the agreed management actions during 2009/10

In addition to the above, as part of our interim controls work we also considered:

- Progress in implementing prior year (2007/08) recommendations – Out of the 9 recommendations followed up, 7 were fully completed by management.

- Scottish Water's Internal Audit Function, in particular the staffing of Internal Audit and the work undertaken by Internal Audit during 2008/09. On a quarterly basis Internal Audit report to members of the Audit Committee on relevant Audit Scotland publications and national report findings. Going forward, Internal Audit will also be providing Audit Committee members with details on how Scottish Water is progressing with good practice lessons from these reports. Particular reports discussed and considered during the 2008/09 financial year were: Energy Efficiency; Managing Major Projects; and Use of Consultants. We are pleased to report that we have placed reliance on certain of the work undertaken by internal audit.

- Overall governance arrangements including a review of Board and key Committee minutes, financial reporting to the Board and risk management arrangements. Effective structures and reporting were noted.

PricewaterhouseCoopers LLP
3 June 2009

1. Introduction

1.01 Our overall responsibility as external auditors of Scottish Water is to undertake our external audit in accordance with the principles contained in the Audit Scotland Code of Audit Practice ("the Code") revised and published in March 2007.

1.02 The Code sets out the need for public sector audits to be planned and undertaken from a wider perspective than in the private sector, involving assurance on the financial statements but also consideration of areas such as regularity, performance and achievement of best value.

1.03 In addition, we have a dual reporting responsibility for the audit: to the Board Members of Scottish Water and to the Auditor General for Scotland.

1.04 Scottish Water, as a publicly owned organisation is directly answerable to the Scottish Government. In undertaking our external audit we take account of the wider perspective outlined above whilst also recognising the regulated environment Scottish Water operates in and the requirements of the Water Industry Commission ("WIC"); in particular the role the WIC play in terms of assessing Scottish Water's performance against key service delivery targets and setting customer prices.

1.05 Set out below for information is a summary of our responsibilities as your external auditors and the responsibilities of Scottish Water Board Members and the Chief Executive.

Responsibility of Scottish Water Board Members and the Chief Executive	Responsibilities of External Audit
• Maintaining proper accounting records. • Ensuring the regularity of transactions by putting in place systems of internal control to ensure that financial transactions are in accordance with the appropriate authority. • Preparing financial statements which give a true and fair view of the financial position of Scottish Water and its income and expenditure, in accordance with UK Generally Accepted Accounting Principles ("GAAP").	• Issuing an audit report (opinion) on whether the financial statements give a true and fair view of the financial position and expenditure and income of Scottish Water. • Determining whether the financial statements have been prepared in accordance with relevant legislation, accounting standards and other reporting requirements. • Considering the regularity of expenditure and income.

Acknowledgements

1.06 We would like to thank all management and staff involved for their assistance throughout the audit process.

2. Audit Process and Independent Auditor Opinions

Financial Reporting

2.01 The financial statements of Scottish Water for the year ended 31 March 2009 have been prepared to comply with the Water Industry (Scotland) Act 2002 and UK Generally Accepted Accounting Principles ("GAAP").

Audit Process

2.02 The draft financial statements and supporting schedules were made available to us at the start of our audit allowing us to progress and complete the audit within the agreed timeframe.

2.03 The overall quality of the working papers and internal review processes undertaken by management were of a high standard. We believe an effective working relationship exists between ourselves and your managers and staff and that an efficient audit process was achieved throughout the year.

Accounts Approval

2.04 The consolidated financial statements were presented to the Audit Committee on 2 June 2009 and approved by the Board on 3 June 2009.

Audit Adjustments

2.05 We are pleased to report that during the course of our audit no material adjustments were identified.

2.06 Under International Auditing Standard ("IAS") 260 – "Communication of audit matters to those charged with Governance" we are required to report all unadjusted errors (over a de minims level set by us) to members of the Audit Committee. Only one matter of this nature has arisen and we draw your attention to the information set out in paragraphs 3.20 to 3.31 concerning the "Wholesale Income Uncertainty Provision"

Scottish Water

2.07 We are pleased to report that our **true and fair opinion** and **regularity opinion** on the financial statements for the year ended 31 March 2009 is **unqualified.**

2.08 We also provide a view as to whether those parts of the Remuneration Report subject to audit have been properly prepared. Our opinion on the relevant parts of the **Remuneration Report is unqualified**.

2.09 It should be noted that our audit opinion does not extend to other parts of the Annual Report.

Scottish Water Subsidiaries and Joint Venture

2.10 In addition to the external audit of Scottish Water, we are also the appointed external auditor for:

Subsidiaries (part owned)	Joint Venture
• Scottish Water Business Stream (SWBS)	• Scottish Water Solutions (SWS)
Subsidiaries(100% owned)	
• Scottish Water Horizons • Scottish Water Business Stream Holdings (SWBSH) • Scottish Water Horizons Holdings	

2.11 The five organisations noted above produce separate statutory accounts, under the requirements of the Companies Act and are therefore subject to separate external audits. For all five organisations our audit opinions on their financial statements are **unqualified**.

Water Industry Commission (WIC) – Regulatory Accounts

2.12 On an annual basis the WIC requires the production of Regulatory Accounts. As the external auditors of Scottish Water we provide an audit opinion on certain elements of the Regulatory Accounts.

2.13 Our opinion in respect of those aspects of the Regulatory Accounts, which are subject to audit, is **unqualified**.

3. Accounting Issues

Introduction

3.01 Set out below, we have highlighted certain areas of particular audit focus during the financial statements element of our audit; these relate to balances contained within the financial statements which involved an element of judgement by management.

Bad debt provision (£270.9 million)

3.02 The bad debt provision for domestic water charges totals £270.9 million as at 31 March 2009.

3.03 Management prepared a number of supporting schedules outlining information on debt collected since 1996, debt analysis and collection rates for each Local Authority and forecast collection rates based on prior year trends.

3.04 The principal element of the bad debt calculation are the overall household debt collection rates provided by each Local Authority. The average collection rate as at 31 March 2009 is forecast at 95.66%.

3.05 The calculation of the provision for 2008/09 is consistent with Scottish Water's accounting policies, and consistent with the method of calculation utilised in prior years.

Household Credit Note Accrual (£18.1 million)

3.06 Included within the Balance Sheet of Scottish Water is a household credit note accrual of £18.1 million (£15.9 million in 2007/08).

3.07 A household credit note accrual is necessary as the income received by Scottish Water, collected from tax payers by the individual local authorities, in respect of household water charges may be incorrect.

3.08 Past expenditure shows that incorrect charges may have been applied as the property has been included in the wrong property band, resulting in a higher than due water charges. In addition, overcharging also arises from discounts in respect of housing benefit or vacant properties not being applied accurately or on a timely basis, again, resulting in the tax payer paying more water charges than due.

3.09 It is recognised that potential errors and overpayments may take a certain length of time to be identified and subsequently corrected, resulting in Scottish Water having to issue refunds/credit notes against income received in prior years.

3.10 To support the accrual, Management has established a detailed calculation model outlining the initial gross income received in respect of household charges from 1996/7 to date compared with actual income received once credit notes had been processed.

3.11 In a consistent manner to prior years, management estimated the potential income to be refunded through credit notes by calculating the historic average movement between income received and credit notes issued.

3.12 In addition for 2008/09, Management took into account the level of credit notes already issued during the year, which had experienced a marked increase compared with prior years, due to the current economic climate and more customers claiming benefits retrospectively.

3.13 Based on these trends, a rate of 1.3% was used to calculate the credit note accrual for 2008/09. Based on evidence prepared by Management, and evidence of increased credit notes during 2008/09 and 2009/10 to date, this approach does appear to be reasonable.

Restructuring Provision (£8.2 million)

3.14 The financial statements include a restructuring provision of £8.2 million. This provision relates to the anticipated costs for staff leaving under voluntary redundancy or taking early retirement.

3.15 This provision is supported by an agreed staff listing which calculates costs of either voluntary redundancy or early retirement for each identified member of staff. The restructuring has been approved by the Scottish Water Board.

Wholesale Income Uncertainty Provision (£10.2 million)

3.16 From 1 April 2008 the supply of water to the non-domestic market was opened up to competition from other service providers. Scottish Water retained control over water infrastructure and competing companies purchase water from Scottish Water on a wholesale basis, which the competing companies then sell to their customers.

3.17 Five suppliers have been granted licences to provide services to the non-domestic market – Scottish Water Business Stream (a subsidiary of Scottish Water), Satec, Osprey, Ondeo Industrial Solutions and Aimera. To date Scottish Water Business Stream is the principal provider to the non-domestic market.

3.18 On opening up the market the Central Marketing Agency ("CMA") was established. The CMA is a company limited by guarantee, owned by its members. Scottish Water and Scottish Water Business Stream are members, as well as other retailers that have entered the market.

3.19 The CMA is responsible for maintaining the underlying data that is used to calculate water charges from Scottish Water to service providers. It is not responsible for determining the accuracy of meter readings or confirming the data provided by either Scottish Water or the licensed providers. The principal roles of the CMA are:

- Maintaining a record of all non domestic customers and which provider serves each customer;
- Preparing billing information which is submitted to Scottish Water to bill individual providers;
- Calculating the charges owed to Scottish Water by each provider; and
- Calculating an estimated weighted average water cost (in units), in line with agreed pricing schedules.

3.20 The CMA provides Scottish Water with billing data, which it then uses to bill the licensed providers on a monthly basis.

3.21 Within the 2008/09 financial statements is a provision for £10.2 million described as a "wholesale income uncertainty" provision. This provision is designed to recognise that certain wholesale income received during the year may need to be refunded to the licensed providers.

3.22 Management considers a wholesale income provision is necessary due to:

- Scottish Water bill Scottish Water Business Stream (SWBS) in accordance with schedules received from the Central Market Agency (CMA). During 2008/09 difficulties were experienced by Scottish Water in relation to the quality and reliability of the data held and provided by the CMA. A number of charges were calculated incorrectly by the CMA, for example inaccurate discounts were applied resulting in Scottish Water receiving more income than it was entitled to receive.

- Based on CMA billing schedules, Scottish Water invoices SWBS on a monthly basis. However, there is a long time lag of up to 18 months from when estimated meter readings (the basis for monthly billings) become actual meter readings (the determination of actual charges). This information is then reconciled by the CMA and necessary adjustments made to Scottish Water's income.

- The licensed providers are responsible for notifying the CMA of vacant properties so that CMA billing data can be updated. Scottish Water receives no income from the provider if the property is vacant. At present this information is submitted to the CMA from the licensed providers without any independent verification. By way of example, as at 31 March 2009, Scottish Water Business Stream considered 14,000 properties to be vacant, which were not registered as vacant by the CMA. Therefore, income currently being received by Scottish Water is potentially overstated.

3.23 However, unlike the detailed trend data available to support the household bad debt provision and credit note accrual, similar detailed information is not available for wholesale income. This is principally due to the CMA only being in existence from 1 April 2008.

3.24 In accounting terms, in order to include the balance as a provision within the financial statements, the balance needs to meet three key criteria set out within Financial Reporting Standard (FRS) 12 Provisions:

1. Present obligation of a past event	✓	Yes – Scottish Water has received income of which certain balances need to be refunded to the wholesale licensed providers once actual data is known and errors are corrected.
2. Probable outflow	✓	Yes – it is probably that Scottish Water will need to refund SWBS relating to income received in 2008/09.
3. Reliable estimate	✗	Given the limited information available to Scottish Water, it is difficult for Management to determine an estimate which is reliable, based on reliable supporting data or trends.

3.25 Of this £10.2 million provision, management has been able to provide specific examples and calculations to support a provision of around £5 million. However similar data could not be provided for the additional £5.2 million. In addition, we have inspected a range of calculations suggesting no overall reliable estimate can be made. It is not possible to conclude, given the judgemental nature of these issues, with any reliability whether this provision will prove to be over or understated.

3.26 We acknowledge that Management has taken best efforts to calculate this provision. However based on this lack of reliability, the balance should more appropriately be disclosed as a contingency liability within the financial statements. The balance is below our overall materiality level and does not result in a qualification to our audit opinion. Management do not intend making any adjustment in the 2008/09 financial statements.

3.27 Discussions are ongoing between the CMA and Scottish Water to resolve the quality and potential lack of reliability of data provided to Scottish Water by the CMA. However, this is an area of significant concern for Scottish Water, requiring Scottish Water to operate a dual wholesale income database to allow it to compare anticipated income with the income billing schedules provided by the CMA.

3.28 Management should continue (as they have been doing) to address their concerns with the CMA, working closely with the CMA to resolve quickly, the underlying data quality and reliability issues. The difficulties experienced by Scottish Water will become significantly greater should more of the non domestic market choose to receive their water from a licensed provider other than Scottish Water Business Stream. Scottish Water Business Stream is a wholly owned subsidiary of Scottish Water meaning its profits and results are consolidated with the Scottish Water Group Accounts. This would not be the case for other providers.

Action 1

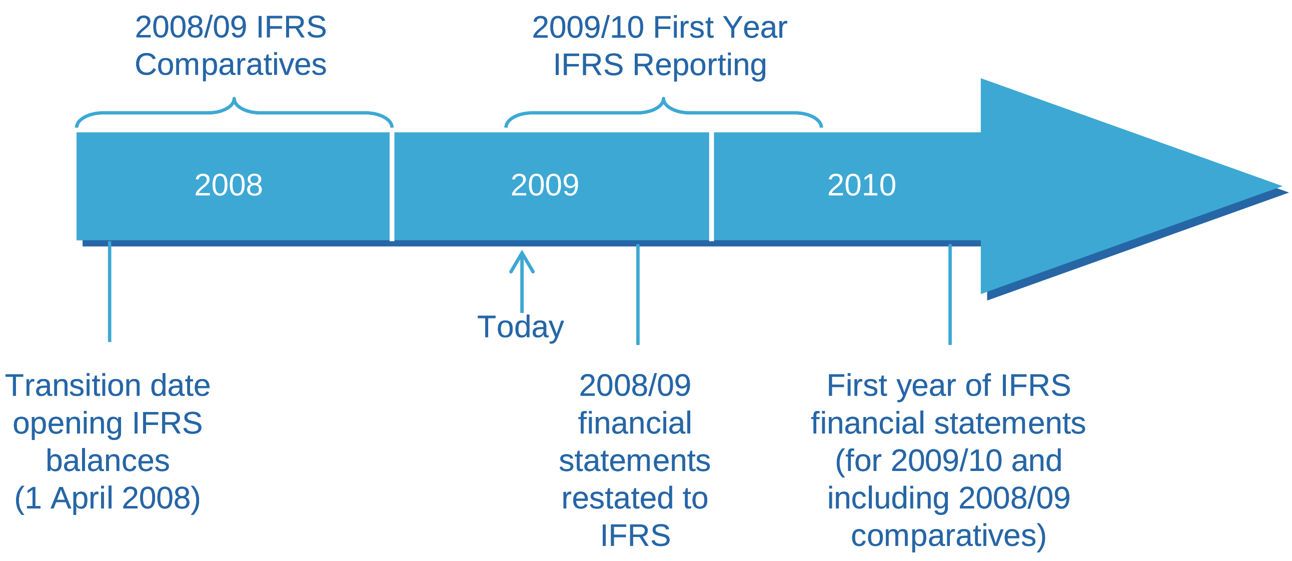
Other Accounting Treatments

3.29 During the year management discussed a number of other accounting treatments with us. This approach allowed us to work closely with management to agree appropriate accounting treatments at an early stage. A particular accounting treatment discussed and agreed related to: Financial Reporting Standard ("FRS") 17 Accounting for Pension liabilities. This concerned pension disclosures included within the 2008/09 financial statements and the actuarial assumptions proposed by the Actuary (Hymans Robertson).

International Financial Reporting Standards

3.30 During 2008/09 Management prepared 1 April 2008 opening balances for Scottish Water under International Financial Reporting Standards ("IFRS"). The opening balances were reviewed for reasonableness by us in February 2009, based on Audit Scotland guidance. Our findings were reported to Management at that time and principally concerned the overall good progress made towards IFRS conversion, although further work was needed on the accounting treatment of PFI agreements.

3.31 The timetable for full IFRS implementation is as follows:



3.32 The next step before introducing IFRS compliant financial statements in 2009/10 is for Management to produce a full set of shadow IFRS statements for 2008/09. The deadline for completion of the shadow IFRS financial statements is November 2009. These will then be reviewed by us during November and December 2009, with our findings reported to management and the Audit Committee.

4. Financial Performance 2008/09

Scottish Water Group Financial Performance

4.01 The Scottish Water Group financial performance, as set out in the consolidated Income and Expenditure account for the year ended 31 March 2009, is set out below:

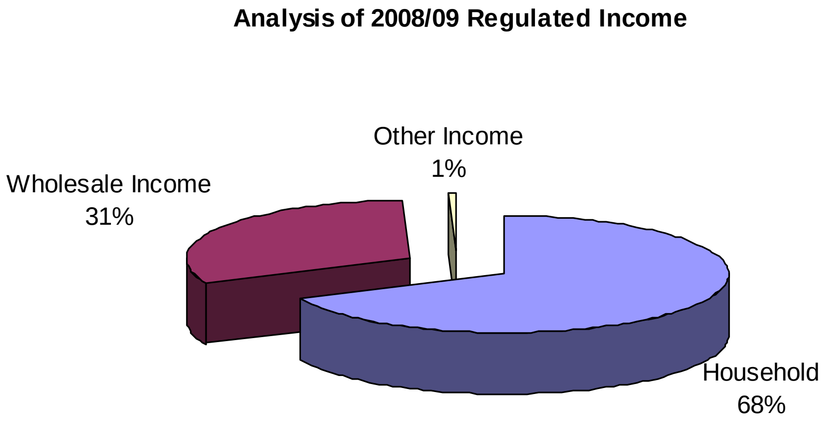
	2009
	£ million
Turnover	1,094.6
Cost of sales	(632.7)
Gross surplus	**461.9**
Admin expenses	(101.8)
Surplus on ordinary activities before interest	**360.1**
Net interest payable	(149.9)
Other finance costs	(1.4)
Surplus on ordinary activities before tax	**208.8**
Taxation	**(63.9)**
Retained surplus for the year ended 31 March 2009	**144.9**

4.02 This compares to a retained surplus of £195.4 million in 2007/08 with the year on year reduction principally arising from:

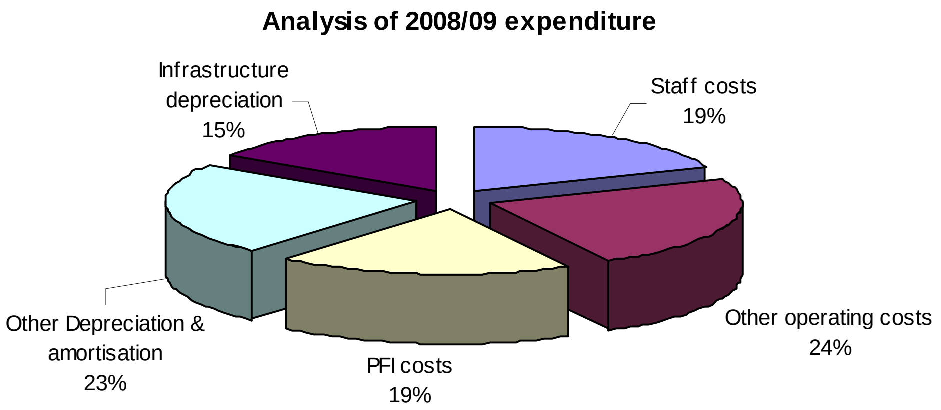
- increased infrastructure depreciation charges, reflecting the level of underlying and long term forecasted infrastructure investment to deliver Scottish Water's capital investment programmes;
- additional costs to achieve the challenging leakage targets set by the regulator; and
- increased tax charges due to the change in effective tax rate from 17.5% to 30.6% due to changes introduced by the Finance Act 2007 in relation to assets classified as industrial buildings.

4.03 Key income and expenditure sources in 2008/09 were as follows:

4.04 Regulated Income:

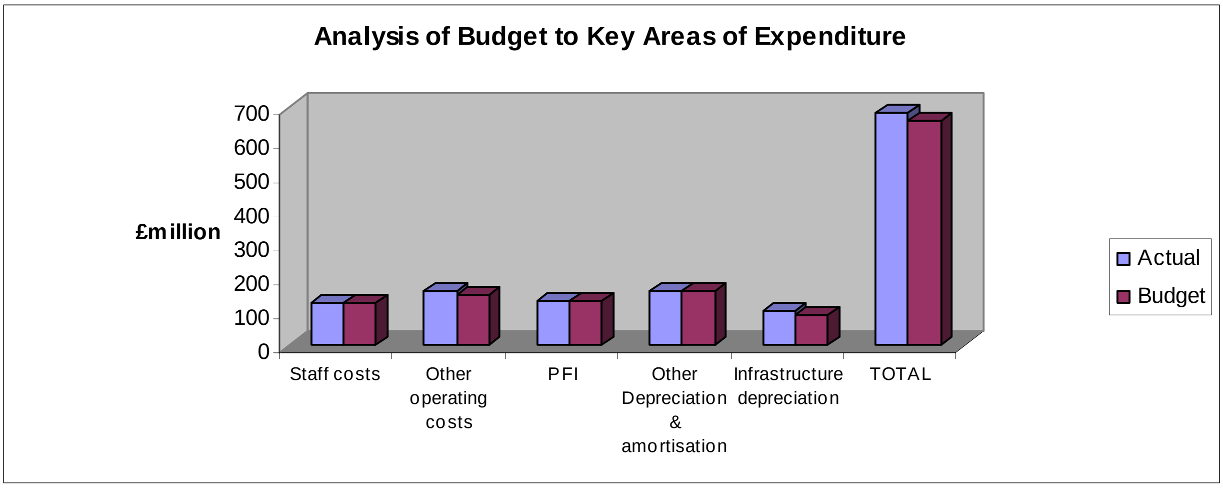


4.05 Regulated operating Expenditure:



Actual Outturn compared with Budget (Scottish Water only)

4.06 The Scottish Water actual financial outturn for 2008/09 was materially in line with the budget. In terms of expenditure this is demonstrated below:



4.07 Overall, regulated operating costs were £0.3 million below budget but this was after absorbing increased expenditure to improve leakage performance, voluntary severance costs and increased levels of provisions associated with bad debt restructuring.

Capital Programme

4.08 Quality and Standards (Q&S) capital programmes 2 and 3 incurred gross expenditure of £686.6 million in 2008/09; this was within the planned expenditure range of £650 million - £690 million. This expenditure was £16.4 million greater than budget. Due to the additional expenditure in 2008/09, the planned capital expenditure for 2009/10 has been reduced by £11.2 million.

Bank/Cash Balance as at 31 March 2009

4.09 The closing cash balance for the Scottish Water Group, as at 31 March 2009 was £75.2 million. This cash balance is split across the Scottish Water Group as follows:

	Cash Balance (£million)
Scottish Water	15.9
Scottish Water Horizons	7.0
Scottish Water Horizons Holdings	3.1
Scottish Water Business Stream	11.0
Scottish Water Business Stream Holdings	38.2
Total Group Cash Balance	75.2

4.10 The balance of £38.2 million within Scottish Water Business Stream holdings is a loan received direct from the Scottish Government during 2008/09, replacing initial lending by Scottish Water in 2007/08 and is available to Scottish Water.

4.11 It had previously been planned that the cash balance associated with regulatory outperformance would be converted to a financial reserve by investing in UK Government Gilts. However, reflecting the current economic downturn and lesser availability of Government funding, all funds available will now be utilised to fund Scottish Water's investment programme during 2009/10. See additional commentary in Section 5 - Forecast financial position for 2009/10.

5. Financial Forecast and Pressures

Financial Forecast 2009/10

5.01 The approved Scottish Water budget for 2009/10 (excluding Horizons, Scottish Water Business Stream and Business Stream Holdings) is summarised below, extracted from Scottish Water Board papers:

	£ million
Total Income	1,062.7
Total regulated operating expenditure	(304.1)
Other expenditure e.g. PFI costs, depreciation, gain/loss on asset sales	(434.5)
Regulated profit before interest	**324.1**
Interest	(162.0)
Regulated profit before Tax	**162.1**
Non-Regulated profit before tax	**1.1**
Taxation	(45.7)
Forecast Scottish Water Profit after Tax	**117.5**

5.02 Management considerations built into the 2009/10 budget:

- Income has been forecast based on agreed water charge increases (which take effect from 1 April 2009) and a prudent increase in the customer base, reflecting the downturn in new housing developments.
- Operating expenditure has been calculated based on prior year expenditure levels, factoring in increases in expenditure where known. Operating expenditure efficiencies of £13 million are anticipated.
- Capital expenditure is budgeted at £690.0 million. Net borrowing of £250.5 million is required to achieve this level of capital expenditure. However borrowing limits set by Scottish Government cap borrowing at £181.8 million. The shortfall in funding will be met by utilising certain cash balances and an inter-company loan from Business Stream Holdings Limited (see paragraphs 4.10 – 4.12).

Future Challenges and Pressures

Price Determination

5.03 Scottish Water is currently in the process of submitting information to inform the price determination for the next regulatory period (2010 – 2014). The second draft business plan has been submitted to the Water Industry Commission.

5.04 Set out within the business plan is a set of financial assumptions, including:

- Revenue required from customer charges (household and wholesale)
- The transfer of outperformance benefits from the 2006-10 regulatory period to the 2010 – 14 period
- Financial ratio's in relation to gearing, operations to debt and interest cover
- Financing and borrowing costs
- Inflation rates

5.05 Within the 2006 – 10 regulatory period the level of borrowing available to Scottish Water from the Scottish Government has reduced by approximately £96 million. This reduction will have an impact on Scottish Water in terms of the need to reduce costs and maximise cash available to deliver the required levels of capital investment.

5.06 In addition it is recognised by Scottish Water that the current economic downturn is having an adverse impact on Scottish Water's funding and income collection rates (see 5.06 – 5.07 below), and is likely to continue to do so.

Household customer income

5.07 On an annual basis the collection of household income has continued to improve over the last few years, assisted by a number of joint working initiatives with a number of Local Authorities. These initiatives are part funded by Scottish Water. However, due to the current economic downturn, household customer collection rates which had previously levelled off may start to decline during 2009/10 and beyond. Therefore, in order to address this Scottish Water has considered further initiatives for 2009/10 and beyond, including:

- Data segmentation – analysing the debtors database to target various customer segments for example those than "can pay" and "won't pay", to allow customers to be targeted more effectively, ensuring that the most likely to pay are pursued.
- Further discussions with debt management companies to consider what alternative debt collection options are available and what the additional costs would be to Scottish Water.
- Continuing to work with the Department of Work and Pensions to improve the timeliness of updating claimants' benefits data, in order to identify earlier who has stopped paying, to ensure they are quickly brought into the debt collection process.

5.08 For 2009/10 a fund of £250,000 is to be made available to further support the joint working in place between Scottish Water and the Local Authorities. Local Authority's with a deteriorating collection rate performance will be prioritised.

Financing

5.09 Scottish Government set limits on the amount of money that Scottish Water can borrow. In addition, the WIC sets limits on the customer prices Scottish Water can charge. Implicit within the price limits set by the WIC are targets for operating and capital expenditure levels. Scottish Water must operate within the borrowing limit set and the income received from customer charges.

5.10 For the 2006-2010 regulatory period Scottish Water's borrowing limit was £799.5 million augmented by revenue received.

5.11 Revenue received varies year on year due to:

- Increases/decreases in the customer base
- Increases/decreases in charges (limited by the WIC for each customer tariff plus inflation, which is based on the retail price index - RPI)

5.12 In the current economic downturn, RPI is rising less than Scottish Water's cost inflation meaning additional savings over what was previously anticipated will be required.

Capital Infrastructure Programme

5.13 Scottish Water is currently progressing its Quality and Standards ("Q&S") Capital Investment Programme 3 and is seeking to achieve the targets, set out and agreed with the WIC and contained in the Delivery Plan. Particular challenges are:

- The need to ensure capital spend is undertaken consistently throughout the year as opposed to being significantly higher in the final quarter of the year.
- The need to manage the Q&S 3 programme to ensure capital projects are completed within the regulatory period e.g. before April 2010 to avoid capital projects bridging regulatory periods.
- Maintaining focus on updating an ageing infrastructure and at the same time delivering new large scale projects.
- Closely monitoring Scottish Water's reliance on external contractors to deliver the capital works within the agreed timeframe ensuring specialists are available to deliver the workload.

Leakage Targets

5.14 During 2008/09 Scottish Water met the challenging leakage targets set by the Water Industry Commission. These targets were met through significant expenditure during the year of £20.8 million (£8.3 million in 2007/08). Further leakage targets will be set by the WIC for 2009/10. Leakage targets are reflected in Scottish Water's Overall Performance Assessment (OPA) score and are considered and monitored on a monthly basis.

6. Key Performance Indicators

6.01 For 2009/10, it have been agreed with the Board that key performance indicators (KPIs) will be presented in two tiers:

Tier One	Financial indicators, leakage targets, cumulative output delivery, customer satisfaction, health and safety and overall OPA targets and score.
Tier Two	Individual performance indicators including OPA components, certain new measures in relation to wholesale activity, contribution to carbon footprint and total number of staff.

6.02 Tier one KPIs for 2009/10, including 2008/09 comparatives are set out below for information:

	2008/09			2009/10	
Key Performance Indicator	**Target 2008/09**	**Stretch Target 2008/09**	**Actual Year-end 2008/09**	**Updated Delivery Plan Target 2009/10**	**Stretch Target 2009/10**
OPA score (YTD = 12 month rolling average)	223	251	252	241	271 (The regulatory target set by the WIC is a score of 241)
OPEX spend against target profile £m (Core Delivery Plan)	£290.5m	£275.5m	£290.2m	£304.1m	£296.0m
Scottish Water Profit before Tax (excluding Depreciation and Amortisation)	£446.1m	£461.1m	£458.90m	£463.4m	£478.4m
Capital Spend on Q&S2 and Q&S3 programmes (£m)	£670m	N/A	£673m	N/A	£625.9m
Cumulative % output delivery Q&S2	99.55%	N/A	99.55%	99.89%	99.89%
Cumulative % output delivery Q&S3	76.7%	N/A	81.1%	95.5%	97.0%

	2008/09			2009/10	
Key Performance Indicator	**Target 2008/09**	**Stretch Target 2008/09**	**Actual Year-end 2008/09**	**Delivery Plan Update 2009/10**	**Business Target 2009/10**
Compliance with WIC leakage reduction ML/d	70	100	122	Discussions are ongoing between the WIC and Scottish Water to determine the leakage targets for 2009/10 and how these are going to be measured by the WIC.	
Health and Safety – Number of reportable incidents to Health and Safety Executive	42	N/A	35	N/A	38
Customer satisfaction survey - % satisfied.	79%	84%	80%	N/A	84%

6.03 As outlined above, the key performance indicators set by Scottish Water have been agreed with the regulator, reflected in the delivery plan and/or within the final price determination for the 2006-2010 regulatory period.

6.04 The tier one indicators will continue to be monitored by the Board on a monthly basis, with action agreed where necessary to ensure Scottish Water stay on track to deliver the agreed targets.

OPA Score

6.05 OPA is an index that measures customer satisfaction. There are a total of 12 elements which contribute to the overall OPA score including, for example, drinking water quality, complaints, telephone answering, leakage and interruption to supply.

6.06 On a monthly basis an OPA steering group meets to analyse OPA data and agree necessary actions. OPA scores are verified independently by the WIC.

7. Governance and Internal Control Arrangements

Governance and Control

7.01 It is part of management's overall responsibility to design and maintain an appropriate system of internal controls to provide reasonable assurance that accounting systems provide timely, accurate and reliable financial information and to safeguard Scottish Water assets. As auditors, we obtain a sufficient understanding of internal controls to plan the audit. We only evaluate and test those internal controls on which we plan to rely during our audit and which are required in relation to our Code of Audit Practice responsibilities.

7.02 Systems reviewed during the course of our 2008/09 audit included: the Main Accounting System, Bank and Cash, Debtors, Creditors, Payroll, Asset Management and Information Technology (IT) General Controls. During the course of our work we did not identify any significant control weaknesses. A total of 3 recommendations were reported, which were in relation to potential improvements within the IT General Controls Environment. In particular, our recommendation in relation to fully testing the Board's disaster recovery plan is being reviewed and a plan established by Management to fully test the disaster recovery plan during 2009/10. All findings were accepted by management and an action plan established. We will follow up the agreed management actions during 2009/10

7.03 In addition to the above, as part of our interim controls work we also considered:

- Progress in implementing prior year (2007/08) recommendations – Out of the 9 recommendations followed up, 7 were fully completed by management.
- Scottish Water's Internal Audit Function, in particular the staffing of Internal Audit and the work undertaken by Internal Audit during 2008/09. We are pleased to report that we have placed reliance on certain of the work undertaken by internal audit.
- Overall governance arrangements including a review of Board and key Committee minutes, financial reporting to the Board and risk management arrangements. Effective structures and reporting were noted.

Prevention and Detection of Fraud and Corruption

7.04 Our approach has been determined through consideration of the incentives, pressures, opportunities, attitudes and any indicators of fraud.

7.05 As part of our rotational plan to review the key mechanisms for the prevention and detection of fraud and corruption, we have reviewed certain elements of Scottish Water's fraud and corruption arrangements, in particular internal regulations and controls, members and staff conduct.

7.06 Our enquiries of management and our testing of financial records did not reveal any illegal or possible illegal acts. However, improper conduct is usually carefully concealed and consequently, the probability is not high that our regular audit work, however diligently performed, will bring it to light.

7.07 Internal audit has followed up on six different instances of alleged fraud during 2008/09. Internal audit has kept the Audit Committee up to date on the status and likely outcomes of their investigations and actions taken.

Audit Scotland National Performance Studies

7.08 On a quarterly basis Internal Audit report to members of the Audit Committee on relevant Audit Scotland publications and national report findings. Going forward, Internal Audit will also be providing Audit Committee members with details on how Scottish Water is progressing with good practice lessons from these reports. Particular reports discussed and considered during the 2008/09 financial year were: Energy Efficiency; Managing Major Projects; and Use of Consultants.

Price review

7.09 As part of the price review currently being undertaken by the WIC, Scottish Water has submitted its second draft business case to the regulator. This process drives the prices that Scottish Water can set over the next four year regulatory period (2010 – 2014).

7.10 Set out below is the timetable between the submission of the second business plan through to the finalisation of the price review:

Activity	Date
Submit second draft Business Plan	March 2009
Stakeholder information days – supply and demand and capital maintenance	April 2009
Stakeholder information days – capital expenditure efficiency, operating cost efficiency	May/June 2009
Publish draft determination price limits for 2010 – 2014	30 June 2009
Close of period for representations on draft determination	23 September 2009
Ministers issue directions for 2010 – 2014	September 2009

7.11 Set out within the business case is Scottish Water's strategic vision. The five strategic goals are:

- To provide high quality customer service
- To deliver efficient investment
- To improve organisational capability
- To maintain financial strength
- To be sustainable

7.12 As auditors, we will continue to monitor the progress of the business plan and the setting of prices, considering the implications for Scottish Water.

Scottish Water – Annual outperformance incentives plan (AOIP)

7.13 Scottish Water operates a number of outperformance incentive schemes for staff, managers and directors. The outperformance schemes are based on an agreed outperformance structure, approved by the Remuneration Committee, and remain broadly consistent with prior years.

7.14 Annual outperformance incentive payments for 2008/09 were calculated based on Scottish Water's performance during 2008/09 in respect of:

Measure	Target	Stretch Target	Actual Performance	% of outperformance allocated in calculations
Profit before tax excluding depreciation in comparison with the targets in the final price determination	£446.1m	£461.1m	£458.9m	30%
Outperformance in respect of the final determination OPA target of 232	232	251	252	40%
Investments:				15%
• Output delivered	85%	110%	114%	
• Q&S2/3a investment	£650m	£670m	£686m	
Leakage reduction (Mega litres per day)	70	100	122	15%

7.15 On an annual basis the Internal Auditor reviews the incentive calculations by tracing the base data e.g. OPA score for 2008/09 to third party evidence such as those formal reports issued by the WIC. We have reviewed the work undertaken by the Internal Auditor and re-performed certain of the calculations to confirm the calculation of the incentive payments. Once calculated the incentive payments are approved by the Board's Remuneration Committee and reflected in the Remuneration Report within the Board's Annual Report.

Appendix 1: Action Plan

Risk Ratings: Our findings are classified based on the following risk ratings:	
Higher	Significant issue requiring immediate attention by management.
Medium	Issue identified which needs to be rectified but there is likely to be no material impact on the achievement of objectives.
Lower	Minor issues identified.

Recommendation No.	Recommendation and Risk Rating	Management Response
Action 1 (paragraph 3.31)	Management should continue to address their concerns with the CMA and work closely with the CMA to resolve quickly, the underlying data quality and reliability issues. **Risk Rating – Higher**	Due to the nature of these issues there is a range of dates with all being completed circa 18 to 24 months. However, there is a meeting with the CMA scheduled 28 May 2009 to go through our issues list. **Responsible Manager:** Manager - Jessie McLeman **Implementation Date:** Ongoing – implemented over next 18 to 24 months.

Appendix 2: Communications to Management

International Auditing Standard (“IAS”) (UK&1) 260 – Reporting to those charged with Governance, requires that the External Auditor communicates certain matters to those charged with governance.

Those charged with Governance is taken to be the Members of the Audit Committee with responsibility discharged through the regular meetings of the Audit Committee during the year. Summarised below are the requirements set out within IAS 260 together with reference to the relevant communication with you during 2008/09 or comments as appropriate.

Communication Required under IAS 260	Reference/Comment
Engagement letters	Signed Engagement Letter with Audit Scotland at the start of our 5 year appointment and updated annually.
Independence	Audit Planning document reported to November 2008 Audit Committee and confirmed no member of audit team has any direct interest, financial or otherwise, in Scottish Water.
Audit Approach and Scope	Audit Planning document (reported to Audit Committee November 2008).
Accounting Policies/Practices with a Material Effect on the Financial Statements	Section 3 of our Annual Report to Board Members and the Auditor General for Scotland.
Potential Effects of Material Risks and Exposures	Audit Planning document (November 2008).
Audit Adjustments	Section 2 of our Annual Report to Board Members and the Auditor General for Scotland.
Material Uncertainties relating to Going Concern	None identified.
Disagreement with Management about Matters that could be Significant to the Financial Statements	Section 2 our Annual Report to Board Members and the Auditor General for Scotland.
Expected Modifications to the Auditors Report	No modifications identified. A true and fair opinion provided.
Letter of Representation	Signed by Management 3 June 2009.
Material Weaknesses in Internal Control	Internal Controls findings reported separately in our Interim Management Letter (March 2009) and Section 7 of our Annual Report to Board Members and the Auditor General for Scotland.

Communication Required under IAS 260	Reference/Comment
Fraud	Discussed fraud arrangements with the Chair of the Audit Committee (October 2008), Management throughout audit process.
Laws and Regulations	We have not identified any material breaches of laws and regulations in the period which impact on the 2008/09 Financial Statements.
Audit Materiality	Audit Planning document – presented to Audit Committee in November 2008
Fair Value Measurement and Disclosure	Included in representation letter, signed by management dated 3 June 2009
Related Parties	Other than those transactions disclosed in the financial statements we have not identified any further transactions requiring disclosure.

Formal Reporting to Management during 2008/09

During the year we have presented a number of formal reports to Management and the Audit Committee and produced certain outputs. Our principal outputs during 2008/09 are summarised below:

Formal Output	Timing
Audit Plan	November 2008
Interim Accounts – Audit Opinion	November 2008
Detailed Timetable for 2008/09 Financial Audit	February 2009
IFRS Opening Balance Sheet Letter	February 2009
Interim Management Letter (including follow up of prior year recommendations)	March 2009
Annual Report to Board Members and the Auditor General for Scotland	June 2009
Audit Opinions 1. Scottish Water (true and fair and regularity) ✓ 2. Remuneration Report (elements only) ✓ 3. Scottish Water Business Stream ✓ 4. Scottish Water Horizons ✓ 5. Scottish Water Solutions ✓ 6. Scottish Water Business Stream Holdings ✓ 7. Scottish Water Horizons Holdings ✓ 8. Scottish Water Regulatory Accounts ✓ Unqualified Audit Opinions	June 2009

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